CAN CONDUCT BE REGULATED IN FINANCIAL SERVICES?

A MERCER I KEPLER PERSPECTIVE

14 MARCH 2018

AUTHORS

Sophie Black, Partner

Claire Morland, Principal

Keri Smith-Ryan, Senior Associate

CAN CONDUCT BE REGULATED IN FINANCIAL SERVICES?

The reverberations of the financial crisis are still impacting us a decade on. Immediately after the financial crisis international bodies including the G20 and the EU tasked their regulatory bodies - the FSB and, in the EU, the EBA and ESMA - to find a solution to manage risks in systemically important financial institutions with the objective that the taxpayer would never again be required to bail out the banks.

The focus was on prudential regulation and, with media and public attention on bankers' bonuses, there was specific focus on bankers' pay. As we now know the solutions were simply not sufficient.

In the aftermath of the financial crisis a series of conduct related issues continued to emerge on a global basis. Boston Consulting Group reported last year that USD321billion[1] had been paid in fines by banks globally over that decade. Clearly, this is just the tip of the iceberg. In addition to fines, the cost of risk taking and misconduct also includes the cost of client rectification and redress as well as other P&L impact. Perhaps most troublesome is the reputational costs and the concomitant loss of trust in our global banking system. The focus on prudential measures and remuneration has simply not been sufficient.

The broader agenda

What is banking for? The reason government stepped in to bail out banks during the financial crisis is the public social role banks play in the smooth running of the economy, as well as the corporate purpose. Banks operate with a social licence[2]. This requires banks to set standards to achieve this purpose and Baroness Onora O'Neill of the UK Banking Standards Board argues that the standard which matters most is trustworthiness[3]. This must be demonstrated in pursuing both the corporate (shareholder) and public purpose of banks and the wider financial services industry.

Attention therefore turned to the more fundamental question of determining accountability and responsibility recognising the importance of the most senior management of a firm in setting the tone on culture and conduct from the top and for creating a strong governance framework.

Mercer Kepler agrees with the FSB[4] that the available tools for managing conduct should not be limited to remuneration in isolation but should be considered across the full employee life-cycle - hiring, performance management, talent development, change of role and promotions as well as termination and succession planning.

The Senior Managers' & Certification Regime (SMCR)

The regulators are now focused on this broader agenda with, the UK leading with the Senior Manager & Certification Regime (SMCR), followed in Australia with the Banking Executives' Accountability Regime, the aptly named BEAR modelled on the UK SMCR.

At the time of the consultation on SMCR, prior to its introduction there was a proposal to reverse the burden of proof in cases of failure to carry-out prescribed responsibilities. After much debate, the conclusion was that it would have been too fundamental a change to the British legal system and so, with the SMCR, the burden of proof still lies with the regulator. However, there is a specific framework setting out Senior Managers' responsibilities supported by the duty of responsibility specifying that the regulator can take action against a Senior Manager when there has been a breach in the Senior Manager's area of responsibility which the Senior Manager could reasonably have been expected to take steps to avoid.

With the extension of the SMCR to a broader church of organisations in the financial services sector, the regulator is expected to apply proportionality in making an assessment of what could reasonably be expected - given the size, scale and complexity of the firm. While this is positive it does require a judgement on how proportionality should be applied. Again, firms must consider carefully how this is operated in practice - governance and process is critical to support the basis for decision-making.

One particular area which was under the spotlight was how to manage the collective responsibility for board decision-making in the context of the SMCR individual accountability requirement. This has now been clarified by the regulator with Senior Managers accountable for their individual contributions to collective decisions for areas for which they are responsible.

Culture and conduct

The SMCR sets out a number of defined areas of responsibility which must be allocated to Senior Managers, the prescribed responsibilities. This includes responsibilities for culture[5]. This is the elephant in the room – while there is no agreed definition of culture in an organisational context we all recognise that the culture of a firm - its institutional culture - is fundamental to how it approaches doing business. The complexity is that it is difficult to manage and even more difficult to measure.

A firm's institutional culture can set the standard for good practice - but this depends on a firm having a healthy culture and this is not always the case - there have been notable exceptions played out in high-profile cases of misconduct. The fact that a firm will have a culture is not optional, one will emerge regardless therefore it is incumbent on leaders to actively manage the firm's culture. There is recognition that if culture is not tackled it is not possible to manage risk and conduct. In the City Values Forum's recommendations on Governing Culture, Sir Win Bischoff, Chairman of the FRC, commented that:

"*Culture is a critical element in the long-term success of any business. It is both a risk and an opportunity - a healthy culture which is consistently nurtured and developed can protect and enhance the value of an organisation and help differentiate it from its rivals. As we have seen all too often, if culture is neglected this can lead to a destruction of value."*[6]

There is developing best practice on culture. The City Values Forum has published recommendations on the approach including an agenda for boards and a roadmap[6]. What is clear is that culture is individual to the firm, leadership plays a crucial role and the tone must be set from the top by the company chair and senior managers and cascaded down through the firm. The Banking Standards Board aims to raise standards in banking and this includes institutional culture[7]. Perhaps, the good news is that Mercer Kepler's research paper 'In Good Company' found that companies with a 'good' culture outperformed in terms of delivering shareholder value. As this is a point in time we cannot of course create a causal link. However, we intend to undertake this research annually and hope that longitudinal data will point to a causal link.

The recent FCA Discussion Paper[8], 'Transforming Culture in Financial Services' recognises the impact and role of culture to rebuild trust in financial services. It asks, 'how can regulation promote healthy culture?' - and, identifies the role of leaders in managing culture which is regulated through the Senior Managers' Accountability Regime and the role of individuals which is regulated with the SMCR Conduct Rules. This will be supplemented in the extension of the SMCR with a proposed prescribed responsibility for conduct. The FCA recognises that there is no 'quick fix' and that the SMCR alone is not sufficient.

What is in the toolkit to support these requirements?

The SMCR is wide-ranging in its requirements and sets a framework for raising standards on accountability and governance and enhancing conduct in the financial services sector. So, this leads us to the critical question of what firms should be doing to support their Senior Managers in both managing these accountabilities and protecting their legal position. What is in the toolkit to support these requirements?

Recognising the impact and importance of culture Mercer recommends that companies set up a culture sub-committee of the board to set standards on culture, monitor and measure performance and progress in this area supporting the Senior Manager responsibility for culture.

On the wider agenda, it is critical to have a framework of governance with appropriate delegations clearly documented and supported by robust processes. It will be important to have evidence so that Senior Managers can demonstrate that they have carried out their responsibilities. This in itself is a discipline which Senior Managers must cascade. The 'banana skins' must be anticipated and the evidence must be available for the audit trail. Put simply, good housekeeping is essential.

On the basis that 'what gets measured gets done', how can companies measure performance? In the past, the focus has been on measuring performance through the financial KPIs. However, as regulators expand the scope of the regulation to cover culture and conduct, a framework is needed to measure *qualitative* as well as *quantitative* deliverables with these then used to reward contribution to sustainable value creation.

Companies are addressing this requirement by introducing balanced scorecards. These provide a holistic approach to measuring success. With financial KPIs measuring financial performance and prudential strength to meet shareholder and regulatory expectations, the qualitative measures used in the balanced scorecards can be designed to meet the expectations of different stakeholders. So, for example, client metrics can be used such as Net Promoter Score, client service levels and brand strength. Suitable employee measures could include progress on the gender pay/role gap and other diversity & inclusion metrics measured year-on-year as well as employee engagement scores from staff surveys. These are all important measures to support company reputation.

The measures in the company level balanced scorecard can be cascaded to business area specific balanced scorecards to improve line of sight. The business area scorecard objectives can be further cascaded and included in the performance objectives of individuals with performance outcomes providing a sound basis for pay and promotion decisions recognising both '*how*' as well as '*what*' has been achieved.

Further to this it is important that a firm's HR practices across the employee life cycle support and embed the firm's values in order to sustain a healthy culture.

Conclusions

Regulatory enhancements since the financial crisis have not been sufficient to prevent ongoing misconduct scandals. With a heavy focus on regulatory compliance there was still opportunity to game the system. Mindful of this, there has been a change in gear to focus on a more holistic approach with the SMCR providing a strong accountability framework for senior management with ownership and responsibility for institutional culture. This gives optimism that conduct in financial services will improve and the social purpose of financial services will be both recognisable and recognised.

REFERENCES- CAN CONDUCT BE REGULATED IN FINANCIAL SERVICES?

1. Boston Consulting Group report https://www.bcg.com/en-ru/d/press/2march2017-global-risk-2017-146764
2. Speech by Mark Carney, Governor of the Bank Of England https://www.bankofengland.co.uk/speech/2015/building-real-markets-for-the-good-of-the-people
3. Baroness Onora O'Neill speech to the Federal Reserve Bank of New York https://www.bankingstandardsboard.org.uk/remarks-by-baroness-onora-oneill/
4. Financial Stability Board (FSB) Supplementary Guidance to the FSB Principles and Standards on Sound Compensation Practices - http://www.fsb.org/2018/03/supplementary-guidance-to-the-fsb-principles-and-standards-on-sound-compensation-practices-2/
5. PRA Prescribed Responsibility H – 'Responsibility for overseeing the adoption of the firm's culture in the day-to-day management of the firm'. Prescribed Responsibility I – 'Responsibility for leading the development of the firm's culture by the governing body as a whole'
6. City Values Forum's recommendations on Governing Culture - http://www.cityvaluesforum.org.uk/
7. Banking Standards Board - https://www.bankingstandardsboard.org.uk/what-is-the-bsb/
8. FCA Discussion Paper DP 18/2 - Transforming Culture in Financial Services - https://www.fca.org.uk/publications/discussion-papers/dp18-2-transforming-culture-financial-services

Mercer's Financial Services Executive Remuneration Team

Gordon Clark
Partner
020 7178 5110
gordon.clark@mercer.com

Sophie Black
Partner
020 7178 6990
sophie.black@mercer.com

Peter Smith
Partner
020 7178 5119
peter.smith@mercer.com

Amanda Flint
Principal
020 7178 3276
amanda.flint@mercer.com

Claire Morland
Principal
020 7178 3221
claire.morland@mercer.com

Keri Smith-Ryan
Senior Associate
020 7178 5114
keri.smith-ryan@mercer.com

This briefing is for general guidance and does not necessarily cover all areas of the topics included in this briefing. It is not designed to give legal or other professional advice.

Registered in England 984275
Registered Office: 1 Tower Place West, Tower Place, London EC3R 5BU
www.uk.mercer.com

MERCER | KEPLER