

# Bank Governance Leadership Network ViewPoints

21 March 2014

TAPESTRY NETWORKS, INC · WWW.TAPESTRYNETWORKS.COM · +1 781 290 2270

## A new era of conduct supervision: consequences, challenges, and opportunities

Research from the London School of Economics suggests that in the five years since the crisis, conduct-related fines and charges have exceeded £148 billion for 10 of the largest global banks.<sup>1</sup> New allegations of bank misconduct continue to emerge. Conduct has negatively affected bank profitability and shareholder returns, and conduct issues have raised prudential concerns regarding capital adequacy, tarnished the reputations of individual banks and the sector overall, and eroded trust in the financial system. To address the issue, banks have invested heavily in increased compliance and controls, withdrawn questionable products and services, and improved product approval processes and sales practices, but increasingly intense conduct supervision continues to create challenges for banks, regulators, and consumers.

Bank Governance Leadership Network (BGLN) participants, including non-executive directors and executives from global banks, met with senior regulators in London on 18 February to discuss this new era of conduct supervision, practical approaches for addressing conduct, and opportunities for increased cooperation. This *ViewPoints*<sup>2</sup> captures the essence of the meeting dialogue along with prior conversations with bank and regulatory leaders in the BGLN. We hope that it serves as a catalyst for further action.

### Conduct is a global issue and is increasingly focused on both retail and wholesale markets

The UK's Financial Conduct Authority (FCA) has been a leading proponent of intensive bank conduct supervision, though it is increasingly evident that this is a global trend. One participant commented, "*Conduct supervision is the UK's next great export.*" In the United States, the newly created Consumer Financial Protection Bureau (CFPB) has pressured some major banks to stop selling products that the CFPB deems harmful to consumers, including deposit advances. Globally, supervisors are increasingly analyzing product design as part of their consumer protection mandate, to the point of exercising de facto approval authority over bundling of such items as checking account features, credit card offers, and financial-advice offerings.

---

*"Conduct supervision is the UK's next great export."* – Director

---

Until recently, conduct issues were largely associated with the retail market, but with recent settlements and new allegations surrounding the manipulation of Libor, foreign-exchange issues, and problems relating to swaps and derivatives markets, regulators have grown

# Bank Governance Leadership Network ViewPoints

concerned not only with protecting retail consumers, but also with maintaining the integrity of markets. The FCA, for example, has promised “a renewed focus on wholesale conduct” to ensure “trust in the integrity of markets” and to “[prevent] market abuse.”<sup>3</sup> Moreover, the FCA does “not believe there is a clear divide between ‘retail’ and ‘wholesale’ markets,” and says their approach “will recognise that activities in retail and wholesale markets are connected and that risks caused by poor conduct can be transmitted between them.”<sup>4</sup> Consequently, market conduct is receiving increasing supervisory attention even among regulators whose mandate is primarily prudential, with one regulator commenting, “*Conduct is as important as financial risk – that’s been the revelation of the last two years.*”

Bank leaders recognize the need to address these issues head on. Banks have refocused on core values, and on ensuring that those values are driven into the culture of the businesses. While it remains an important compliance issue, conduct is becoming a core strategic issue shaping front-line business decisions.

---

*“Conduct is as important as financial risk – that’s been the revelation of the last two years.” – Regulator*

---

## **Evolving standards and outcome-based supervision create new challenges**

Shifting regulatory expectations, when they are focused on outcomes, rather than principles, create challenges for banks, because regulators’

expectations can be unclear to bank leaders at the start and may evolve with time. Participants also noted that as standards evolve, outcomes that were acceptable or even normative at one point may be deemed unacceptable at some future point, thereby making banks vulnerable to retrospective action. One participant stated, “*Principles that define acceptable behavior are something we can live by; outcomes are much harder. It’s difficult for a company to plan without clarity.*” Many participants noted that even after investing heavily in controls, changing product offerings, and launching ambitious cultural reform programs, large global banks may still encounter conduct issues. One remarked, “*There’s a high potential that even with good processes, customers do get the wrong products on occasion.*”

In this new era of conduct supervision, two critical questions emerge:

- **What constitutes fair treatment of customers?** Regulators have stated that there will not be rule-based demarcations of product acceptability. Although bank leaders have accepted that there are no safe harbors in the new world of conduct supervision, they continue to press regulators for more clarity about good outcomes. They seek to understand broad concepts such as fairness, caveat emptor, and customer “sophistication,” and to determine their duty of care for different customer segments. One participant asked, “*To be considered good in conduct, do we need to decide whether customers who want a product really need it?*” Participants repeatedly asked

## Bank Governance Leadership Network ViewPoints



where the customer's responsibility lay vis-à-vis the banks. Some asked whether the concept of caveat emptor still exists, with one participant remarking, *"There has to be some reliance on caveat emptor – without that, how do you do anything in the retail market?"* One regulator responded, *"Caveat emptor is not dead, but it is more subtle."*

Though regulators suggested that they would not focus on protecting sophisticated, institutional customers, it is not clear where the line between retail and wholesale markets will be drawn, and which customers will be considered sophisticated. A participant asked, *"On one end of the spectrum are widows and orphans, and on the other you have hedge funds – where's the line?"* The FCA has published a report on the use of behavioral economics that notes, "Some errors made by consumers are persistent and predictable ... [The FCA] will need to understand how information problems, consumers' behavioural errors and firms' competitive strategies combine to produce observed market outcomes."<sup>5</sup> Some participants were troubled by the use of behavioral economics in conduct-related matters. *"Customer inertia is massive; beyond attempting to make it easier to change banks, is it wrong that banks can make money off that?"* one participant asked, and then observed, *"In a way, fractional reserve banking – our very core – depends on customer inertia."*

### ■ Are some traditional marketing and sales practices inherently unfair?

Participants asked whether practices such as cross-subsidization, product bundling, and differential prices for new and existing customers ("front-book/back-book pricing") represent acceptable conduct. One participant summed up the issue: *"The real problem is that we have a model of personal banking that we all know to be untrue. Because customers get free banking, you're running a business that relies on covert charges, and once you have that, it's very difficult to discern what is fair and unfair."* In response to questions on front-book/back-book pricing, one regulator suggested banks could be more forthcoming, responding, *"Bundling might be fine with transparency, and if your incentive structure doesn't reward non-transparent products that aren't in the customer's interests."* Given the fallout from payment protection insurance, issues regarding these practices remain at the top of bank leaders' minds.

---

*"Because customers get free banking, you're running a business that relies on covert charges, and once you have that, it's very difficult to discern what is fair and unfair." – Director*

---

# Bank Governance Leadership Network ViewPoints



Some participants feared that regulatory action could be taken any time customers lost money. As one said, *“All the customer has to say is that something wasn’t explained, and unless you had documentary proof that you did say it ... the onus is on financial institutions to prove innocence, and that is incredibly costly.”* Moreover, given the risks inherent in financial products, *“it’s very hard to lead customers to the best outcome,”* particularly with *“products that are uncertain and variable.”*

These questions are creating significant challenges for banks, regulators, and consumers. These could have some unhelpful consequences, especially in the short term, including:

- **Increasing withdrawal of financial products and services.** Some participants expressed concern about the withdrawal of products and services from certain markets or market segments as a result of increasingly strict approaches to conduct. This withdrawal can be most acutely seen in wealth management: one participant said that *“nobody has been able to operate in the market. For those that are ... It has the customer at the center, but it’s had two bad effects: an advice process that ... leads to a worse understanding of what [customers] bought,”* and many firms have struggled to find a way to effectively provide advice to some customers, *“creating a part of society that can’t get advice.”*

- **Discouraging innovation in banking.** Many participants feel that profitability is now seen as an indicator of misselling, with one saying, *“High profit margins are seen by regulators as a sign that banks must be ripping someone off.”* Moreover, some feared that any innovation, even those that increase value to customers, could lead to penalties on the grounds that the previous products had delivered insufficient value. One participant thought that if the FCA continued with retrospective enforcement it risked removing *“any incentive to improve products.”*

## Ensuring good conduct may require fundamental changes

Bank leaders widely acknowledge that conduct problems threaten their institutions’ continued viability. At this meeting and previous BGLN sessions, regulators and bankers reviewed practical steps for maintaining good conduct. Nonetheless, some supervisors assert that deeper, more fundamental changes are needed, including overhauls of bank strategies and business models.

## Embedding institutional and individual accountability

Individual and institutional accountability is one key to minimizing misconduct. In the United Kingdom, the FCA has called for increasing use of attestation by senior executives. As one participant remarked, *“Part of accountability is clear knowledge of responsibility, objectives,*

# Bank Governance Leadership Network ViewPoints

*and job description – this is where [the FCA proposed] Senior Persons Regime could help.”* Several participants were concerned that “*more attestation leads to more checklists and backup documentation. It won’t lead to cultural change; it will just be compliance.*” Still, increasing individual accountability can be a powerful motivator. It is increasingly common to use penalties to punish even minor or indirect conduct infractions. Several participants commented, however, that modern HR regulation and fears of legal reprisal can make it difficult to “name and shame” conduct violators or, in some cases, to explain why someone has left an institution.

One participant described an approach that would include not only “*the one who pushed the button,*” but also managers with some oversight, including those responsible for hiring. Participants also suggested that employees should be judged on “*how quickly they find and address issues, not necessarily just the point of malice.*” This would have the additional benefit of creating a workplace where employees felt comfortable with escalating problems up the chain of command. Participants felt that conduct-related behavior should be assessed in performance evaluations, but noted that an annual review “*isn’t helpful given the delay and lack of transparency*” and that “*notable events should be looked at when they happen.*”

By incorporating conduct issues more explicitly into compensation, banks can discourage behaviors that can lead to misconduct, such as the development of overly complex products or

overly aggressive sales processes. One participant remarked, “*The consequences need to be large enough to make a difference – 10%–20% of someone’s total compensation.*”

## **Committing to simplicity and transparency in customer interactions**

On numerous occasions, conduct regulators have judged banks’ traditional product disclosures insufficient or even intentionally obscure. A director acknowledged, “*We have been poor at explaining the range of possible outcomes to customers,*” adding that banks could also do more to “*ensure not only that this is disclosed somewhere in the legal documentation, but also that the customers understand what we have disclosed.*” In some cases, product innovation may have led to unnecessary complexity that made it difficult for consumers to understand and compare what they were being offered. Although banks have made efforts to simplify and to be clear in their disclosures, further simplification and more work may be needed to promote customer understanding.

## **Operationalizing conduct risk**

Some participants asked whether a bank should have an explicit conduct risk appetite or tolerance. All will say that they have zero tolerance for misconduct, but in practice, one asked, “*What is good? Is it that [a bank is] 95% free of conduct breaches? 100%?*” In general, bank and regulatory participants agreed that “*there’s a margin of error – 3% is probably fine; 50% is not.*” Many banks are trying to measure improvement, with one participant saying,

# Bank Governance Leadership Network ViewPoints

*“We’re trying to consider whether there are metrics that speak directly to outcomes – would it be sufficiently evidentiary that we’re getting the desired outcome?”* One participant described a pragmatic approach: *“The aspiration is zero, but in the real world ... you track it in practice, defining it as no more than X [losses] in a period, and then make sure the trend is positive year-on-year.”*

Additionally, many banks are revisiting product governance related to both the “manufacturing” processes (product development, approvals, and prelaunch reviews) and distribution models. One participant noted that there are *“different approaches to conduct and compliance between product committees and sales processes.”* By separating these two areas, banks can better identify where misconduct originates and improve processes to prevent future incidents.

## **Changing culture within banks**

One participant reflected the tone of the meeting as a whole: *“A common theme throughout this is culture.”* Controls and processes have been generally acknowledged as necessary, but inadequate on their own. Banks and regulators increasingly view culture as a primary driver of good or bad conduct – though as one participant commented, *“[Controls and culture] are not independent; they’re undoubtedly linked.”* In particular, the perception that banks have placed employees’ and shareholders’ interests above those of customers has been highlighted as a potential cultural issue in many banks.

## **Addressing conduct through business model changes**

Some regulators argue that too much focus on compliance and controls will prevent banks from examining and correcting business models that exploit asymmetric information or behavioral biases in customer interactions. One participant, recounting the steps banks have taken to deal with conduct, said, *“[After] they stop being in denial, they start spending huge amounts of money on their second and third lines, and then [they] realize it’s a first-line problem [so] they focus on a cultural change program, and only then do they realize it’s a business model problem.”* Another stated, *“Conduct is not a risk to be managed – that will lead to [it becoming] a compliance exercise – it is more a culture and business model question.”* A regulator asserted, *“Some think the question is, ‘How do we avoid retrospective action?’ We need to turn that around. The real message is that strategies and business models need to take the customer into account. That’s much more difficult.”*

# Bank Governance Leadership Network ViewPoints



## Digitization creates opportunities and challenges for addressing conduct risk

With customers increasingly interacting with banks through digital channels (e.g., mobile and Internet banking), many participants asked what a loss of human interaction could mean for conduct risk. One participant noted that well-documented, auditable, and transparent digital processes could reduce the risk of individual bad actors and enable better internal monitoring and external supervision. Additionally, greater reliance on digital channels also means a greater reliance on online disclaimers for customers purchasing products or services, which could be problematic, because as one participant observed, *“No one reads disclaimers – a ticked box on a screen doesn’t mean anything.”*

Consequently, many participants are asking how regulators will address the digital banking transformation. One participant noted, *“The laws on selling financial products ... were all written 20 years ago on the assumption of face-to-face, or possibly telephone channels.”* With the rapid digitization of banking, one participant commented that *“regulation around conduct rules [must] enable financial institutions to safely use digital channels to meet customer demands and [to build] conduct regulation into those channels.”*

## Banks and regulators have a shared agenda and an appetite for getting conduct right

Most participants engaged in BGLN discussions acknowledged the importance of addressing outstanding questions and developing a framework that will give bank boards and regulators – and through their actions, the general public – confidence that conduct issues are being addressed. The scope and scale of looming foreign-exchange market manipulation investigations, ongoing reviews of products and practices, and tests of new regulatory approaches all indicate that we remain *“in an uncomfortable transition period.”* It is essential that banks and supervisors rebuild their relationship and collectively address the risk of significant conduct issues. Banks and regulators can only reestablish trust if they can *“find a route to a sustainable conduct environment.”*

As a participant said, *“Regulators and banks want the same things; there is a shared agenda. We need a method to achieve it.”* Bank leaders understand their responsibilities for driving improvement in every area, despite these concerns. Equally, regulators are aware that the regulatory system must evolve even as the banks adapt their strategies and business models. *“We don’t want the banks to fear us,”* said one supervisor, continuing, *“we want more dialogue.”*

---

*“Regulators and banks want the same things, there is a shared agenda. We need a method to achieve it.”*

– Director

---

# Bank Governance Leadership Network ViewPoints



Participants suggested the following potential topics for future dialogue:

- **Clarifying the principles that guide “good” conduct.** While an “outcome-based” approach does not rely on explicit rules, greater clarity on the principles of “good” conduct, that recognize that industry practices may not have aligned with principles for acceptable conduct, could help build some shared understanding between regulators and banks. One participant stated, *“Principles are important to help define acceptable behaviors. Outcomes test to see if the principles are effective. The concern is that a small number of outcomes can be used retrospectively to say that we’ve got it all wrong.”* Clarity regarding which customers require which level of protection would help banks tailor their conduct practices. A director noted, *“Some products that are deemed bad are actually good for some customers. It is a judgment call.”*
- **Defining effective conduct governance.** Several directors expressed uncertainty regarding the board’s role in the issue of conduct. One asked, *“For directors, do we have to look at processes or outcomes?”* Another stated that some banks’ practice of having the board review products may not be helping conduct and asked, *“Is it appropriate for boards to review products? How do you determine if product governance is working?”* Furthermore, boards struggle with indicators to determine whether or
- how far their banks are moving in the right direction and the relative tradeoffs as they seek to reduce risk, but hopefully in improve the quality of customers and revenue.
- **Rebuilding trust between banks and regulators.** Banks and regulators need to reestablish mutual trust if outcomes are to be improved. One participant remarked, *“We need to create an environment where escalation is automatic ... [and there’s an] incentive to work [together] to fix this, being confident to change things without automatic redress.”* Another participant added, *“If coming forward leads to enforcement, it leads to a loss of trust.”* Finally, another participant commented, *“It’s important that the industry show that conduct is under better control and that the regulator has it under control – if [the regulators] don’t have confidence in the industry, how are customers supposed to have confidence?”*
- **Simplifying products and pricing.** A participant asked, *“What can we do to reduce complexity in some of these products?”* Banks continue to worry that historical practices on pricing that remain industry standards may one day be deemed unacceptable retroactively by regulators. One participant stated, *“Front-book/back-book pricing is something that regulators are clearly exploring and reviewing. Actually, in some of these products where there is an industry practice that is exploiting inertia*

## Bank Governance Leadership Network ViewPoints



*in long-tenured customers to subsidize attractive offers for new customers, even where the whole industry doesn't like it, it's hard to have anyone break ranks. There could be potential for regulatory intervention by establishing some ground rules: it's OK to have an introductory offer, where prices go up in year two or three, so long as you're transparent about it, [but] practices built upon consistently raising the price the longer you remain with a product or bank are not fair customer treatment."*

★ ★ ★

It was clear from the tone and content of the meeting that participants from both banks and regulators found even this short dialogue highly useful. Nonetheless, as one put it, *"There is more to do. We need to tackle these issues one at a time. Maybe we need smaller groups of people who will commit to address[ing] some of these things, with bank directors and supervisors, like we have here, to help work out what constitutes a sophisticated customer, how customer inertia should be dealt with, and so on."*

We hope that the BGLN can continue to serve as a useful forum for improving communication and understanding between banks, regulators, and society.

# Bank Governance Leadership Network ViewPoints



## About the Bank Governance Leadership Network (BGLN)

The BGLN addresses key issues facing complex global banks. Its primary focus is the non-executive director, but it also engages members of senior management, regulators, and other key stakeholders committed to outstanding governance and supervision in support of building strong, enduring, and trustworthy banking institutions. The BGLN is organized and led by Tapestry Networks, with the support of EY. *ViewPoints* is produced by Tapestry Networks and aims to capture the essence of the BGLN discussion and associated research. Those who receive *ViewPoints* are encouraged to share it with others in their own networks. The more board members, senior management, advisers, and stakeholders who become engaged in this leading edge dialogue, the more value will be created for all.

## About Tapestry Networks

Tapestry Networks is a privately held professional services firm. Its mission is to advance society's ability to govern and lead across the borders of sector, geography, and constituency. To do this, Tapestry forms multi-stakeholder collaborations that embrace the public and private sector, as well as civil society. The participants in these initiatives are leaders drawn from key stakeholder organizations who realize the status quo is neither desirable nor sustainable, and are seeking a goal that transcends their own interests and benefits everyone. Tapestry has used this approach to address critical and complex challenges in corporate governance, financial services, and healthcare.

## About EY

EY is a global leader in assurance, tax, transaction, and advisory services to the banking industry. The insights and quality services it delivers help build trust and confidence in the capital markets and in economies the world over. EY develops outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, EY plays a critical role in building a better working world for its people, for its clients and for its communities. EY supports the BGLN as part of its continuing commitment to board effectiveness and good governance in the financial services sector.

*The perspectives presented in this document are the sole responsibility of Tapestry Networks and do not necessarily reflect the views of any individual bank, its directors or executives, regulators or supervisors, or EY. Please consult your counselors for specific advice. EY refers to the global organization and may refer to one or more of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. This material is prepared and copyrighted by Tapestry Networks with all rights reserved. It may be reproduced and redistributed, but only in its entirety, including all copyright and trademark legends. Tapestry Networks and the associated logos are trademarks of Tapestry Networks, Inc. and EY and the associated logos are trademarks of EYGM Ltd.*

# Bank Governance Leadership Network ViewPoints



---

<sup>1</sup> London School of Economics, "[£150 Billion in Five Years – New League Table Throws New Light on Cost of Banking Misconduct.](#)" news release, November 28, 2013.

<sup>2</sup> *ViewPoints* reflects the network's use of a modified version of the Chatham House Rule whereby names of network participants and their corporate or institutional affiliations are a matter of public record, but comments are not attributed to individuals, corporations, or institutions. Network participants' comments appear in italics.

<sup>3</sup> Financial Services Authority, *Journey to the FCA* (London: Financial Services Authority, 2012), 12.

<sup>4</sup> *Ibid.*, 31.

<sup>5</sup> Martin Wheatley, "[Foreword.](#)" in Kristine Erta, Stefan Hunt, Zanna Iscenko, and Will Brambley, *Applying Behavioural Economics at the Financial Conduct Authority* (London: Financial Conduct Authority, 2013), 3.

<sup>6</sup> Proposed in an amendment to the UK Financial Services Bill, the Senior Persons Regime would allow the UK Prudential Regulation Authority or FCA to pursue enforcement action against senior managers at banks if the banks contravened EU banking regulations while the executives were in positions of authority. See Christopher Braithwaite, John C. Ahern, Tim L'Estrange, Lucas J. Moore, and Harriet Territt, "[Banking Reform in the UK: A New Senior Persons Regime.](#)" October 2013.