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Vocational Banking:
Restoring trust and confidence in financial services

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Debating trust and confidence in banking

Speech by Martin Wheatley, Chief Executive of the FCA, delivered at ResPublica's Vocational Banking event in London. This is the text of the speech as drafted, which may differ from the delivered version.

It's become somewhat unusual, in our era of 24-hour news consumption, for old topics to attract significant public attention. The ink is rarely dry on one story before the next begins.

Today's theme, however, is very much an exception to the rule here.

As we saw in last week's global FX fines, the debate around trust and confidence in banking has not been diminished by any sense of the familiar.

In fact, for leaders today, it's arguably a more challenging priority now than it was in 2008 – with each passing crisis making it harder for industry to credibly talk of lessons being learnt.

So, the experience of the sector has not been one of time being any great healer. Indeed, the similarities between cases like Forex and Libor, as well as Interest Rate Hedging Products and PPI, have simply calcified what was already a highly polarised debate.

On the one hand, you have those today who appear reluctant to admit to wider industry challenges around misconduct, dismissing behaviour-related issues as the product of a few 'bad apples'.

On the other, you have those who see repetition as proof that this is a sector that isn't engaged with change. The cycle of misconduct resembling a Mobius loop, where we appear to continually return to the same start point.

Now, both sides can, of course, point to evidence that affirms their own world view. But the truth here is that the debate around trust and confidence in banking has proved resilient, at least in part, because it defies easy analysis.

Yes, it has well-documented challenges to contend with, which I want to look at this morning. But it also has credible reasons for optimism.

> ***"There's an obvious commercial imperative for industry leaders to address cultural issues."***

Most important perhaps, there's an obvious commercial imperative for industry leaders to address cultural issues. Not least the potential, as we've already seen this year, for investor revolts over misconduct issues, which themselves follow successive voting seasons that have been punctuated by rebellions.

Of course, there is an important question here: 'if reputation is so important to firms, why is it that cases like FX, like Libor, PPI and so on, seem to emerge and then re-emerge with such regularity?'

And for banks, there are clearly some significant, complicating factors here around areas like competition, transparency, incentives and the like. Each demanding resolution.

But for me, there are two other decisive issues that require moving forward if there's to be any prospect of definitively resolving this trust and confidence debate.

First, the accountability agenda around governance and structure. Areas highlighted in last year's Virtuous Banking report.

Second, individual accountability and, in particular, the crucial (and often overlooked) importance of middle management.

Structure and governance

On the first point, I think it's worth reflecting, in passing, that the ambition of bank leaders to reform culture is not in doubt here.

No CEO enjoys explaining away conduct crises to investors and customers. Nor the penalties that follow it. In fact, it's hard to think of a topic that is invested with more corporate energy. Boards spend anything up to 80pc of their time debating regulatory issues.

So, the challenge here is not one of intention – it's one of execution and complexity.

Put simply, it is not straightforward to govern the behaviour of individuals in large, heavily stratified banking institutions. Invariably, it takes time.

Of course, the other, linked, governance challenge in establishing long-run change is that there are, almost by definition, significant philosophical complexities involved in setting risk appetites for misconduct.

So, the conundrum for leaders here is that it's clearly more problematic to manage so-called 'soft risks' – such as behaviours, choices and values – than it is to set controls and ratios that are governed by mathematical models.

It's difficult, for example, to come up with a 'value at risk' figure that satisfactorily states an appetite for conduct failure in the same way you would for, say, the overnight position of an investment portfolio.

You might be willing, as a firm, to lose up to £100m on that portfolio based on a three standard deviation price movement. But what would be the conduct equivalent here?

No more than two attempts to manipulate global benchmarks? No more than five major counterparties front-run on their transactions? No more than £10m of products mis-sold in any one day?

Clearly, the output of a formula along these lines is incoherent. You cannot easily box company culture into a formula – or at least not without risking damage to 'softer', invisible balance sheet issues like reputation.

But of course, the irony here is that the first instinct of modern governance is nearly always to reach for numbers in assessing risk. Partly because they're the lingua franca of finance.

But also because there's pressure on Boards and executive committees to base strategy on scientific measures of business risk.

There is, however, a key difficulty here.

In seeking definitive, measurable conclusions, there's a danger that analysis replaces judgement. Rather than supports it.

No-one, by way of example, was seriously talking pre-2007 about chains of accountability. Even post-Leeson.

Yet as the crisis unwound, and we moved through a cycle of mis-conduct cases – all without anyone appearing to be held responsible – it quickly became one of the most significant conduct risks facing firms.

So, as we move things forward, it will be an imperative for leaders, including policy makers, to not just ask if something is doable, or whether there's a measurable risk, but to interrogate the principle behind it.

And this certainly applies to that core debate around accountability, where the industry found itself confronting some very challenging questions. The most important, and difficult of which was probably the following:

How was it possible to justify an environment where rewards were heavily individualised – yet responsibility for mistakes were mutualised? So, protection, if you will, on the basis of a 'Murder on the Orient Express' defence, where personal refuge was sought in numbers.

Accountability regime

Looking back today, of course, this context seems remarkable in as much as it appeared to invert principles of corporate self-preservation. Defending the individual over the collective.

Even Victorian banking – with requirements on staff to put up surety as a condition of employment and the like – had an arguably more nuanced understanding of personal accountability.

So perhaps inevitably, what followed was a period of intense political and societal scrutiny. The Parliamentary Commission on Banking Standards published its report on professional standards and culture two years ago.

ResPublica, as we all know, published its research paper in 2014. And in March, the FCA and PRA released their feedback statements on a number of core accountability-related issues.

One of the most important of these – certainly in terms of this debate around governance, structure, stratification, opacity and the like – has been the development of a requirement for firms to construct so-called 'responsibility maps'. Organograms setting out the allocation of responsibilities across individuals, governance arrangements and the like.

These, in turn, are being supported by the arrival of 'Statements of Responsibility' – establishing, in some detail, the individual areas each senior leader will be accountable for – across all 17 management functions, including:

- exec directors;
- significant responsibility senior managers;
- money laundering reporting;
- compliance oversight and heads of internal audits

Crucially, this does away with the current emphasis on 'influence', which is a difficult concept to objectively define, and ambivalent enough to provoke legal uncertainty. And it brings us towards a system where responsibility becomes clearer and more immediate.

It also, importantly, moves us away from a position where determining who is accountable for what within organisations can be an enormous undertaking for policy makers.

So, while regulators can today collect and enrich literally billions of data points to detect sophisticated algorithmic market abuses, establishing the most basic line management relationships have, in the past, proved hugely problematic in the face corporate filibustering.

Now, the other key area here, of course, will be the new Presumption of Responsibility, which lies at the centre of this industry debate around high standards of accountability, and how they ultimately change the City.

The core ambition, effectively, is to make sure that where a firm contravenes a regulatory requirement, in an area for which a senior manager is responsible, it will be up to that manager to satisfy regulators that they took reasonable steps to prevent the contravention happening.

That differs to the system as we have it today, where it is for the regulators to establish what steps the senior manager took, which steps weren't taken and whether they were reasonable in the circumstances.

So, the broad political intention here is to rebalance responsibilities and avoid a now familiar scenario, where it becomes very difficult for regulators to definitely demonstrate whether X or Y individual, took reasonable steps to prevent their firm breaching a particular regulatory requirement in their business area.

Now, this all invariably opens up a number of important questions. Indeed, the challenge put back to regulators has been: will you apply the presumption proportionately and fairly? And what, actually, are the steps a senior manager has to take to rebut the presumption?

For lawyers, the slightly unsatisfactory answer here, but honest one, is that it's very difficult for policy makers to be prescriptive about the steps that a particular individual is expected to take. Not least because that will depend on the circumstances, including the size of the firm, what the senior manager knew and so on.

And actually, for those senior managers, most of the steps you'd expect them to take appear common-sense, frankly. Behave with integrity; delegate appropriately; make sure you understand your business area; and comply with common law, existing rules and legal obligations.

But it bears repeating here, given the scale of misplaced alarm, that neither the Senior Managers Regime, nor the presumption of responsibility, correspond to a 'heads on sticks' strategy.

Indeed, as is the case now, and as it's required to do, the FCA will apply the presumption proportionately, and in a way that's fair to the subject of the investigation.

> *Heightened accountability should reduce the need for individual pursuits by regulators.*

In other words, there's no prospect of institutional scalp hunting here. Nor is this a matter of public theatre. Quite the contrary in fact. The expectation is that heightened accountability should reduce the need for individual pursuits by regulators. That's the whole point.

Middle management

Time will tell, of course, just how significant this reduction might be. But for boards and executive committees, the clear upside here is that a functioning accountability regime offers the prospect of employees becoming less prone to regulatory transgressions.

And this brings me on to my final topic this morning: the critical, but underplayed importance of middle management in restoring trust and confidence.

So, while we've quite rightly and properly seen significant attention focussed on the most senior leaders, there's been far too little debate around the many thousands of decision makers beneath them.

In part, no doubt, this is some reflection of the importance that modern business attaches to those at the top of organisations. Vanguard founder, John Bogle, famously talked about successful managers being paraded like 'Hollywood stars'.

It's an imperative, however, that leadership responsibility at the top, isn't taken to imply a lack of responsibility for change in the middle. Bank Boards are, frankly, no more able to reform cultures on their own, than star riders are able to win cycling tours without pelatons and domestiques.

In fact, you could argue that those at the centre of organisational pyramids should, by basic law of averages, influence greater numbers of colleagues on a personal, day-to-day basis than a clutch of senior leaders.

The core question for policy makers here, of course, is whether this influence tends to the positive or negative? And the answer, I suppose, depends on how that question is framed.

Do we imagine that middle managers in banking are fundamentally different from any other industry? The answer is surely not. Or at least not in a pejorative sense.

But if you ask whether the environment they operate within creates a greater test of moral resolve? Then the answer is quite possibly 'yes'.

In fact, a recent European study of culture in banking explicitly noted the capacity, as it put it, of the industry to weaken the 'honesty norm' in its workforce.

And middle management, the so-called 'permafrost', must be seen - if only by virtue of its quantum - as a key engine of change here.

Certainly, it cannot be a coincidence that even as leaders are explicitly talking up the value of cultural change, more than half of their financial service executives, presumably informed by those immediately above and around them, told the Economist Intelligence Unit that ethical flexibility remains important for career progression.

Now, it's not the job of regulators to mandate how firms manage what are, effectively, business issues. Nor is there any desire in the City for policy makers to become the conscience of capitalism.

But there is clearly a responsibility here to support the creation of an environment that can reduce the incentive for misconduct. Create that 'honesty norm' if you like.

And this, essentially, is where the new certification regime comes in.

So, while the current, approved person regime, captures individuals at the top of the organisation, as well as those in some customer facing roles, there's a blind spot here, in as much as middle management, and some material risk takers, are not subject to the same regulatory fit and proper standards.

For leaders, this is a problem because accountability structures begin to resemble safety nets with significant holes. You might have junior advisory staff in banks approved. Senior commodities traders not.

The certification regime will help address this. Placing a much clearer expectation on firms to uphold standards of fitness and propriety of anyone in a so-called 'significant harm function'.

And this brings me on to my last point for this morning: the new set of conduct rules, which now capture all individuals involved in financial service activity in banks and, in turn, sit alongside both the senior managers and certified persons regime.

So, what we have here then, are a very high level, but significant suite of requirements that apply to a far larger percentage of employees than we've encountered before.

Indeed, the only individuals in banks who won't be covered, will be ancillary staff performing jobs that don't directly relate to the core financial service role of the organisation. So, reception staff, security, caterers, cleaners and so on.

For those to whom the Conduct Rules do apply, however, the new requirements will include: acting with integrity; professionalism; paying regard to the interests of consumers; treating them fairly; and being open and co-operative with regulators.

Now, this is not, I would argue, an impossible benchmark against which to measure employees.

And the expectation is that, in the vast majority of cases where staff ignore the rules, firms would take any corrective action themselves. Albeit within a framework that does allow the FCA to take enforcement action if needed.

So, what we have here – in effect – are principles that provide a clear baseline for all staff. And should support key areas like performance management, career progression and the like, as well as giving staff greater confidence to challenge colleagues if basic principles are abused.

Conclusion

Now, for the purposes of today's debate, there is no doubt that this collection of policy work – from statements of responsibility to certification regime and conduct rules – represents one of the most significant post-crisis reforms for financial leaders.

Certainly, it will be a critical means of addressing that core challenge: the reformation of an environment that seems to test moral resolve to its limits.

Reduce incentives for misconduct. Increase personal accountability and you have the basis for rebuilding trust and confidence in the UK's enormously important banking sector.

And that, surely, must be in the interests of us all. The re-orientation of the conversation away from systemic risk. Away from conduct risk. And back to the business of a financial sector driving the real economy forward, while supporting many millions of customers.