Ravi Menon: Building a culture of trust in the financial industry

Opening address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Monetary Authority of Singapore-Singapore Academy of Law Conference, Singapore, 23 January 2015.

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Chief Justice Sundaresh Menon

Justice Steven Chong

Mr Timothy Massad, Chairman, US Commodity Futures Trading Commission

Distinguished guests, colleagues, ladies and gentlemen,

Bad behaviour in finance

Six years ago, the Global Financial Crisis tipped national economies into recession and brought to their knees some of the most hallowed names in the financial industry. But the biggest casualty of the Crisis could well be trust:

- trust between regulators and financial institutions;
- trust among financial institutions; and
- trust that the public places in the financial industry – that their bankers are honest and their financial advisors are acting in the best interest of their clients.

And six years after the Crisis broke, the global industry continues to be dogged by shocking revelations of financial malfeasance, mis-selling, and dishonesty.

- In the US, large banks are paying billions of dollars to settle charges against them for mis-selling mortgage-backed securities which led to massive losses for their buyers.
- In the UK, over 13 million complaints have been made against retail banks for the aggressive mis-selling of so-called Payment Protection Insurance (PPI).
- We read of traders in banks circumventing internal rules to make outsized market bets that subsequently resulted in large losses for these banks.
- And in financial centres across the world, including Singapore, regulators have uncovered attempts by traders at several major global banks to manipulate key financial benchmarks used to set rates for loans and foreign exchange contracts.

Little wonder that global surveys show that levels of trust in the financial industry are lower than ever.

- According to Edelman, a public relations firm, banking and financial services ranked last among 15 industries that the public trusted "to do what is right".[1]
- In countries most affected by the financial crisis and its aftermath, levels of trust are lower still – barely 30% of the public in Europe trust their banks.

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1 Edelman Trust Barometer, 2013 and 2014.

Why trust is critical to finance

Financial products and transactions can be quite complex and information asymmetries often place financial institutions in a more advantageous position compared to their customers.

- Trust that the bank is sound is critical for savers to keep their monies in bank accounts and for borrowers to make long term investment decisions.
- Trust that financial advisers and insurance agents are dealing fairly is important for consumers committing large portions of their savings for a long period of time.
- Trust that asset managers and investment brokers are acting in the clients' interest and not front-running them is key to the investment process.

The licensing and regulation of financial institutions confers a degree of legitimacy on them. But being a bank, an insurance company or a capital markets intermediary is not just about holding an official stamp to collect and manage funds.

- As Mark Carney puts it, financial institutions also need a social licence to operate.[2]
- They earn this social licence through a track record of exemplary conduct and a reputation for integrity and prudence.
- Their obligations towards their customers and counterparties must be based on not just a contractual obligation but a moral one as well.

Getting the culture right

What accounts for the repeated cases of misconduct in the global financial industry? Weaknesses in governance, risk management, and operational controls have allowed unbridled risk-taking and encouraged some individuals to push, and in several cases, break the bounds of what is permissible. Since the financial crisis, the international regulatory community has issued directions and guidance to tighten financial institutions' governance standards and curb excessive risk-taking.

But weaknesses in governance and control, grave as they were in some financial institutions, cannot fully account for the spate of misconduct. There are deeper issues of trust, ethics and culture in the financial industry that we need to confront.

First, finance is at risk becoming more "de-personalised". Long-term relationships with customers are being replaced by more transient transactions with counterparties.

- Raghuram Rajan observes how increasing product complexity and reliance on technology has created a detachment from the customer.
- It ultimately leads to a reductionist view of finance where "money is the measure of all worth", a state that is hardly conducive for ethical conduct.[3]

Second, compensation structures tend to over-emphasise profits as performance measures. Excessive focus on sales targets and commissions has incentivised a "trading mentality" which is often associated with too much risk taking or scant regard for client interests or the sustainability of relationships.

Third, and more fundamentally, departures from ethical conduct are too easily tolerated as the norm.

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[2] Mark Carney, "The Future of Financial Regulation", MAS Lecture, Singapore, 2014.

[3] Raghuram Rajan, "Where Money is the Measure of All Worth" in Fault Lines: How Hidden Fractures Still Threaten the World Economy, 2010.

- In a global survey of financial sector executives by the Economist Intelligence Unit, more than half the respondents felt that their career progression would be difficult without being "flexible on ethical standards".
- If you look at the email and chat room messages between traders involved in the rigging of financial benchmarks, they betray a lack of any sense of guilt or wrong-doing.
- In fact, traders were congratulating and complimenting each other on their manipulation.
- And when subsequently questioned by their superiors or regulators, they offered an array of self-justifications, chief of which is "everybody does it".

But everybody does not do it. I believe the vast majority of people working in the financial industry are committed to serving their clients or customers fairly and with integrity. But the unethical actions of a few have undermined trust and created instability.

Reform of the financial industry will not be complete until this issue of trust and ethics is addressed. This requires "getting the culture right". And by culture, I mean the shared values, attitudes and norms that guide actions.

There is increasing international regulatory guidance to improve risk governance and align compensation schemes with long-term sustainability and customer interests. This is necessary but not sufficient. There are limits to what externally imposed rules can do to promote the right values in financial firms.

- Because culture develops from within a firm, it invites a certain resonance from the members of that firm – in a way that will be difficult for an externally imposed set of rules to achieve.
- For the same reason, the behavioural norms that a firm's culture and value system promotes are more amenable to internal governance and self-policing than rules that rely on external enforcement.

In short, rules tell us what we can do, but values tell us what we should do. A mechanistic compliance with rules cannot be an adequate substitute for an internalised sense of responsibility and basic morality that a finance professional owes to his client or counterparty.

How can we build a culture of trust and strong values in the financial industry? We need an ecosystem to do so – with a role for regulators, the industry, and most important, the firm itself.

What can regulators do?

First, the role of regulators. The international regulatory community has been intensifying efforts to ensure that financial institutions foster a sound risk culture and conduct themselves in a prudent and socially responsible manner. But instituting a good risk culture is not merely about slapping on more rules or adopting a perfunctory, checkbox approach to compliance.

MAS therefore takes an intensive supervisory approach to risk governance and culture in financial institutions. We prefer this to an overly prescriptive regulatory approach based on one-size-fits-all rules that may be less effective in addressing idiosyncratic risks. Financial firms differ widely in goals, activities, and culture.

Instead, close supervision – consisting of both onsite inspections and offsite reviews – provides MAS with a good view of a firm's risk governance and culture and practices on the ground. This allows us to assist the board and management in identifying emerging areas of vulnerabilities and to take pre-emptive corrective actions where necessary. Let me cite two areas we focus on: compensation and fair dealing.

Compensation is an important mechanism to shape incentives and behaviours. Compensation structures must motivate not only high performance but also high ethical standards.

- Some jurisdictions have placed restrictions on bonus payments – how much can be paid or over how long a period.

MAS has put in place rules and guidelines that are consistent with the Financial Stability Board's principles for sound compensation practices. They require the compensation of a bank executive to be aligned with not only the risks that the bank undertakes, but the time horizon of those risks. But we have chosen not to cap bonus payments or be overly prescriptive in our rules. Such measures may have unintended consequences or could be easily circumvented.

Instead, MAS has stepped up its supervisory intensity of financial institutions' overall compensation policies and practices.

- We assess the effectiveness of the firm's compensation system, its relationship with the firm's governance framework, and its impact on risk-taking behaviour.
- We intend to conduct deeper-dive reviews, to examine how a firm makes compensation decisions in practice, as well as the extent to which the firm's board and management deal with issues relating to compensation and risk culture.

A second area of focus is fair dealing: are firms dealing fairly with customers? MAS has issued guidance on fair dealing principles and outcomes that financial firms should achieve.

- We assess whether the board and management have put in place initiatives to foster a corporate culture of fair dealing.
- We evaluate the processes in place to ensure that clients and customers are offered products and services that suit their needs.
- We monitor the volume of customer complaints of mis-selling and examine how complaints are dealt with.

What can industry do?

But even the most intrusive supervision can only go so far in promoting a culture of ethics. The industry must itself take collective responsibility to promote higher ethical standards. It is better that industry develops codes of good conduct that take into account operational realities that they know best and that holds firms accountable to their peers, than wait for the regulator to set rules that may be impractical or too onerous.

The industry has already begun to do so.

- In the UK, high street banks have set up the Banking Standards Review Council (BSRC), which aims to work with the industry to improve banking practices in three broad areas: culture, competence and customer outcomes. Participating banks will be required to commit to a programme of improvement and report to the BSRC on their performance every year.
- In the Netherlands, the Dutch Banking Association is exploring plans for a disciplinary system for ethics violations, similar to what the medical profession is subject to.

I am pleased to note that in Singapore, our industry associations have not lagged behind.

The Association of Banks in Singapore (ABS) has published guidance for its member banks and minimum service standards that customers can expect from their banks.

- The Code of Consumer Banking Practice commits member banks to treat their customers “fairly and reasonably”.
- A separate Private Banking Code of Conduct sets out standards for financial advisors, not only for professional competency but ethical conduct as well. The Singapore Foreign Exchange Market Committee (SFEMC), an industry association of major foreign exchange market participants, has published a guide to conduct and market practices for treasury activities. More commonly known as the Blue Book, the guide has recently been updated with instructions on the governance, requirements on professional conduct and best practices for participants in benchmark rate settings.

The industry could consider going further in promoting and reinforcing ethical standards and good practices:

- Industry may want to consider a mechanism or process by which firms could be benchmarked against and held accountable to industry standards on ethical behaviour and professional conduct.
- Industry may also want to conduct periodic surveys on stakeholders’ views on risk culture, governance, and market conduct, to help identify potential blind spots and emerging areas of risk.

What can firms do?

But ultimately it is the financial institution that must bear responsibility for getting the culture right. This requires setting the right moral tone from the top. Many financial firms have issued values statements and codes of conduct espousing principles, norms and behaviours that apply universally across the firm. It is important to have such a tangible point of reference for standards of conduct, but setting the right tone requires more than lofty exhortations for good behaviour.

First, lead by example. Management must take time and effort to clearly articulate the firm’s core values and purpose. They have to demonstrate commitment and credibility by “walking the talk” with concrete policies, processes and actions. The firm’s leaders must themselves be seen to be guided by those same qualities they want their staff to emulate. And programmes to build a culture of trust and ethics cannot be a one-off exercise to fend off bad publicity or to placate the regulator. Shaping culture demands a sustained effort.

Second, create a safe environment for whistle-blowing. This means providing the necessary mechanisms to challenge, question, and report ethical breaches.

- A number of banks in Singapore have put in place new channels for whistleblowing and enhanced the escalation and investigation processes to facilitate staff reporting.

Third, align human resource policies to a culture of trust and ethics. I have already mentioned compensation as being an important way to create incentives for the right behaviour. But the incentives for ethical conduct must go beyond compensation and encompass all HR policies: recruitment, on-boarding, appraisal, training and coaching, promotion, and career development.

- An organisation’s HR policies and practices are the clearest demonstration of its value system, the qualities it regards as important.
- In financial firms, it is important that these policies and practices dispel the perception of good ethics as a constraint on profitability or hurdle to career advancement.

We are beginning to see some progress.

- Performance appraisals in some banks now take into account how an employee's conduct is consistent with the banks' avowed principles and values.
- Others have developed balanced scorecards for remuneration that go beyond traditional measures of financial performance to include indicators relating to culture and controls.
- Yet others take into account a business unit's record on compliance, customer experience, internal audit findings and other relevant considerations to underscore the organisation's behavioural expectations of staff.

Conclusion

Let me conclude.

The global financial industry's standing with the public is at an inflection point. It could continue a downward spiral of mistrust with yet more egregious misconduct, or it could seize this opportunity to restore high ethical standards.

Thankfully, we are in a better place in Singapore. The financial industry here is generally well regarded and trusted. But we have not been immune to some of the egregious practices in global finance, for example, attempts to manipulate financial benchmarks and the mis-selling of financial products. We must be on our guard, and work to further strengthen ethical standards and a culture of trust in the industry.

- We must foster a culture in the industry that looks beyond the question "is this legal?" to the larger question "is this right?".
- For without sound ethics, there can be no trust. Without trust, there can be no confidence. And without confidence, there can be neither growth nor stability.

We are gathered here to discuss the future of financial market regulation. May I suggest that restoring a culture of trust based on strong ethical standards is imperative to securing a bright future for a purposeful financial industry.

Thank you and I wish you all fruitful deliberations.