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Sustainability & Conduct Costs Reporting

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CCP RESEARCH FOUNDATION
Conduct, Culture, People

Introduction

Linking two distinct concepts: i) sustainability and ii) misconduct

Roger McCormick: "How can the financial system ever achieve worthwhile sustainability goals if the business models of banks, and their behaviour, are not themselves sustainable?"

Conduct Costs: Objective and concrete indicator of bank behaviour. Describes the direct financial consequences of misconduct or, more widely, of the crystallisation of "conduct risk". Includes all ascertainable direct costs of misconduct (e.g. customer remediation, repurchasing securities) and <u>not just regulatory fines.</u>

Sustainability accounting: Shifting expectations & perceptions to a well defined, stakeholder engagement process.

"**Libor scandal" and "Conduct Crisis**".

The Results

International Results Table (2010-2014)

Banks	Total Costs 2010-2014 (GBP bn)	Provisions as at 31 Dec 2014 (GBP bn)	Grand Total 2010-2014 (GBP bn)	Grand Total 2009-2013 (GBP bn)	Relative Position to 2009-2013	*Grand Total 2008-2012 (GBP bn)*
BAC	55.80	8.25	64.05	66.40		*54.00*
JP Morgan Chase & Co	28.65	4.26	32.91	35.78		*24.65*
Lloyds Banking Group plc	12.24	3.38	15.62	12.72		*9.24*
Citigroup, Inc	12.17	2.58	14.75	7.57	(+2)	*11.84*
Barclays PLC	8.00	4.59	12.59	7.89		*5.06*
RBS	6.79	4.11	10.90	8.47	(-2)	*4.24*
Deutsche Bank	6.01	3.37	9.38	5.62	(+1)	*3.95*
HSBC	6.39	2.29	8.68	7.21	(-1)	*6.25*
BNP Paribas	6.04	1.72	7.76	3.54	(+4)	*1.89*
Santander	3.87	3.07	6.94	3.57	(+2)	*4.14*
GS	4.05	2.08	6.13	3.65	(-1)	*3.95*
Credit Suisse	4.01	1.84	5.85	3.58	(-1)	*3.00*
UBS	3.42	1.99	5.41	4.18	(-4)	*24.65*
National Australia Bank Group	1.83	1.00	2.83	2.34		*2.19*
Standard Chartered Bank	0.96	0.05	1.01	0.76		*0.75*
Société Générale	0.08	0.86	0.94	0.70		*1.28*
Grand Total [GBP Bn]	**160.31**	**45.44**	**205.75**	**173.98**		***161.08***

International Results Table

Summary of Conduct Costs Results

Total Conduct Costs of 16 of the largest financial institutions, for the period 2010-2014

- **c£160Bn (> £205Bn including provisions)**

Governor Carney: Systemic risks – potential to become endemic; $150 billion in fines reduces lending to the real economy to more than $3 trillion.

Barclays Chairman's Letter in the latest annual report: "We continue to be subject to very significant capital and conduct charges by regulators and governments that are *frankly not sustainable* ...A £50m fine or penalty is the equivalent of employing 1,000 fewer employees, closing 100 small regional branches, or foregoing the capacity to lend over £500m to small businesses or consumers. The societal costs of excessive penalties is very real."

Prudential impact: Bank stress test include projections for conduct costs.

Steps towards a Conduct Costs Report: Part 1

"…A single, objective, industry-wide definition of costs arising from misconduct and its transparent disclosure in firms' annual (and/or corporate social responsibility) reports could also be explored as a way of incentivising improved ethical behaviour across the FICC sector.(1)"

- Page 43 of the Fair and Effective Markets Review – Consultation Document -

(1) The work of the London School of Economics Conduct Costs Project and the CCP Research Foundation (www.ccpresearchfoundation.com) could provide a framework for further development in relation to industry-wide performance measures relating to conduct.

Steps towards a Conduct Costs Report: Part 2

The Final Report of the FEMR further concluded:

> "Historically, FICC market participants appear not to have put sufficient weight on the importance of measuring and addressing issues of poor conduct ...**Increased public awareness of firms' conduct — both good and bad — may also help to align the incentives of executives, shareholders and other investors, not least by bringing competitive pressure to bear**. Currently, there are challenges in collating data on fines levied on firms in a consistent way. Fines are published in different ways by different regulators, and **firms are under no obligation to disclose conduct costs, often aggregating fines with other legal costs in their annual reports. Greater clarity in reporting by firms would help shareholders monitor progress on conduct issues**."

Steps towards a Conduct Costs Report: Part 3

Problem: The current opacity in conduct costs disclosures by banks.

There is no comprehensive reporting of total conduct costs within a bank's financial statements, sustainability reports, or public relations releases.

Often best available proxy for total conduct costs are "provision utilised" figures as reported within the notes to financial statements...BUT these provisions relate to broader categories which, by definition, may include non-conduct costs.

GRI conduct-related indicators (G4-EN29, G4-S08, G4-PR9), and Integrated Reporting are not particularly helpful either.

In sum: it's challenging to estimate a single bank's conduct costs; virtually impossible to calculate the true level based on pubic disclosures. The above results can best considered as best estimates – but estimates for costs that entail systemic risk!

Annual reporting: Materiality vs. constructing legitimacy within society?

Steps towards a Conduct Costs Report: Part 4

The **importance of conduct costs reporting**: provides stakeholders with a common understanding of misconduct and their prudential impact. We can ask: What is driving these costs? Are these costs an industry or bank-specific problem? To what extent should we be concerned about conduct risk and its potential to incite systemic risk?

New City Agenda: Shareholders don't seem to be asking the right questions about how these costs (such as "other" redress) are calculated and whether banks' cultural change programmes will be successful in stemming the tide of the misconduct provisions. Tendency to treat scandals as "historic". Shareholders should play a greater role in ensuring misconduct problems are confronted and addressed with quickly. E.g., Banks have been forced to reassess over 2 million PPI complaints – in itself, adding billions of pounds in administration costs and extra redress.

Evolutionary step: from league table to annual report. The idea is not to 'name and shame' but to promote accountability, bring competitive pressure to lower these costs and celebrate best practice! Good conduct (and better management of conduct risk) should be seen as a competitive advantage .

The **rationale** behind the CC Report:
An industry-wide approach with the use of objective, "public yardsticks".

Steps towards a Conduct Costs Report: Part 5

What we believe the should CC Report should include:

✓A clear definition of conduct costs. (Ideally, all banks should use the same definition). Costs that, in principal, impugn a bank's integrity and good standing

✓Details of all conduct costs that have crystallised during the year. Banks should not use aggregation except for minor items (e.g. £10K or less). Either way, conduct costs should not be aggregated with items that are not conduct costs.

✓Details of all "significant" conduct costs incurred over the previous 2 years (e.g. where the cost exceeded £1,000,000 or related to a criminal offence).

✓The total conduct costs for a year.

✓The total conduct costs for a rolling 5 year period (ending 31 December).

✓Management estimate to all costs consequential to any misconduct report (and not included in the definition of conduct costs) such as the costs of hiring advisers or extra staff to deal with any conduct incident or its aftermath.

✓A detailed, itemised account for all amounts included in any provision that relates to conduct costs.

✓The report should allocate responsibility for conduct costs reductions to a member of the board of directors – and include a report by them on plans to reduce these costs. [SMR Consultation: Senior Management Function (e.g., SMF4 – Chief Risk Function)].

Sustainability Accounting & Public Trust: Part 1

Schaltegger & Burritt: Pragmatic approach dictates that sustainability is a real and tangible corporate challenge. Therefore, the measurement and description of sustainability performance must be of relevance must within the institutional environment. This requires an exploration of "social conditions".

Institutional characteristic: **PUBLIC TRUST**. G30: Trust is a prerequisite for sustainable economic returns and – in the medium term – a source of competitive advantage. Public trust is also linked to the notion of a "**social licence**": the idea that banks require the consent of society to operate and innovate (Bank of England, Governor Carney).

Gold's three-part relation: "A trust B in relation to X, where X can include claims about the world and commitments to perform particular acts ...it is important that B is trustworthy ...Trustworthiness is a feature of actions which require conscious choice."

O'Neill: Trust & accountability go hand in hand. Forms of accountability can support trust. Intelligent systems of accountability allow the public to distinguish between trustworthy and untrustworthy institutions.

Banking: We have the **claim** (i.e. trust has been damaged due to misconduct) and the **commitment to action** (i.e. a commitment to rebuilding trust).

Sustainability Accounting & Public Trust: Part 2

The claim that misconduct has damaged trust

Jaffer et al. (2014): In the UK, the 'Big Bang' of 1986 and creation of "universal banks" resulted in a business model that eroded the trustworthiness in banks through "excessive risk taking, extractions of rents, mispricing of risk, and more general conflicts of interest". So began the claim, or at least its rise in prominence.

The commitment to rebuilding trust

Lambert: There is no doubt that the UK banking sector has lost the trust of the public and must gain it back.

Bank of England: Misconduct imposes costs on society and has undermined trust in banks. To contribute fully to prosperity, banks require a "social licence". That requires fairness and accountability.

Governor Carney: Numerous incidents of misconduct have called the social licence into question.

Sustainability Accounting & Public Trust: Part 3

The commitment to rebuilding trust (continued)

The Chairman's Statements in the 2014 Annual Reports and Accounts of the big four UK also showcased this commitment:

"Conduct issues have delayed the re-build of our capital and directly reduced shareholder value. They have also caused continuing reputational damage. I hope as we move beyond these issues we can fully rebuild the trust of our customers, and by doing so win more of their business" (RBS, 2015, p.7).

"It is essential that we also rebuild trust. This is a major challenge for the UK financial services sector, not just because of the damage caused by the financial crisis but also because of the continuing legacy of past industry misconduct ...It is clear that regaining this trust, which is a business imperative rather than a 'nice to have', will take time" (Lloyds, 2015, p.6).

"Restoration of trust in our industry remains a significant challenge as further misdeeds are uncovered but it is a challenge we must meet successfully" (HSBC Holdings plc, 2015, p.5).

"Conduct issues have hurt Barclays – and the banking industry – causing loss of trust amongst stakeholders. Rebuilding trust is vital, enabling us to meet and exceed the growing needs of customers and clients" (Barclays PLC, 2015, p.5). (To be precise, this statement was in Barclay's 2014 Annual Report and Accounts, but not in the Chairman's statement).

Sustainability Accounting & Public Trust: Part 4

We can add a correlation dynamic to O'Neill's proposition that accountability can support trust: if misconduct is the very thing that undermines public trust then greater accountability on misconduct should help rebuild or support public trust (for banks who can demonstrate their trustworthiness).

CC Report allows for comparison of banks' conduct costs and creates a market for reputation: allowing those with favourable comparisons to rebuild public trust. **FEMR**: Banks feel competitive pressure to reduce these conduct costs, resulting in a 'race to the bottom' of sorts.

The challenge for banks is to embed behavioural changes that leads to higher standards of conduct (and lower conduct costs). Given this, there is a need for banks to better understand both the ethical ("beyond compliance") and risk management dimensions of conduct.

Lambert: Stressed the need for commentary on the individual progress of banks in their efforts to raise standards of behaviour.

The CC Report is there is show stakeholders that banks have taken the positive step of moving beyond attestations of becoming trustworthy to demonstrating this commitment through enhanced accountability. <u>We believe that a reorientation of accounting disclosures that places greater emphasis on conduct performance represents a step towards a more sustainable banking sector</u>.

Conclusion

A call to action.

Lagarde (IMF): We need to cultivate an awareness that private misbehaviour can have a broader social costs. Ethical behaviour is a major dimension of financial stability. Just as we have reduced our carbon footprint, we must also reduce our “financial footprint”.

The end game: for banks to become stewards of, and deserve, public trust.

As a collective, we have the power to envision a greater future: one of renewed faith in financial markets, one of enlightened leadership, one of inspired change.

Conclusion

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