UNIVERSITY
of
GLASGOW

Ethics Colloquium, 4 December 2012

Regulating banks and financial services

It's fair to say that over the last half century, we've done a reasonable job of making cars, travel by aeroplane and train, food, medicine, and electrical goods and devices much safer and more straight-forward for people to choose and purchase. Things have went wrong, but overall things work. We've acted **with a view to prevent harm**, rather than cure, or try to compensate it.

Yet when it comes to banks and financial services why haven't we made the same progress?

The concept of consumer protection as we know it today can be traced back fifty years ago, when President Kennedy delivered his speech to the US Congress on '*Protecting the Consumer Interest'*.[1] JFK's essential message was that the march of sophisticated technology had rendered many consumer laws obsolete, and that it was necessary to protect consumers with four new areas of rights[2]:

a right to be safe – to be protected against the marketing of

[1] http://www.presidency.ucsb.edu/ws/index.php?pid=9108#axzz1oFBmlXcW; http://www.jfklibrary.org/Asset- Viewer/Archives/JFKWHP-AR7096-A.aspx
[2] http://www.consumersinternational.org/our-work/wcrd/about-wcrd

goods hazardous to health;

the right to be informed – to be protected against misleading information and to be given the plain facts to make an informed choice;

the right to choose – access to a variety of products at competitive prices with satisfactory quality at a fair price;

a right to be heard – to ensure that the consumer voice formed part of Government and regulatory policy at all levels.

Of course, **even when we have been given all of these rights** – whether as regulatory rules or as statutory consumer law rights – **when it comes to financial services things have still went horribly wrong.**

The global financial crisis that broke in 2007 has been described as a many-headed hydra.[3] The crucible for that crisis included greed, global regulatory failures, excessive leverage, insufficient capital liquidity, the ability for assets to move rapidly across borders, boom time borrowing and property bubbles.

Here in the UK much has been said of '**light touch regulation'** as a component of the crisis. Most people forget that the FSA only took over the regulation of mortgage lending in 2005 - three years before the crash - and retail banking regulation from the Banking Code Standards Board in November 2009.

A lot of what went wrong in both areas **was due to a light touch approach**, but was compounded by the fact that the FSA were taking

[3] http://www.timeshighereducation.co.uk/story.asp?storyCode=414355&sectioncode=26

over from another regulator and, in the case of retail banks, from self-regulation, which was not working well.

Since the crisis, much work has been undertaken at the global, EU and UK levels to prevent a repetition of the conditions that led to the meltdown and near collapse of our banking system. I don't propose to go into these systemic and macro prudential initiatives, other than to make a couple of brief observations.

In the UK we now have the **draft Financial Services (Banking Reform) Bill** that will take forward the recommendations of the **Independent Commission on Banking**, chaired by Sir John Vickers.[4] The principal recommendation being the ring fencing of the consumer activities of deposit taking and retail banking from the risky activities of investment or 'casino banking'.

A key driver for past financial instability and recklessness were the bank's **'off-balance sheet vehicles'** – the so-called **'structured investment vehicles**'. The SIVs were part of the largely unregulated **'shadow banking' system**, which trades heavily in the derivatives market where credit and debt obligations are sliced and diced into CDOs and CDSs.[5]

Why does the shadow banking system matter? Because this year the size of this market was estimated at **67 trillion dollars** – or to put it another way **almost 100% of the world's GDP**.[6] The

[4] http://www.hm-treasury.gov.uk/fin_stability_regreform_icb.htm
[5] Collateralised Debt Obligations; Credit Default Swaps.
[6] http://www.zerohedge.com/news/2012-11-18/global-shadow-banking-system-rises-record-67-trillion-just-shy-100-global-gdp

international Financial Stability Board is committed to delivering a reform package for the regulation of this system by the end of this year.[7] The key to effective and robust financial regulation is to appreciate the global nature of the market and the need for both international and domestic solutions.

Closer to home, the UK has had more than its fair share of financial scandals. The forecast for the final scale of claims for **Payment Protection Insurance** (PPI) **mis-sold by the banks** could be as high as 12 billion pounds – as at today's date, 6 billion pounds has already been refunded.

Interestingly, **the only senior manager ever sanctioned for mis-selling PPI was the Chief Executive of Land of Leather** who was personally fined £14,000 for mis-selling around £3.5M of PPI. The cost to the banks of the redress is huge, but the fines have been tiny in relation to the detriment caused.

Isn't there an ethical or moral hazard if directors can take excessive risk, generate excessive profit, and ultimately walk away from a scandal relatively untouched and unscathed? In relation to PPI, let's also not forget that all those billions of pounds in profits would have been retained if the firms had won their High Court case last year to block the FSA's redress for customers who were mis-sold PPI.

More recently, interest rate swaps sold to small businesses seem to have turned into potentially toxic products without being spotted by the FSA. Before this of course we have had significant levels of

[7] http://www.telegraph.co.uk/finance/comment/9529471/Regulators-must-shine-a-light-on-shadow-banking.html

consumer detriment caused by unauthorised overdraft charges, which were the responsibility of the OFT, and the spiral of debt that these created for so many people.

Much of the problem with bank charges came from the fact the banks told us banking was free. But free banking does not exist! In the 1980s, when it first came into the UK, it was innovative. What we have seen, ultimately, is that the banks have been innovative in the UK. Packaged bank accounts were an innovation. The use of smartphone technology is an innovation. The difficulty has been that innovation **has generally been to the exclusion of transparency of cost.**

If you look at overdraft charges over the last decade, it had become an unethical mess in the UK, with the UK Supreme Court finding in November 2009 that the less well-off had been subsidising the better-off.[8] Something like 12 million account holders were cross subsidising, disproportionately, 42 million account holders. **Was this reverse Robin Hood approach ethical, fair or sustainable?**

If we talk about packaged bank accounts, we see these products are problematic too. One in five people in the UK now has as packaged bank account, but we know that fewer than one in 10 use the bundled services. **They have been sold stuff they don't necessarily need, want, or will ever use.**

Today's conference is about ethics, and the argument I would like to

[8] http://www.supremecourt.gov.uk/decided-cases/docs/UKSC_2009_0070_Judgment.pdf

develop in relation to UK financial services is that **many of our scandals and problems can be traced back to a lack of professional ethics;** my proposition is **that ethical failure is a *causa causans* of so many of our financial problems**.

In the UK, we have inherent cultural problems where the behavior of financial firms, including the incentivisation of staff through commission and pay, is to treat consumers not as customers or as human beings, but rather as simply someone to sell to, regardless of whether the product is necessary, relevant or appropriate for them.

Now, I accept that regulation has a central role to play here – and I want to say something later about the forthcoming changes in our regulatory landscape that should help. **But blaming the regulator for financial scandals is a bit like blaming a police officer when someone steals your car.** At the end of the day the buck has to stop with the person who stole your car. **And in relation to banks and financial services unless we get the culture and ethics right within the heart of authorised firms, how can we ever secure better outcomes for UK consumers?**

In relation to cultural problems it's instructive to look at how financial service firms deal with customer dissatisfaction. In the first six months of last year there were almost 2 million financial service complaints reported to the FSA.[9] The figures for July to December 2011 were higher given the number of payment protection insurance (PPI) complaints that had been placed on hold pending the BBA's

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[9] http://www.fsa.gov.uk/library/other_publications/commentary/aggregate_com This excludes 'non-reportable' complaints, which had been resolved by close of the next day of business.

High Court case, lost last April.[10]

Out of all of these reportable incidents, UK banks accounted for almost 70% of the total, with customer service, bank charges and disputed sums accounting for the biggest source of complaints in retail banking. That's a lot of unhappiness.

The Triodos survey of 2,000 British adults earlier this year found that 40% of consumers were either dissatisfied or disaffected with their bank with 18% of respondents advising that they would not recommend their bank to a friend.[11] This is consistent with a survey Triodos undertook last year, which found a similar level of customer disillusionment. The reasons given then for dissatisfaction broke down as: 38% citing poor customer service; 38% complained about the hefty bonus culture; and 29% were unhappy that they were not being treated as an individual.[12]

People no longer trust their bank, as they did in the not too distant past. We have a cultural problem, and at the heart of all of these problems is a lack of professional standards and ethics.

In many respects, the LIBOR inter-bank lending rate scandal was the straw that broke the camel's back and resulted in the UK Parliamentary Commission of Banking being set up earlier this year as a joint select committee with members of the House of Commons

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[10] *BBA v. FSA and FOS and another:* http://www.judiciary.gov.uk/media/judgments/2011/bba-fsa-judgment

[11] http://www.thisismoney.co.uk/money/saving/article-2105443/Failing-banks-leave-customers-unhappy-year-ago.html

[12] http://www.which.co.uk/news/2011/02/brits-fail-to-find-reasons-to-recommend-their-bank-244503/

Treasury Select Committee and the House of Lords.

Many commentators think the LIBOR scandal has already sparked a decisive change in banking culture – certainly that is the view of Andy Haldane, Director of Financial Stability at the Bank of England.[13] He believes we are beginning to see a shift in the right direction and takes the view that: "In terms of the loss of incomes and outputs this [financial crisis] is as bad as a world war. It would be astonishing if people were not fed up, on the streets and asking big questions about where finance has gone wrong."

The FSA's own submission to the Parliamentary Banking Commission recognises the important role of culture, professional standards and ethics. The FSA has made the follow observations:

> "In some sectors of the economy (for example the provision of medical or legal services) society assumes that appropriate individual behaviour and organisational culture can be fostered through a commitment to 'professional standards and ethics' which are to different degree defined and codified. All individuals who work in an authorised firm are required by the FSA to have the skills, knowledge and expertise necessary for the discharge of the responsibilities allocated to them. Individuals who carry out certain regulated activities for retail clients are also subject to detailed requirements in the FSA's Training and Competence (TC) handbook. **However professional competence does not in itself guarantee that those who possess it will use it in an**

[13] http://www.moneymarketing.co.uk/andy-haldane-libor-scandal-sparked-decisive-change-in-banking-culture/1062686.article

ethical fashion and/or for the benefit of customers. The Commission might therefore wish to consider whether there could be a role for professional or ethical codes of conduct in banking, similar to those that exist in some other areas".

And perhaps **<u>that is the crux</u>**; in order to get the right culture and behavior in our financial system we needs robust ethical standards, and a good ethical code of conduct which has to be ingrained and embraced by those who sign up to it, and ultimately policed and enforced to make sure it is not a paper or box ticking exercise.

I had the privilege of giving oral evidence to the Parliamentary Commission on Banking at Westminster in September on behalf of the Consumer Panel. I suggested that in order to tackle cultural problems - and the problem with incentivisation – we ought to go back to the old-fashioned way of fixing things by having a professional body with professional standards. If bankers who had significant influence functions were members of a professional body, all this—the problems with ethics, the problems with how the regulator is treated, and the gaming of the regulator—could be sorted out through that professional body.

In that regard, all that we have in the UK at present is the Chartered Banker Institute, which is a voluntary body with 9,000 bankers as members, only 4,000 of whom have the highest qualification. There is no mandatory qualification for bankers, yet with any other part of our life—whether this is doctors, accountants, lawyers, or other professionals—we have a system in place that is a profession with a code of ethics and standards. Surely there is a greater role for the Chartered Banker Institute to do more, if it is given the support, resources and backing to do so?

Having a professional body and robust ethical code also gets round all the legal problems about criminal sanctions and civil sanctions which are notoriously difficult to enforce in financial services due to the complex structure of decision making and identifying individuals who are ultimately accountable and responsible for actions.

The Banking Standards Commission is due to issue an *interim* report on the 18th of December.

Looking forward, the FSA itself will be split next year with prudential regulation being managed by a new Prudential Regulation Authority (PRA) based within the Bank of England, and with conduct supervision going to a new Financial Conduct Authority (FCA), which will also take on the OFT's responsibilities for the regulation of all UK consumer credit.

Seven weeks ago John Griffith Jones and Martin Wheatley, the new chairman and chief executive of the Financial Conduct Authority, launched an impressive booklet describing the new FCA's approach to regulation.[14] The FCA will replace the FSA at the beginning of April if the legislation, which is still working its way through Parliament at the moment, goes according to plan. The Approach document makes the FCA look a lot more impressive than the FSA, from the consumer

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[14] http://www.fsa.gov.uk/about/what/reg_reform/fca/the-journey-so-far/fca-approach/chapter1

protection point of view, but has worried the industry. They are afraid that the intrusive approach it describes will ultimately increase costs and reduce the availability of financial services for the public.

The FCA will have new powers including product intervention and banning powers, and it is also expected to have a new power to cap the cost of certain products. **What will be different about the FCA?** It has said it will be:

- much more engaged with consumers to understand their experiences
- clearer with firms about its expectations
- more open and transparent in the way it operates
- intervene earlier to tackle risks to consumers before they materialise
- tougher and bolder, building on and enhancing the FSA's credible deterrence strategy; and
- have high quality business analysis at the heart of its decision-making process.

All of these regulatory approaches are very welcome, good and positive; **but unless our banks embrace a proper code of professional standards and ethics, we will have failed to tackle the root cause of our problems.**

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4 December 2012