BANK OF ENGLAND

Speech

Remarks at the Banking Standards Board Panel "Worthy of trust? Law, ethics and culture in banking"

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It is a pleasure to host this Banking Standards Board event "Worthy of trust? Law, ethics and culture in banking" and to join this distinguished panel.

Over the past decade, banking has suffered twin crises of solvency and legitimacy.

The first is being addressed by comprehensive reforms. As a consequence, large banks are now stronger, more liquid, and more focused.[1]

This immense progress has been overshadowed by a crisis of legitimacy. A series of scandals ranging from mis-selling to manipulation have undermined trust in banking, the financial system, and, to some degree, markets themselves.

Multiple factors contributed to a tide of ethical drift.[2] Market standards were poorly understood, often ignored and lacked teeth. Too many participants neither felt responsible for the system nor recognised the full impact of their actions. Bad behaviour went unchecked, proliferated and eventually became the norm.

The economic consequences have been enormous. Global banks' misconduct costs have now reached over $320 billion – capital that could otherwise have supported up to $5 trillion of lending to households and businesses.[3]

But there is a bigger cost.

An industry the scale and importance of finance needs social capital as well as economic capital. It requires the consent of society in order to operate, innovate and grow.

Repeated episodes of misconduct have called the social licence of finance into question.

In a system where trust is fundamental it ought to be of grave concern that only 20% of UK citizens now think that banks are well-run, down from 90% in the late 1980s.[4]

[1] For example, their capital requirements have increased 10-fold. And in response these banks have raised over $1.5 trillion of capital in recent years.

[2] There are multiple root causes: (i) market structures presented opportunities for abuse and were vulnerable to conflicts of interest and collusion; (ii) systems of internal governance and controls were incapable of asserting the interests of firms – and society – over those of staff; (iii) compensation packages rewarded short-term returns and ignored long-term value creation and good conduct; (iv) and dearth of personal accountability.

[3] For misconduct costs see BCG report, "Global Risk 2017: Staying the Course in Banking, March 2017 http://www.bcg.com/publications/2017/financial-institutions-growth-global-risk-2017-staying-course-banking.aspx. Estimates of the impact on lending capacity are Bank of England calculations.

[4] British Social Attitudes Survey (2013).

From ethical drift to ethical lift

The scale of these shortcomings is why the Bank of England has been pursuing a series of measures to convert ethical drift into ethical lift. Domestically we are working closely with the Financial Conduct Authority (FCA) and HM Treasury. Internationally, we have catalysed a series of actions at the Financial Stability Board (FSB) that will be presented to the G20 Leaders' Summit in July.

Allow me to review the main elements before concentrating on how codes of conduct and the Senior Managers Regime (SMR) can lift standards and improve culture.

Let me be clear at the outset that the Bank of England holds itself to the highest standards. In that spirit, I will extend my remarks to review some lessons the Bank can learn from the events surrounding Charlotte Hogg's resignation, and the steps we are taking in response.

The UK Action Plan to improve conduct

Our action plan for the financial system begins with stronger deterrents. In the UK, important steps have been taken to strengthen laws and regulations, though some gaps remain, most notably in the FX market.[5] But authorities cannot and should not try to legislate for every circumstance, watch every transaction, or anticipate every market innovation. So while fines and sanctions have roles in deterring misconduct, they will not, on their own, bring about the cultural change we need.

We must move from an excessive reliance on punitive, *ex post* fines of firms to greater emphasis on more compelling *ex ante* incentives for individuals, and ultimately a more solid grounding in improved firm culture.

This includes reducing opportunities for bad behaviour, for example, by overhauling the regulation of key benchmarks in FICC markets.

More fundamentally, it requires compensation rules that align better risk and reward. In the UK a significant proportion of variable compensation now must be deferred for a period of seven years. This ensures that it can be clawed back over the time scales it generally takes for conduct issues to come to light.

To address the "rolling bad apples" problem, mechanisms are now in place in the UK to ensure that when individuals move on their history will be known to those who consider hiring them.[6] The FSB is now considering whether to adopt such an approach more broadly.[7]

[5] The UK's Fair and Effective Markets Review (FEMR) recommended that the EU's market abuse regulation should be extended to cover every major fixed income and currency market, that criminal sanctions be updated, and maximum prison terms extended. See: http://www.bankofengland.co.uk/markets/Pages/fmreview.aspx

[6] The PRA has introduced requirements for regulated firms to provide employment references to one another in a mandatory template when hiring Senior Managers. This includes information on an individual's conduct record, and their fitness and propriety.

This is all constructive but insufficient. That's why we have emphasised measures to ensure firms and their employees take responsibility – individually and collectively – for their own conduct. These range from securing compliance with minimum standards to a common and dynamic understanding of good practice that is widely understood and collectively enforced.

UK authorities have used their convening powers to encourage market participants to establish standards of market practice that are well understood, widely followed and, crucially, that keep pace with market developments.

This is what the Banking Standards Board is doing by promoting higher standards of conduct and competence across the UK banking system. It's why the global FICC Market Standards Board (FMSB) is establishing readily understood standards for their markets. And it's why the FX Committees will launch in May the first globally consistent code of conduct for FX markets.

But codes are of little use if nobody reads, follows, or enforces them. This is where the UK's Senior Managers Regime comes in.

Senior Managers Regime

The SMR addresses the common refrain of senior management that they weren't aware that misconduct was taking place in their firms. The SMR sets a series of requirements for the most senior decision-makers of banks, building societies and major investment firms.

The SMR re-establishes the link between seniority and accountability. Senior Managers are now held accountable if they fail to take reasonable steps (including training or proper oversight) to prevent or stop regulatory breaches in their areas of responsibility.[8]

And the SMR prescribes responsibilities – typically to the Chair and CEO respectively – for developing and embedding a firm's culture.

Under the related Certification Regime, firms must also annually assess and certify the fitness and propriety of a wide range of risk-taking employees.

Although the SMR is only a year old and we are all learning by doing, there are encouraging signs that it is making a difference.

[7] See FSB press release at: http://www.fsb.org/2017/02/fsb-assesses-implementation-progress-and-effects-of-reforms/. Additionally see FSB "Stocktake of efforts to strengthen governance frameworks to mitigate misconduct risks", forthcoming March 2017.
[8] The SMR came into effect on 7 March 2016. Insurers are required to meet similar standards under Solvency II and in future, the SMR will apply to them directly, as it will to other participants in FICC markets.

For firms, the SMR is clarifying and improving governance, accountability and decision-making processes. Senior Managers are increasingly focusing on building cultures of risk awareness, openness and ethical behaviour. In the words of one chairman "responsibility for culture has moved to the top of my agenda."[9]

For supervisors, the regime is helping identify weaknesses in governance and accountability, and encouraging the necessary changes. This is particularly true in cases where authority has historically been blurred such as in cross-border banking.

Adoption is spreading. Some international firms are voluntarily adopting elements of the SMR's certification requirements to strengthen their global operations. And the FSB is now explicitly reviewing the merits of such "responsibility mapping".[10]

Recent events

The SMR has also been adopted by the Bank of England.[11] We chose to because our mission demands that we hold ourselves to the highest standards of governance and accountability.

One of our colleagues did not meet these high standards recently. Our newly appointed Deputy Governor for Markets and Banking, Charlotte Hogg had previously not disclosed a relevant family relationship, as was required under our staff Code of Conduct.

For those who have questioned whether we "get it", we do. We know this honest mistake was also a serious mistake – one that was compounded by the fact that Charlotte Hogg had overseen the development of our new Code.

We were clear upfront that there must be consequences for both her and the Bank.

Our minimum response would obviously be what we would expect to see in the firms that we supervise. Let's be absolutely clear about this baseline. In analogous situations in the private sector, we expect:

- Evidence that the firm is taking the matter seriously;
- Proportionate consequences for the individual, including some form of disciplinary warning and possibly some impact on remuneration; and
- A wider review of lessons learned if there was any evidence that there was a systemic problem.

[9] See page 16, Financial Reporting Council (FRC), "Corporate Culture and the Role of Boards: Report of observations", July 2016.
[10] See Footnote 7 for details.
[11] With appropriate modifications to reflect the fact that it has a very different range of functions to a commercial bank and is accountable to a different range of stakeholders, including Parliament. For further details see: www.bankofengland.co.uk/about/Documents/smr.pdf

Now consider the Bank's response to Charlotte Hogg's case:

- She was formally warned in the strongest – and most public – of terms.
- There were consequences for her compensation. While she couldn't forfeit a bonus as Bank of England Governors cannot receive one, she waived her salary increase this year.
- Court reassigned her COO responsibilities.
- Court reconfigured reporting lines and internal structures in order to improve governance, compliance and disciplinary processes, including reassigning the SMR responsibility for implementing our Code.
- And, on the basis of this one incident, the independent directors of Court have initiated a widespread review that will draw on the expertise of the Independent Evaluation Office, Internal Audit and the National Audit Office. Its results will be made public.

In other words, consistent with our higher standards, the Bank planned a tougher response than we would expect in the private sector, but one that, in our judgement, was still proportionate to an honest mistake that was freely and transparently admitted.

The Treasury Select Committee (TSC) reached its own judgement, which in turn triggered Charlotte Hogg's decision to resign.[12] I fully respect both the TSC's judgement and her decision.

I wanted to speak to this, not to continue the debate about the rights and wrongs of this case, but instead to highlight some of the lessons that the Bank and industry might draw from it.

In particular, I want to dispel the urban myth that has developed around these events. While the Prudential Regulation Authority (PRA) can impose financial penalties and suspension under the SMR, we do not run for our regulated entities a disproportionate "one strike and you are out" regime for an honest mistake. Neither explicitly nor implicitly. Not I as Governor, not the CEO of the PRA, not the head of the FCA. Not any of our supervisors in the PRA.

The SMR is about clear responsibilities, proportionate consequences, and developing a culture of openness and accountability.

Proportionate means taking into account the severity of the incident, the track record of the individual and their firm, as well as the firm's wider response. An honest mistake that is freely admitted for which a firm takes prompt remedial action is not a firing offence.

And here's my point: we must not let recent events inadvertently tighten perceived standards for the industry because that could have Senior Managers running scared, drive compliance underground and undermine

[12] For TSC report see: https://www.publications.parliament.uk/pa/cm201617/cmselect/cmtreasy/.../1092.pdf

our collective objectives. Another risk, flagged by some, is that it will also become harder to find candidates of sufficient calibre willing to take on senior roles.

This is why last week I spoke with the CEOs or Chairs of all of the major banks to reiterate our expectations as regulator. I'm glad I did because they were all concerned about precisely such unintended consequences.

The best in the industry are committed to making the SMR work – not because they have to – but because a regime with clear responsibilities, proportionate consequences and a culture of openness helps to build the culture that will over time help regain trust for the industry.

Conclusion

Changes to incentives, new codes and a clearer mapping of responsibilities will all help improve conduct and lay the groundwork for better culture.

Of course, integrity can neither be bought nor regulated. Even with the best possible framework of codes and principles, the soundest compensation schemes, and the most committed efforts to improve transparency, financiers – in both the public and private sectors - must consistently challenge themselves and the standards they uphold.

We are seeking to raise expectations and norms by using a combination of hard and soft law, with much of the latter developed by the private sector. The best view finance as a profession with a purpose to serve their clients. They see themselves as custodians of their institutions, with a sense of responsibility for the system.

Cultural change takes time. We know this from our own efforts. We have made great strides under our 'One Bank' strategic plan. Two-thirds of staff now feel encouraged to try new ideas, three-quarters indicate that their managers act on their suggestions, and 60% are comfortable speaking up on an important issue. All of these metrics have significantly improved in the past few years.[13]

We have comprehensively overhauled our governance, openness and accountability in recent years.

With the arrival of Anthony Habgood as Chair, Court has been strengthened and now acts as a unitary board and meets the best practice found in the private sector. Its independent members now have more tangible influence on the Bank, including through formal powers to observe the meetings of the Bank's policy committees and to commission independent reviews into the Bank's performance. Its minutes are now published after a lag of six weeks rather than a hundred years. It regularly releases reports on matters of

[13] 'Reflecting diversity, choosing inclusion' speech given by Mark Carney, 9 February 2017

concern ranging from policy, such as economic forecasting, to conduct, such as the Grabiner report into the FX market.[14]

We know we have more to do.

That's why the independent non-executive directors are reviewing the Bank's response to recent events.

That's why our next strategic plan will focus to even greater degree on changing how we work. To maximise the potential of our people, the Bank needs to embrace fully collaborative working in diverse teams that value robust debate.

And it will focus on improving how we communicate, both internally and externally. We want all our colleagues to feel empowered to raise issues promptly, to challenge and to voice any concerns they have.

These initiatives will help us build the trust that is crucial to delivering our mission. And they will help us merit that trust by making us more effective.

The Bank will learn the lessons of these unfortunate events and apply those lessons to reinforce what's best in banking and the Bank of England.

[14] For details of recent Court reports see: http://www.bankofengland.co.uk/about/Pages/ieo/default.aspx. Additionally, see Grabiner, "Bank of England Foreign Exchange Market Investigation", 2014, at: www.bankofengland.co.uk/publications/Documents/news/2014/grabiner.pdf