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University of London

Centre for Commercial Law Studies

Institute for Regulation and Ethics

Keynote Speech by Sir David Walker

Delivered at the Institute for Regulation and Ethics conference on:

Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform. An appraisal of the G30 Report

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Organisers:

Dr Costanza Russo, IRE Co-Director

John Taylor, IRE Advisory Board

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Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform

1. I appreciate this opportunity to contribute to today's discussion on banking conduct and culture. In deference to the conference theme I will focus my remarks on banks and banking, a business activity whose social externalities are much greater than those of most others. But problems of conduct and culture are not confined to banking. It would be incomplete not to at least identify behavioural elements that are common and relevant in differing degrees for many other businesses which similarly call for close awareness if not pro-active remediation.

2. Trust in an entity reflects confidence earned on the basis of observed conduct and values which, together, constitute the culture of the organisation. I want to make two observations on trust in this sense at the outset. The first is that, despite all the efforts at reform that have been initiated and are currently in train, trust in banking is still at a very low level. As evidence, I take the Edelman survey of how banks and banking are perceived on the criteria of trust by global opinion leaders vis-à-vis other industries. The latest survey shows banks with the second worst score behind media, some 25-30 per cent behind the score for the leading industry and with a small deterioration between 2014 and 2015. Surveys just for the UK have shown a similarly depressing picture. The fact that the score continues to be so poor despite all the efforts at reform now in train underscores the asymmetry of the situation, namely that the process of rebuilding trust takes much longer than losing it.

3. My second observation relates to the key difference between trust and trustworthiness. This is the difference between perception and substance. Trust will be misplaced if the conduct and behaviour of the entity is not dependably trustworthy. This could happen where an entity's cultural performance deteriorates but this is not immediately felt or recognised by customers and clients. On the other side, substantial progress may have been made in boosting an entity's culture but external perception, still negatively coloured by previous inadequacies, may not have caught up with the substantive improvement. This difference between trust and trustworthiness is critically important in any historic appraisal.

4. There is a tendency to look back to the culture of banks and banking several decades ago through rose-tinted spectacles. There was certainly much less complaint then and, while I have not disinterred any opinion polls from that time, they would surely have given a much less critical perspective on bank culture than we see today. But the fact that there was much less client complaint 30 years ago should not in itself be taken as evidence of strong bank cultures. Competition technology, social media and the emergence of claims management companies have together greatly magnified opportunities for, the social acceptability of, and the practice of complaint.

5. As to underlying trustworthiness, we should have in mind that activities such as insider trading, front running, concealment of high front-end commissions on in-house products and other charges alongside the persistence of wide net interest margins for banks, not wholly attributable to the configuration of interest rates, were an at least tacitly accepted part of the financial landscape. Much of this would today be barred by regulation if not, like insider trading, be treated as a criminal offence.

6. Given the hugely negative continuing impact of the financial crisis on economic activity it is not surprising that political, media and other social animus targeted at banks and bankers is so profound and persistent. Against this perspective the role of the many other contributors to the crisis tends to be overlooked. Future financial historians will note that other guilty parties should also be in the dock, including national Treasuries, central banks, regulators and shareholders for many or all of whom the extended financial boom phase brought immediate benefits that largely distracted attention from rapidly accumulating financial risks. But while banks and bankers might expect a more balanced judgement than financial history has accorded them hitherto, the harsh fact remains that much was wrong with banking, these deficiencies greatly magnified the crisis and remediation is urgent.

7. Great progress has been made in prudential regulatory initiative to boost bank capital ratios and liquidity and in reducing leverage. Expert opinions differ on whether what has been accomplished is a sufficient strengthening in the resilience of bank balance sheets. But the risk of crisis of the kind seen in 2008-2009 and the vulnerability of tax-payers to bank failure has been greatly reduced. So specific capital and related prudential requirements can be designated as “hard” requirements, where point-in-time boxes can be ticked to measure progress. But the harder task ahead now relates to conduct and behavioural issues which, though often described as “soft”, are, paradoxically, hard to implement and calibrate. I have in mind here issues where even the parameters of any box to be ticked are hard to define. The two questions are

why standards were so widely deficient in the period before the crisis, the diagnosis, and what can and should be done to remedy the position, the prescription.

8. Within major banks different specific factors contributed to the attrition in professional standards and behaviour before the crisis. But some combination of three core explanatory ingredients appear to have been present in most cases. First, the heady mix of a generalised short-term focus and market and buyside pressure to manage balance sheets “efficiently”, that is, with high leverage, both enabled and required banks to generate high returns on equity with focus on immediate revenues with reduced attention to risk. In this go-go environment, where holding and trading in structural capital market products offered a means of enhancing immediate performance, inconvenient behavioural corners were cut and wilful blindness crept in.

9. Second, what is altogether clear with hindsight, and should of course have been better recognised at the time, was the perversity of financial incentives for individuals who, with little or no job security, were rewarded with substantial bonuses related to short-term performance. This can now clearly be seen as a toxic combination which displaced the weight that should have been given to risk and wider behavioural standards.

10. Third, and ultimately probably the most significant explanatory variable, was the board level attention deficit in respect of both financial risk and conduct. Only a third of global SIFIs had a dedicated board-level financial risk committee at the time of the crisis and dedicated board focus on conduct, behaviour and ethics generally appears to have been still less. As a consequence, there was inadequate explicit guidance to executives on board expectations as to conduct and values and chief executives and heads of business units were relatively undistracted in their drive for short-term performance. This group board and leadership deficit appears to have been magnified in some cases where key business decisions were dominated in an unbalanced way by the short-term interests of the best performing business units rather than the longer-term interests of the group as a whole.

11. Eight years after the crisis, most banks are now working prodigiously to ensure higher standards of conduct and behaviour within frameworks for action such as that recommended by the Group of Thirty. One major “climatic” change compared with the eight years before the crisis is the growing recognition that embedding the right conduct and values can no longer be treated as an optional and costly indulgence. The impact of technology in developing social media and,

through transparency, facilitating comparison in pricing and performance, promoting customer readiness to switch business and to seek redress for bad service is increasingly relevant for business performance, brand value and for shareholders. Traditional banking is being disintermediated in an array of ways in the face of new technology applied in particular to payments. This disintermediation rests partly on the apparent attractiveness and vigorous marketing efforts of new technology providers, who at this stage suffer from no negative baggage from earlier conduct failure. But it is importantly reinforced by persistent lack of trust in banks, which further boosts the need for early progress in rebuilding it.

12. The G.30 report sets out a comprehensive array of recommendations. I will highlight four themes that are in my view essential to success in embedding the right conduct and values that, together, create the entity's culture. First, the role of the board is critical. It begins with the board's responsibility for appointment and monitoring of the CEO – described by one expert commentator as a "sacred trust". The CEO's role is to execute the board's strategy for the entity in the widest sense, clearly including its financial performance. But the specific role of the CEO in embedding the targeted conduct and values from the top to the bottom of the organisation is indispensable. If the CEO, and the senior executive team that he or she leads, is inadequate in discharging this obligation, the right culture is very unlikely to emerge. Put bluntly, if the CEO does not demonstrably "get" culture, it will not be embedded.

13. Second, given the scale of the challenge of strengthening and sustaining a strong culture as, so to speak, the new norm, the board should in my view constitute a dedicated committee to guide and oversee progress. The committee should have regular dipstick intelligence on progress, supplemented to the extent possible by provision for direct encounter with customer experience.

14. Third, while the understandably instinctive priority is the rebuilding of trusted relationships with customers and clients, ultimate achievement of the desired conduct and behaviours calls also for an indispensable internal ingredient. An atmosphere of trusted relationships among executives within the organisation is an essential concomitant of building trust externally. Internal politics are the enemy of a healthy culture in which employees should be encouraged and ready to "speak up" as well as having as, so to speak, last-resort access to a whistleblowing process.

15. In emphasising in this way the critical and underestimated significance of internal culture, I readily acknowledge that getting this right will often call for

sensitive judgement in respect of tolerance, not necessarily resting exclusively on a narrow legal assessment. Bank boards and executive committees will need to be wary of allowing an atmosphere of tolerance for minor breaches that could be taken to imply a tolerance for and thus accommodate more serious failures. Disciplinary action may need to be exemplary and may on occasion require corporate readiness to terminate employment in a particular case despite the risk that subsequent litigation brought by the affected individual might succeed. The delicate balance here will often be between equitable treatment of an individual given his or her rights, on which legal advice within the HR function will properly focus, and the need for the entity to take an overt and demonstrable stand on a particular issue. On the other hand, tough sanctions against minor breaches can risk generating an atmosphere of concealment for fear of the consequences of discovery. To reiterate, creation and maintenance of a healthy internal culture is likely to require continuing judgement in striking the right balance between exemplary discipline and tolerance for the occasional minor transgression. Getting this balance right is difficult but critical.

16. Fourth, the need for the board and executive to focus on the longer-term relates not only to achieving sustained financial performance but has also a critical cultural dimension. Over-attention to quarterly earnings in deference to sellside analyst and buyside scrutiny risks acceptance of a cutting of corners and is inimical to embedding of the desired culture. Fortunately, regulatory requirements in respect of quarterly financial reporting have now been greatly eased in the UK and the European Union. While banks are unlikely to be first-movers in taking advantage of this very welcome policy development, the mind-set of bank boards and executives should be more explicitly attentive to the medium and longer-term. Further, they should seek to elicit greater acknowledgement and support from major shareholders in this respect as an important manifest of their own good stewardship.

17. The foundations of the culture of a bank, but also of any non-financial entity, are necessarily built from within as the immutable non-transferable responsibility of the board, the CEO and senior executive team. In this context, and as the G.30 report highlights, there are severe limits to the ability of the conduct regulator to contribute to the embedding of a strong culture within an institution beyond the setting of unambiguous rules for basic standards. Going beyond this involves clear risks of stimulating box-ticking compliance with any regulatory rule that intrudes into cultural space, sidelining or vitiating the internal effort to boost conduct and values. There is also material risk of exploitation of ambiguity in any externally-imposed cultural rule, subverting its purpose.

18. This does not of course mean that the state and health of a bank's culture is outside the proper interest of the conduct regulator. The desirable relationship between conduct regulator and regulated should be one of trust, in which the regulator has confidence in a bank's commitment to embedding a strong culture and the bank's board and executive have confidence in an open dialogue with the regulator in which any identified transgressions are judged maturely with credit given for the quality of the bank's overall culture. The regulator's observation and knowledge of how different banks, for example, measure and assess their cultural performance over time may provide valuable insight as part of a peer review process. And if the regulator concludes that a bank neither has nor is seeking to establish a robust culture, it is surely the regulator's prerogative and indeed obligation to press for appropriate change, if necessary in the board or executive, to rectify the position.

19. Separately from the appropriate role of the conduct regulator, as I describe it here, I am concerned that there is a real and present danger of enforcement zealotry. This is sometimes somewhat euphemistically described as promoting derisking, but the result may be displacement of internal judgement within the framework of a bank's established culture by forcing disengagement from any business activity or initiative that might increase future exposure to heavy financial penalty. There is risk that enforcement pressure of this kind is obliging banks to withdraw from the provision of services which have a societal significance which may be given little or no weight in the narrow agendas of enforcement agencies. I have particularly in mind here the generalised withdrawal from provision of overseas remittance facilities and from countries with less developed financial systems. The doubt is whether appropriate balance is being achieved here between important but differing public policy objectives.

20. In closing these remarks, I want to highlight three areas that potentially have great relevance for, or will be greatly influenced by, the progress of banks in re-establishing their reputations over the next few years. The first relates to recognition by asset owners and third-party fund managers of the need for their investee banks to build and maintain strong cultures. Concern is increasingly expressed that a combination of increasingly tough capital requirements and the scale of financial penalties is making major banks uninvestable. This concern is in my view unduly pessimistic, but the financial performance of a bank that fails to rebuild its cultural reputation is bound to be increasingly under competitive pressure. Part of the stewardship responsibility of major shareholders and fund managers should be seen to cover banking culture, or the lack of it. An important ingredient in stewardship on these lines will be enhanced dialogue between board and fund manager to provide assurance on the board's capability and commitment to substantive progress in the medium-team as counterpart to

a reduced buyside preoccupation with the short-term. I reiterate here that we should not underestimate the potential corrosive effect on an entity's culture of what has hitherto been an undue short-term earnings focus.

21. Second, a major and very welcome development is the creation of the Banking Standards Board. After a prolonged phase in which the concept of self-regulation in banking was, understandably, discredited, there is recognition both that the required improvement in standards cannot be delivered more than partially by the conduct regulator and that a shared commitment to self-regulation on an industry-wide basis gives valuable reinforcement to the cultural programmes of individual banks. This endeavour to revive self-regulation as a major part of the standard-setting process deserves to be welcomed as a timely and major initiative here in the UK which might, and I hope will, in due course be emulated elsewhere.

22. Finally, while the ways in which the march of technology will impact financial services will differ among the wide array of different types of banking activity, it is clear that the scale of change in prospect is massive even over the relatively short-term. An inevitable feature, already apparent in areas such as payments, will be a substantial process of disintermediation which will greatly reduce the scale of and employment in banking as we know it. While this disintermediation pressure is set to intensify, it is not irresistible and the smart bank will adapt and anticipate it. An important part of that adaptation should be cultural, and should enable the bank to retain the confidence of its customers, however technology changes the form of customer engagement.

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