INCENTIVISING COMPLIANCE
in the banking industry

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One consequence of the global financial crisis has been an explosion of calls for a radical change of culture in the banking sector — for a shift to a much more responsible, prudent, long-termist business model, and for a corresponding transformation of attitudes and values. Last year's events in the UK imparted fresh impetus to the debate about what needs to be done. This paper explores the potential regulatory activity in this area and its limitations.

The Barclays LIBOR settlement provoked a huge backlash, in the wake of which the Serious Fraud Office initiated two Barclays-related criminal investigations (one on LIBOR-fixing, the other on 'certain commercial arrangements' made with the suppliers of Qatari capital in 2008 at the height of the financial crisis). HSBC was the subject of a scathing US Senate case study focused on abject weaknesses in its anti-money laundering controls in the US.[1] The New York State Department of Financial Services accused Standard Chartered of 'grave violations of law and regulation' mainly in the form of wire-stripping to conceal Iranian connections in payment messages. Standard Chartered quickly settled, paying a $340 million fine.[2] Both banks remain in settlement discussions with the US federal authorities.

Diverse ideas have been put forward about how to instill a culture of integrity in the banking sector. These include ethical training for employees, setting the 'tone from the top', board-level ethics committees, more 'process-oriented' regulation, ring-fencing of retail and investment banking, and 'mutually interdependent' (rather than antagonistic) relationships between banks and regulators. There is no room for a critique of these ideas here.

The starting point for this paper is the commonplace observation that profit (for the firm) and bonus and commission (for the individual) are dominant motivators of behaviour in banking. People who work in banking are generally more interested in making money than in public service or other forms of job satisfaction: that is part of the culture. This simple observation has powerful implications. It points us in the direction of sanctions and incentives structured by regulatory intervention as a means of reorienting the behaviour of banks and their people. If regulators can reframe the incentives and disincentives at work in the banking environment, they will be speaking to bankers in their own language — in other words harnessing their motivation and mobilising it to achieve a more socially acceptable end. In this paper I explore the potential, some of it yet to be fulfilled, of regulatory activity in this area, and also its limitations.

What is the problem?

The most widely recognised manifestation of banking's dysfunctional culture is the prudentially reckless risk-running in wholesale and credit markets which (along with global macroeconomic imbalances) lay at the heart of the financial crisis and led ultimately to large public subventions in major financial centres (US, UK, Switzerland), as well as countries such as Belgium, Ireland and Spain.

Alongside this, at least in the UK, there has also been extensive mis-selling to customers (in the form of selective explanation of the material features of financial products, or unsuitable or seriously suboptimal recommendations), and poor-quality compliance with the anti-money laundering (AML) regime. The worst mis-selling episodes have related to occupational pension transfers and opt-outs in the 1990s, and payment protection insurance (PPI) more recently, each occasioning well over £10 billion of redress. Concerns over the sale of interest rate derivatives to small businesses are also current. Meanwhile extensive blindness or indifference to high money-laundering risk was documented in an FSA report in 2011.

Some countries may have greater problems than others, but it would be optimistic to ascribe these problems just to the UK. Concern about how interest rate derivatives have been sold has emerged in Italy, Australia and the US, as well as the UK. And the 'incremental yet pervasive detriment to consumers caused by poor, conflicted advice' now seems to be widely acknowledged in Australia.[3] In relation to anti-money laundering, the Swiss federal AML authority has identified issues comparable to the UK's.[4] In Australia, serious doubts have now been raised about the quality of Australian banks' AML compliance in relation to customers who are PNG — 'politically exposed persons'.[5]

What all these episodes have in common is that they show profit, commission and bonus-seeking being put ahead of bona fide compliance and customers' interests. As Andrew Haldane, an executive director of the Bank of England, puts it: 'Banking [in the years before the global financial crisis] became a transactional business, underpinned by a sales-driven, commission-focussed culture.'[6] If this culture is to be transformed, the incentives and disincentives to which behaviour responds must also change.

Sanctions

Regulatory sanctions: corporate accountability

A critical question is whether there is enough deterrence in the system. When delinquent banks are subject to regulatory punishment, are the penalties heavy enough to deter other banks in the same regulatory jurisdiction? Looking around the world, the answer is generally no. A crude application of the economic theory of deterrence[7] would tell us that the sanction should (i) exceed the profitability of the wrongdoing, and (ii) be multiplied by a factor derived from the improbability of being both caught and selected for enforcement proceedings. So, for example, if the profitability is $100 million and the chance of being caught and proceeded against is 5 per cent, the penalty should be more than $2 billion. Few, if indeed any, regulatory authorities operate on this basis, and there is little sign of engagement with step (ii) of the calculation above. The US comes closer than most, but even the recent fine upon Barclays represented 0.5 per cent of affected revenue.[8]

There are counterarguments against the crude economic approach. First, it postulates that each bank is nothing more than an amoral calculator of risk and reward. Thus to the extent that banks have values and scruples, it is reasonable to suppose that they can be deterred from wrongdoing by lower levels of penalty.

Second, what about reputational risk? It is often urged that the 'real' penalty is the reputational damage a bank suffers when it is 'named and shamed' in enforcement proceedings. We should be skeptical about this. Individual customers and counterparties have little incentive to cold-shoulder a bank simply because it is in trouble with the authorities. Even when customers have been the victims of the delinquency, as in the UK retail mis-selling scandals, the practical consequences in terms of loss of market share appear to have been limited. If the wrongdoing is socially harmful but without concrete victims (for example, running excessive money-laundering risks), the incentive to take one's business elsewhere is negligible. Of course, it is an entirely different matter if the bank appears to be a credit risk.

Third, the cost of regulatory sanctions must be viewed alongside the costs of redress, where the misbehaviour is met with individual claims before courts or ombudsmen, class actions, or mandated redress programs. The prospective costs of making redress, it can be argued, also have deterrent value. This argument is valid — up to a point. As a rule, redress is merely restitutive: there is no allowance for the probability/improbability of redress being pursued, and therefore nothing corresponding to step (ii) of the economic deterrence model. And the redress point falls away altogether when there are no determinate victims: again, a cavalier approach to AML may serve as an example.

While each of these arguments has some substance, none has enough to dispel the overall impression that regulatory sanctions for misconduct by banks could and should be higher than their current levels, in order to strengthen general deterrence. This is not to say 'the sky's the limit'. The prudential implications of financial penalties are an important limiting factor, especially in the context of the current drive to strengthen capital buffers for institutions of systemic significance. In particular, it would be self-defeating to impose a fine of prudentially damaging magnitude upon a bank in order to sanction it for prudentially reckless behaviour. There may be occasions when the imposition of heavier capital requirements through the exercise of supervisory powers would be a more apt response than resorting to enforcement proceedings. That said, prudential intervention is not satisfactory as a general substitute for enforcement proceedings for misconduct, because it lacks the transparency and demonstration effects of the latter.

Individual accountability

It is not surprising that there has been a renewed focus in recent years on coupling corporate accountability with that of key individuals, as a means of countering individual irresponsibility and moral hazard. This is a sensible control strategy, as long as individual liability to regulatory sanction is premised on individual culpability (for example, negligence), and not some notion of guilt by association or strict liability. The latter not only

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run counter to principles of justice, but would also heavily discourage individuals from stepping into senior roles subject to regulatory jurisdiction.

In practice, however, the potential of regulatory enforcement proceedings against key individuals as a regulatory tool is limited (even when the necessary legal framework is in place) by two challenges. First, it can be very difficult to reconstruct for enforcement purposes what was a senior individual's own sphere of responsibility, and then to demonstrate personal negligence within that sphere and hence personal liability. The challenge is illustrated by the recent UK case of Pottage, where the Financial Services Authority sought and failed to demonstrate that in response to warning signs, the new UK head of wealth management at UBS ought to have instituted a comprehensive review of systems and controls in his business area some time before he actually did.[9] Second, with personal reputation and standing at stake, senior individuals subject to enforcement proceedings are frequently disposed to contest the case all the way (and have access to the means to do so), whereas accused institutions are often much more inclined to settle. As a result of these two factors, regulatory enforcement of individual accountability entails large resource commitments, and resource-constrained regulators must weigh carefully the investment involved against the likelihood of success.

An alternative form of individual accountability for banking delinquency might be sought through the criminal justice system. There can be no doubt of the existence of public appetite for criminal punishment of individuals with an egregious role in the fiascos of 2008. The stumbling block is the mismatch between populist impulse and legal definitions of criminal offences. Leaving aside cases of outright fraud, especially mortgage fraud, much of the imprudent behaviour associated with the financial crisis seems to defy categorisation in criminal terms, however much we might wish otherwise. In the UK the government has proposed the creation of a new offence of 'reckless misconduct in bank management', even though it believes the amount of material to collect 'in a substantial financial collapse case would be enormous, and the task of analysing it to a proper standard would be formidable. This could make such investigations extremely costly, and result in prosecutions which could run into years rather than months.'[10]

Criminal justice is a costly commodity, prosecution agencies are stretched in terms of resources, and cases against bankers are likely to be very hard fought. There is unlikely to be scope for a step-change in criminal deterrence.

It is time for an overall conclusion on sanctions. It is inevitable that there will be an 'undersupply' of enforcement proceedings, whether regulatory or criminal, relative to the number of situations in which they would be warranted. This makes it all the more important that, when proceedings actually are brought and successfully concluded, the sanctions imposed should not only outweigh the profit that accrued to the wrongdoer, but also be heavy enough to be deterrent to others, even in situations where the probability of being subjected to enforcement proceedings is relatively small.

Incentives

In a recent survey of 500 senior financial professionals in the US and UK, 30 per cent of respondents reported 'feeling pressured by bonus or compensation plans to violate the law or engage in unethical conduct'.[11] About a quarter said they believed that financial services professionals might need to engage in unethical or illegal conduct in order to be successful. While it may be possible to find fault with the methodology of surveys such as this, it reinforces the now widely held view that remuneration structures are a major driver of poor behaviour in the banking sector.

For this reason regulation of the incentives that motivate the business behaviour of individuals in the first place (and not just the controls that aim to constrain them) has become a vital task.

The most advanced effort is the Financial Stability Board's Principles and Standards on Sound Compensation Practices, which are to be implemented throughout the G20, including Australia and the UK. The FSB expressly characterises its Principles and Standards as designed to achieve 'lasting change in behaviour and culture within firms'.[12] The focus is on aligning the material incentives of key individuals in the firm — the 'material risk takers' — with the prudent long-term interests of the firm itself. A critical device for bringing this about is the requirement that payment of a substantial proportion of variable remuneration — in other words, bonus — should be deferred for at least three years, and that a substantial proportion of the bonus should take the form of equity, to give the executive more of a stake in the long-term performance of the firm.

The complexity and challenge of this effort is evidenced by the rapid proliferation of guidance material and monitoring mechanisms (national and international) in just three or four years. It is important to bear in mind that the FSB regime has a purely prudential purpose: the main focus is on systemically significant institutions, and on risks to their capital and liquidity. In principle, therefore, the goal of the regulators and the long-term interest of the banks concerned — to avoid excessive prudential risk-taking — are mutually aligned. This ought to make the regulatory task easier than it would otherwise be.

Regulating remuneration at the interface with the bank's clients with its prevalent sales culture is a different matter. In relation to consumer protection, the distorting and detrimental effects of commission bias have been recognised for a long time, but (perhaps because of competition policy concerns) the appetite for radical intervention has, in Australia and the UK, emerged only recently. The UK's Retail Distribution Review commission ban[13] and ASIC's ban on conflicted remuneration are important and worthwhile initiatives. Both, however, will require intensive supervision and enforcement activity to succeed because they will (or should) interfere with product manufacturers' ability to retail high-margin products whose distribution has hitherto been incentivised by high commissions.

In relation to AML, the motivational impact of incentives on attitudes to money-laundering risk and compliance regimes has attracted relatively little regulatory attention, though the FSA has now said it will take an 'ongoing interest' in the effect of remuneration structures on how bankers handle such risks.[14] There is every reason to believe that the issue of incentives, and the impulse to 'do the business', is as critical here as it is in relation to the customer interface generally.

Regulation of incentives at the customer interface will prove to be a difficult undertaking. The relevant populations are large, and therefore hard to monitor. Compared to the prudential sphere, banks and financial advisers will be less likely to identify their own long-term interests with the goals of the regulator. There will be a constant search for avoidance and circumvention devices. And motivational devices other than commissions and bonuses can be found to sustain the pressure to sell among staff: these include social pressure[15] and the fear of job loss.

To make headway, therefore, regulation of incentives will need to be display several features:

- *Sensitivity to industry developments and flexible responsiveness.* Regulators will need to be alert to the latest industry 'work-arounds' and to operate within a framework of rules that allows them to counter them quickly. Otherwise formal compliance coupled with avoidance will characterise the regime in practice.
- *Co-optation of senior management through corporate governance mechanisms.* Regulation of incentives needs to be complemented by corporate governance requirements (e.g. for board-level remuneration committees whose operation is transparent to the regulator) which make it clear to directors and senior managers that they have accountability to the regulators for delivering compliant remuneration structures in their firms.
- *Active monitoring and enforcement.* Regulators will need to practise active surveillance and to be prepared to bring proceedings for violations of their incentive requirements per se — which brings us back to the role of sanctions.

Regulating incentives entails problems and challenges of its own, and can only make a contribution to raising standards of conduct (and ultimately attitudes and values) in banking when combined with other tools including substantive behavioural standards, corporate governance requirements, and serious enforcement. Nevertheless the potential of the technique — changing the rules of the game for financial sector players by changing the structure of the rewards they may gain and the forfeits they may incur — as a means of changing behaviour warrants the substantial investment it will require. ■

Notes

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