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Home
Latest Issue
Issue Archive
Annual Reviews
TalkingPoints
10Questions
Advisor Handbooks
ExpertBriefing
FW News

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About
Contact
Subscribe
Editorial Submissions
Advertising
Terms & Conditions

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Corporate Disputes
Risk & Compliance

Search

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Rehabilitating the UK's banking sector

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4

BY

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Less than two years ago, Anthony Jenkins, the chief executive of Barclays Bank PLC, acknowledged that his firm had behaved irresponsibly in the past and was on the long road to rehabilitation. It was an admission of wrongdoing from one the UK banking sector's powerhouses, yet it was also a promise for the future. Mr Jenkins' statement was an assertion that the bank, if not the entire banking industry, was keen to make amends for the shortcomings of the past by embracing a new corporate culture.

Yet despite the reconciliatory tone struck by Barclays, the sector in the UK has continued to lurch from one scandal to another. Accordingly, though we are seven years removed from the onset of the financial crisis, the aftershocks of that fiscal earthquake are still being felt today.

Revelations about the banking sector's transgressions regularly surface and fines in the multimillion dollar range have been levied against some of the industry's biggest players. In the UK, fines and reprimands for scandals including LIBOR and FOREX rigging and PPI mis-selling continue to mount up. As a result of the string of revelations and enforcement actions, for many, trust in the banking sector appears to be at an all time low.

In light of the flagrant improprieties on display within the UK banking sector, responses from commentators have been mixed. To combat illegal behaviour, some have suggested that banks found guilty of misconduct should be banned from trading, executives should have their wages and bonuses cut, and certain traders should be imprisoned.

While punishments of this nature may seem draconian, they may be appropriate given the scale of the problem. A new report from the Cass Business School and think-tank New City Agenda suggests that British banks have been suffering from a "toxic" and "aggressive" culture for years. The various scandals which have emerged were arguably brought about by this destructive culture. The report also suggests that any attempts to reform the existing culture may conceivably take a generation.

Between 2008 and 2014, UK banks are believed to have received around 21 million complaints. The industry has paid out around £38.5bn in fines and customer redress in the last 15 years. Given the level of opprobrium directed at the sector, how can it repair the damage and begin to rehabilitate itself?

A long road

Clearly, the road back from scandal and distrust is likely to be a long one. In recent years, there has been a number of high-profile, damaging incidents which have dramatically affected the public's confidence in the whole sector. As Harvey Knight, a partner in the financial services regulatory group at Withers LLP, notes "The most damaging revelations have been the LIBOR and FOREX investigations, with the regulatory settlements that have been reached in those investigations being consistent with that narrative. As the general public has suspected all along, individual bankers have been found to be in collusion for themselves in the regulatory settlements that have been reached between the banks and their regulators. However, the individual bankers concerned have not been involved in those regulatory settlements. Those individuals now must await the decision of the criminal enforcement authorities and the criminal courts if charged."

For some, though, 'banker bashing' has become a common, but not entirely fair, pastime. In the press, and on the street, there have been mounting calls for some bankers to be imprisoned for their actions. In some respects, it appears that the UK government is heeding these calls. The commencement of the relevant provisions of the 2013 Banking Reform Act will make it a criminal offence for any individual or institution to act in "a reckless manner". Reckless behaviour in this context is described by the Treasury as "behaviour that falls far below the standard expected of someone in that position". Whether prosecutions against bankers would be pursued in the future is up for debate, however it would appear that legislators are laying the foundations for such criminal prosecutions.

Global problem

Though there is a major issue with UK banks, they are not alone. Corruption and unethical behaviour in the banking sector has become commonplace in a number of jurisdictions. According to a study published in the journal Nature in November 2014, the prevalent culture within the financial industry encourages staff members to behave in a dishonest fashion regardless of whether the individuals themselves are inherently dishonest or not. The report, which surveyed investment managers and traders at major international banks, suggests that a number of measures must be adopted to combat the dominant culture of dishonesty. These measures include having bankers swear a professional oath, much like the Hippocratic Oath taken by doctors, which may compel the banking industry to consider the impact of its work on society. The team of economists at the University of Zurich who completed the study argue that more should be done to stop firms from rewarding employees who behave dishonestly going forward.

"As a result of the string of revelations and enforcement actions, for many, trust in the banking sector appears to be at an all time low."

To that end, while the state of the banking sector in the UK is dire, the problem seems to be a banking one, rather than UK-centric. Dr Andrea Bonime-Blanc, chief executive and founder of GEC Risk

Advisory and author of The Reputation Risk Handbook: Surviving and Thriving in the Age of Hyper-Transparency, agrees. "This phenomenon is by no means unique to the UK banking sector," she says. "Indeed, some would argue it started on Wall Street and the US banking sector. It appears to be a cultural malaise that is endemic to the banking sector in many countries – though not all – which can be tied back to a business strategy focused only on the bottom line, and the short-term bottom line at that. Banks that have a longer-term horizon and a more holistic sense of their stakeholders – depositors, for example – did not get into much trouble. Witness the Canadian banking sector, where nothing went wrong around 2008 or since, and where the customer is king and quarterly results are not," she adds.

Instances of corporate wrongdoing have risen around the world. The full cost of corporate malfeasance since 2009 has been around $150bn to $200bn, and that figure may be at the conservative end of the spectrum, according to research by Ecclesiastical Investment Management Limited. Despite the astronomical figures being quoted, alleged impropriety in the global banking sector has continued regardless. In mid-December, the New York banking regulator was believed to be investigating whether Deutsche Bank and Barclays Plc had used algorithms on their trading platforms to manipulate FOREX rates.

Regulatory issues

The UK's banking sector has behaved irresponsibly in the past, and endemic cultural issue have permeated the industry. But it would be remiss to ignore the negligent attitude adopted by many government agencies and regulatory bodies. "Part of the banking sector malaise globally – not only in the UK – isn't only the fault of the banks," says Dr Bonime-Blanc**.** "The government and regulators bear a fairly heavy burden as well, in two different ways. On the one hand, the government hasn't always passed the right kind of smart laws and regulations, often reacting hastily to the latest scandal, thus enacting laws that are either unclear or laden with exceptions. On the other hand, regulators haven't been equipped with the best tools, resources and, frankly, people to do a creditable job of overseeing enforcement in the face of a much more resourceful and wealthy opponent – the banks. The result has thus been a messy mix of uneven and imperfect enforcement, a weak regulator facing a potent sector, something akin to the hen guarding the fox-house. The answer isn't increasingly heavy, complicated and ineffective regulations. The answer is that regulators and governments have to get savvier about what motivates individual and collective behaviour and what a risk-reward matrix looks like, and then pass smarter laws, not more laws."

The issue of whether regulators have enough power to effectively monitor and act on potential problems is one that regulators themselves continue to evaluate. "I think the FOREX scandal has shown that regulators can use the powers they have to work quickly and effectively," says Martin Wheatley, chief executive of the UK Financial Conduct Authority (FCA). "The challenge for us as regulators is to make sure that we are keeping pace with those who seek to break the rules. We are working hard both with regulators and with firms to try and keep ahead of the curve on that. It will always be challenging, but more powers are not necessarily the answer. For me, we have to make the powers we have today work as well as they can."

Following a 13-month investigation, the FCA fined five banks a total of £1.1bn in November 2014, the largest fine imposed by it or its predecessor, the Financial Services Authority. As Mr Knight notes "The FCA has taken the opportunity of the FOREX investigations to get back on the front foot. Experience over the last few years has indicated that if in doubt, the UK regulators now refer a matter to a criminal enforcement agency to consider further action against the individual bankers concerned if they do not have the required power to do so themselves." Yet despite the record-breaking nature of the FCA's fines, there were some who accused the FCA of handing much of the responsibility for the investigation to the banks themselves, and relying on information gathered by the banks and their lawyers. Regulators obviously have an uphill battle when it comes to winning over their critics.

Internal controls

If the UK's banking sector is to truly rehabilitate itself, there must be an increased effort internally to implement robust and comprehensive controls. "Tackling conduct is not just about what the FCA can do – it is also about the culture of the institutions we regulate," points out Mr Wheatley. "I am in no doubt that those at the top, in the boardrooms, understand the urgent need for that culture change. As do the majority of their staff. Every time we read about something like LIBOR or FOREX or the mis-selling of financial products, it only serves to damage further the industry's reputation. The truth is, if the regulator needs to act, then that precious commodity of trust is eroded, and the road back is made a little longer – but I don't think the damage is irreparable. The culture change we need has to flow from the boardroom to the trading floors, to the high street. I believe we are starting to see small improvements, but it will take time and won't happen overnight."

Internal controls are an essential part of the banking sector making headway on the road to reform. By improving processes, banks can stamp out the existing culture which researchers, regulators and many within the industry itself consider to be toxic. However, the importance of internal controls is not just about repairing ties between the financial sector and the public. "I think it is critical for banks, like any other complex institution, to have internal programs, processes and controls that are firstly appropriate to their industry, size and risk profile, and ultimately connected directly to their strategy and performance management incentive program," says Dr Bonime-Blanc**. "**In the absence of these two basic principles, an organisation will lack the resilience to deal with the inevitable scandals that will come. There is an upside to all of this too, by the way: organisations that have strong internal controls, resilience and culture withstand downsides and downturns better, and can unlock value and create an upside where it didn't previously exist."

Conclusion

Evidently, significant damage has been done to the banking industry and the public's faith in it. Although a lot of work lies ahead, the sector must be able to move forward and rehabilitate itself. The challenge facing the industry cannot be shirked. As Mr Wheatley notes, the sector is willing and able to rehabilitate itself. "I believe it will, because it has to," he says. "We simply cannot go on like we have done in recent years. When I speak to chief executives in the City, they feel this need for change as keenly and sharply as anyone else does. It is not in their interest to have their firm's name trashed across the media due to the actions of a few individuals. It will take time, but I have no doubt that the will is there to make that change a reality."

The troubles faced by the UK banking sector are symptomatic of a broader international issue which demands an international response. It will require a genuine, concerted attempt to overhaul banks' internal control functions throughout the industry. Areas such as risk and compliance management and internal auditing must be revisited and strengthened accordingly.

In many respects, the UK's banking sector has reached the point of no return. It is imperative that the country's legislative bodies enact effective and relevant laws which will have a genuine effect on the industry. For Mr Knight, cleaning up the banking sector must occur to safeguard its future. "There is too much at stake," he says. "There needs to be coordination at an international level to ensure that there is no regulatory arbitrage with any 'bad apples' moving to a more lightly regulated jurisdiction. There needs to be a level playing field with universal enforcement of agreed and accepted standards of behaviour." Emphasis will also be on the banking industry itself, both domestically and internationally, to change its ways. Better coordination between regulatory bodies will be beneficial in the long run.

If banks and financial institutions in the UK and beyond hope to re-engage with customers, there must be a concerted effort to re-introduce ethics and integrity to the banking system. By treating customers fairly, and demonstrating that they can again be trusted, banks may be able to recapture the understanding and goodwill of a public that feels mistreated.