Sabine Lautenschläger: Reintegrating the banking sector into society – earning and re-establishing trust

Speech by Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the Single Supervisory Mechanism, at the 7th International Banking Conference "Tomorrow's bank business model – How far are we from the new equilibrium", organised by Bocconi University, Milan, 28 September 2015.

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Introduction

Ladies and Gentlemen, esteemed audience,

First of all let me thank the organisers of this conference, and especially Andrea Sironi, for their kind invitation. I very much welcome this opportunity to elaborate on what I think are currently some of the most important questions in banking:

How can bankers regain the trust that was lost during the crisis?

How can the banking sector be reintegrated into society?

There is no doubt that banks, bankers and the whole industry are experiencing one of the worst crises of confidence ever. The turmoil of 2008 and 2009 played a major role in this loss of public trust, but the problem did not end after the most acute phase of the crisis. Even seven years later, confidence in the banking sector is still very low.

Numerous scandals, like the manipulation of LIBOR rates, large-scale tax evasion, the fraudulent behaviour of rogue traders, misconduct in the selling of mortgages, and large taxpayer bailouts of banks, have reinforced the perception that wrongdoing is widespread in the banking sector.

But mistrust is not only confined to banks themselves. Investors and clients also have less confidence in the correct functioning of the banking sector and in the ability of supervisors and regulators to prevent excessive risk-taking.

We should worry about this loss of trust in the banking sector:

- It impairs the proper functioning of banks to reallocate resources.
- It hampers growth.
- It leads to instability and costly crises.

In a recent paper, Gennaioli et al.[1] illustrated the role that trust plays in banking by comparing finance to medicine. Banking, is a service like healthcare, in which "transactions" take place between two parties that differ in terms of information, knowledge and technical competence. Patients put themselves in the hands of their doctor, and investors, like patients, would like to be in *good* hands and not be taken advantage of.

But how can trust in the banking sector be restored? Who are the key players in this process? Is it enough to reform the regulatory and supervisory framework, as we have done in recent years?

[1] See Gennaioli, N., Schleifer, A., and Vishny, R.W. (2015), "Money Doctors", *Journal of Finance*, Vol. 70(1), pp. 91–114.

Banks, intermediation and trust

Let me start by using a simplification of the activities of banks to explain why it is worthwhile investing in regaining trust. Traditionally, the core activity of a commercial bank is to take deposits from individuals who have a surplus of resources and to allocate those resources to productive activities. Banks thereby perform three main functions. First, they provide payment and settlement services to households, entrepreneurs, companies and other financial institutions. Second, they enable savers to reap the full benefits of long-term investments, while still being able to access liquidity when needed. Third, they assess and monitor the creditworthiness and payment behaviour of borrowers more efficiently than an individual investor could.

Through these activities, banks reduce the inefficiencies caused by asymmetric information and incentive problems between those who save and those who borrow. It is mainly via this channel, that banks create *value* and contribute to economic growth.

However, even though banks assess and monitor borrowers' creditworthiness, savers may still be concerned about whether banks – and their managements – have the necessary skills and will make the required effort to protect their savings. Asymmetric information and incentive problems are still present, but arise at new, different levels: no longer between savers and borrowers, but between savers, bankers and supervisors.

In the relationship between banks and their creditors, incentive conflicts may arise between managers on one side (who set the bank's strategy, make investment decisions and monitor the performance of investment projects and the payment behaviour of debtors) and shareholders and debt holders on the other side (who provide the bank's funding and who bear the ultimate risks and receive the benefits of the bank's activities).

Information problems may also occur among banks that are linked by mutual business relationships or collective vulnerabilities to systemic events.

Asymmetric information and incentive problems can be addressed through contracts, institutions and appropriate regulatory and supervisory frameworks. But this is a rather abstract and idealised view. In reality, more is needed: trust is needed.

The medical analogy is a handy way to illustrate this. Patients can always sue doctors for malpractice. They could always enforce the "contract" with their doctor. However, no patient will ever consult a doctor whom he does not trust, even though he can sue him.

The same applies to banking. In general, creditors will not deposit money in a bank whose integrity and soundness they do not trust.

Shareholders can set up remuneration schemes to incentivise managers whose activities they cannot monitor full time. But shareholders also need to trust their managers, because not all of their activities are perfectly contractible and, even if they were, it could be difficult and time-consuming to enforce the incentive contract in court.

At this point, one could interject that, while trust may have been essential for banking in the past, this is no longer the case today. Our economy and society have undergone dramatic changes in recent decades, which have also affected banks.

Innovation and technological progress have reduced the need for trust in some situations. Computerisation has allowed banks to use data-driven applications rather than rely on expert judgement for the evaluation of creditworthiness of borrowers or the pricing of financial products.

However, banks and their business have become much more complex than they used to be, which increases the asymmetry of information and, hence, the need for trust. For example, it is not now uncommon for banks now to have multiple parent-subsidiary structures operating in different jurisdictions across the globe. Some banking products have become so sophisticated that most people, even some bankers, no longer fully understand them. By the way, I expect every CEO or Board member to do without products which they do not understand. Today, banks are more complex to manage harder to monitor and their activities are more difficult to understand than was previously the case, and the asymmetric information and incentive problems I mentioned earlier are more prominent than ever.

In short, trust is and has always been essential for banks to carry out their activities, foster economic growth and add value to society. *Banking is and always has been trusting*.

What can be done to restore trust?

Given the currently low level of confidence in, and within, banks, what needs to be done to rebuild trust?

The role of regulatory reform

First, whose job is it to regain trust?

In the aftermath of the crisis, significant changes have been made in the regulatory and supervisory framework. Reforms of capital and liquidity regulation, risk management, governance and resolution regimes have been introduced. Moreover, consumer protection has been enhanced. The regulatory framework now has a better and broader base, and is less vulnerable to arbitrage.

While much has been achieved, I would like to highlight one piece of work in particular. Last year, the Financial Stability Board published a set of guidelines on supervisory interaction with banks on risk culture. The guidelines are aimed at assisting supervisors in their assessment of risk culture by listing a number of indicators or practices that can be indicative of an overall sound and well-balanced approach. These include an appropriate "tone from the top" within a bank and other key factors, such as accountability, effective internal communication, the existence of challenge mechanisms within the decision-making process, and incentives for employees.

Supervisors themselves have also changed since the crisis. They are now stricter, more pro-active and assess banks in a much more holistic way. Topics such as governance, remuneration and risk appetite are among the key priorities on every supervisor's agenda this year.

In the Single Supervisory Mechanism (SSM) for example, we are in the final stages of a thematic review of governance and risk appetite in the 123 institutions directly supervised by us which will feed into this year's assessments of the capital and liquidity adequacy of banks.

Our initial findings indicate that a number of banks, while meeting national requirements, do not comply with international best practices with regard to governance. Our key observations include examples of power concentration in individual board members (e.g. holding multiple offices or chairmanships within the same group), a lack of separation between a bank's risk and audit functions, information asymmetries among board members, and instances where the board simply does not take enough time to discuss and reflect on individual issues. It is also apparent that some banks are still in the early stages of implementing their risk appetite framework and therefore still have a lot of work to do to ensure its consistent application throughout the entire organisation.

All of these issues reduce the quality of decision-making and risk awareness within a bank and can obscure or even encourage malpractice. Therefore, we *will* require banks to follow up on these findings.

But are the efforts of regulators and supervisors enough? Can trust be rebuilt simply by having better and more credible rules?

Our finance-medicine analogy suggests that the answer to these questions is no. It is the doctor who holds the key to earning the trust of his patients. Likewise, rebuilding trust in the banking sector requires the active engagement of bankers and their stakeholders. Regulatory and supervisory reforms are necessary, but not sufficient to restore people's trust in banks.

My view is that, while regulatory reform and supervisory action were certainly necessary to lay the foundations on which banks can restore trust, regulators and supervisors are not the key players in this process. The main effort to regain trust must come from bankers, in particular from banks' management and their boards as the tone from the top as well as the accountability of banks' top management are key for risk culture and staff's behaviour. Without their active effort, society will not start to trust again.

The necessary process will be laborious and time-consuming; and it will not be one measure or action that does the job, but rather a complex mixture of governance, risk appetite, risk culture and behaviour from the top.

The role of banks and their stakeholders in restoring trust

So what must bankers do to rebuild trust?

First, bank's management should develop viable business models with a clear long-term perspective. Many of the recent crises have been the consequence of banks targeting high, but risky, short-term gains rather than pursuing lower, but more stable, long-term returns. Banks should refocus on their core functions:

- providing valuable investment opportunities to savers, while shielding them from liquidity risk, and
- providing funds to those who need them, while assessing and monitoring their creditworthiness.

Financial intermediation is not simply a way to garner revenues; it also supports economic growth and thus, ultimately, provides an important service to society.

Significant changes in the economic environment in recent decades have diverted banks from these core functions. It seems that the combination of an increased range of investment opportunities and funding sources, a trend towards more liberal regulation, and an increasingly competitive environment caused banks to reshuffle their priorities towards maximising short-term corporate and often also personal gain. The change in banks' business models from "originate to hold" to "originate to repackage and sell", which was the proverbial spark in the tinder box that set off the financial crisis, can be seen as a prime example of losing sight of the goal of maximising long-term value.

Second, a bank's management and board must have a sense of responsibility for developing the bank's individual risk culture, thus enabling it to deal with risk in a way that supports this long-term business perspective and fosters transparency and accountability.

Every bank needs a strong cultural base, which should embody the bank's essence and aspirations and embrace its role as a profit-oriented organisation without neglecting its relevance for the well-being of national economies and for the finances of both individuals and corporations.

- This strong cultural base should serve as a shared value framework throughout the organisation.
- On top of these foundations, every bank needs clear risk-taking policies, allowing it to reach its business objectives, while ensuring that risk-taking activities beyond the institution's risk appetite can be identified and addressed in a timely manner.
- To complement this, there must be clear governance arrangements defining processes and responsibilities for decision-making, risk management, control and audit.

- Lastly, a bank requires well-functioning communication mechanisms and IT systems to link the bank's decision-making, risk management and control organs together, to convey information to where it is needed, and to help create awareness and transparency about the bank's objectives, policies and values throughout the organisation.

Changing an existing culture and the way an organisation thinks about its business is clearly a major challenge. In particular, at a time when the banking sector as a whole is having to comprehensively rethink the values it embodies and the culture it lives.[2] Although some progress has been achieved recently, much more is still needed. In this context, I welcome the continued initiative of policy-makers to stimulate further progress in this area. For example, in May this year, the G-7 finance ministers and central bank governors urged the Financial Stability Board to begin developing a bankers' "code of conduct" to complement the existing guidance.

Third, banks' senior management and boards have to create adequate incentive schemes, including remuneration policies, to promote long-term perspectives within their organisation. We have witnessed too many scandals over recent years, too many cases of misconduct where responsible parties were not sufficiently held accountable. We have witnessed banks cooperating only reluctantly in criminal investigations, and we have seen interest groups rejecting outright any attempt to reform remuneration in the banking sector.

Regaining trust will not be easy. Bank managers must convince the public that they will reward socially beneficial behaviour, while unacceptable behaviour will be credibly sanctioned, up to the top.[3] Most importantly, people need to believe that managers will be truly responsible for the conduct of those who report to them.

To achieve a turnaround in public sentiment, those working in banks must believe in the value of sustainable business models and ethical behaviour. The tone from the top is key in this endeavour – the message must be that not everything that is legal is also legitimate and that the bank is only interested in legitimate business.

This may require a considerable revision of human resources policies, too.

- For a start, senior management could think about introducing new recruitment and training guidelines that indicate what sort of talent and personalities should be hired and how the bank's values should be taught to employees.
- A well-balanced combination of monetary and non-monetary incentives should be in place. Staff should have reasonable compensation and development options aligned with the behaviour they exhibit in implementing the bank's desired values and culture. Remuneration, performance evaluation and promotion systems should be calibrated in such a way that they reward client orientation, long-term value creation and sound risk management practices rather than short-term revenues. One possibility could be to extend even further the existing claw-back times for bonuses to discourage unacceptable behaviour, possibly up to seven years.
- Staff should face clear rules on responsibility, liability and integrity and be subject to proportionate follow-up or disciplinary measures in the case of infringements.

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[2] For a discussion on the role of culture in the financial industry and its interaction with monetary incentives in shaping behaviours, see Lo, A.W. (2015), "The Gordon Gekko Effect: The Role of Culture in the Financial Industry", *NBER Working Paper*, No 21267.

[3] On the importance of "cleansing" the sector of adverse practices and behaviours in order to "reintegrate" banks into society, see Hartmann, P. (2015), "Financial Reforms in Transition", in Evanoff, D., Haldane, A. and Kaufman, G. (eds.), *The New International Financial System: Analyzing the Cumulative Impact of Regulatory Reform*, Hackensack, NJ: World Scientific Publishing.

Last, but not least, the expectations of bank shareholders are critical and key to re-establishing trust. Their demand for higher returns puts pressure on banks and induces them to embark on risky business activities. Hence, efforts to restore trust cannot be successful without a corresponding change in attitude among shareholders. They must understand that there is no such thing as a “free lunch”. Properly adjusting for risk, shareholders may actually be better off when banks behave cooperatively and achieve a high level of trust.

The role of bankers’ self-interest

Having identified possible actions bankers can take to restore trust, an important question remains. Why should bankers ever take such actions? Is it in their own interest?

As I stressed before, trust is essential for the functioning of the banking sector. Without trust, banks cannot function properly. This not only has negative consequences for the rest of the economy, but also negatively affects banks themselves.

There are several channels through which a lack of trust negatively affects banks. First, it is a potential root cause of crises. Crises usually lead to a significant and often long-lasting contraction in bank profits, as can be seen, for instance, from the large drop in the S&P 500 index for the banking sector. Moreover, they are usually followed by an “aggressive” regulatory response to constrain banking activities.

Second, a lack of trust negatively impacts on the relationship between regulators and banks. The interaction tends to become more adversarial. Regulators become less willing to listen to bankers and to take their views on how to do business into account.

Third, a lack of trust in some banks and bankers usually translates into a negative sentiment towards the entire industry. This, in turn, has negative implications for business. Customers may leave, and it is more difficult to recruit talent. But this negative sentiment not only has repercussions for banks’ business prospects, it also affects the social standing of bankers, whose image is often tarnished in society.

Concluding remarks

Let me conclude.

The recent crisis is a stark reminder that *banking is trusting*.

The dramatic changes in the banking environment brought about by financial innovation and technological progress have not diminished the role of trust in banking. Any lack of trust significantly impairs the functioning of the banking sector and prevents banks from contributing to economic growth. A lack of trust also negatively affects banks’ business and profitability. It is in the banks’ *collective* interest to restore and preserve a high level of trust in, and within, the banking sector.

Rebuilding trust is a long and complex process. It certainly requires effort on the part of regulators and supervisors, and a lot has been achieved there.

But, ultimately, as the analogy with the trust between doctors and patients makes clear, most of the heavy lifting will have to be done by the banks – their senior managements, boards and shareholders – themselves. There is plenty that they can do and should be doing.