Luís Máximo dos Santos: Banking conduct supervision - new challenges 10 years after the financial crisis

Closing address by Mr Luís Máximo dos Santos, Vice-Governor of the Bank of Portugal, at the Conference on "Banking Conduct Supervision: new challenges 10 years after the financial crisis", hosted by the Bank of Portugal, Lisbon, 25 September 2018.

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Allow me to begin my address by greeting and thanking the following for being present: the Minister of State, Pedro Siza Vieira; the Chairman of the Committee on Budget, Finance and Administrative Modernisation of the Portuguese Parliament, Teresa Leal Coelho; the Chairman of the Portuguese Insurance and Pension Funds Supervisory Authority, José Almaça; the Vice-Chair of the Portuguese Securities Market Commission, Filomena Oliveira; and the chairs and directors of the financial institutions represented. I also give my heartfelt thanks to all the speakers for having accepted Banco de Portugal's invitation to join us at this Conference and enrich it with their excellent speeches.

I would also like to give a special mention to those participants from central banks, banking conduct and government authorities of other countries, namely South Africa, Germany, Belarus, Brazil, Croatia, Spain, Italy and Malta. We are very pleased to have welcomed you. I hope that the work of our Conference has corresponded to your expectations and permit me to assume that it has, given the exceptional quality of the interventions.

Ten years ago, the world was plunged into a major financial crisis centred on the United States and Europe. It has been considered the greatest economic and financial crisis since 1929. This time international cooperation and the actions taken by public authorities, namely central banks, prevented the onset of a Great Depression like that of the 1930s.

However, we did not escape a Great Recession which had tremendous consequences at an economic and social level, seriously affecting the lives of many millions of people and the effect of which are still felt today.

Also ten years ago, the Portuguese legislator – by way of Decree-Law No 1/2008 of 3 January 2008 – recognised that the legal framework hitherto in existence was clearly insufficient to adequately protect the interests of bank customers. The new legislation was designed to enable more active intervention by the supervisory authority, aiming to reinforce powers of oversight, decision and sanction. Quoting the preamble of the aforementioned decree-law, it enshrines "conduct supervision of the credit institutions and financial companies, within the framework of the powers of Banco de Portugal, providing the latter with the competences that enable it to carry on effective action to ensure compliance with conduct regulations, be it via out-of-court procedures or customer complaints."

But this Conference was not intended to mark past events regardless of how important they may be.

As we all know, the Conference programme is aimed at the problems of the present and near future and the new challenges they create. Its main objective is to reflect on these challenges collectively, obtain the contributions of players in other experiences nationally and internationally, some of whom do not necessarily have coinciding interests or points of view, but who – I am sure – share the common objective of contributing to a market in retail banking products that is efficient and innovative as well as characterised by a high level of compliance with consumer rights.

If it is true that this Conference does not aim to commemorate past events, it would be very unfair on this occasion not to pay recognition to the teams that, under the leadership of Lúcia Leitão, ensured Banco de Portugal's mission of banking conduct supervision, and which became a separate department in 2011. It is worth highlighting that this role is exclusively carried out at the national level, which makes it even more important.

As we know, the financial crisis profoundly shook the confidence of society in general in banking institutions. This meant that the essence of the business of banking itself was affected. Restoring confidence in the financial sector therefore became a public priority, taken up by political actors, regulators, supervisors and of course by the institutions themselves.

A great many of the problems resided precisely in the existence of serious shortcomings in the conduct of institutions with their customers; the result of unsuitable or inoperative governance systems and a deeply wrong institutional culture.

In fact, the crisis came to expose the risks faced by bank customers even more clearly, especially at the level of credit, and the consequence of such risks to the financial system and economic activity in general.

The acquisition of products unsuited to customers' risk profile and financial capacity, especially in terms of mortgage credit, generated a significant number of default situations, with a strong impact on households' economic situation and the quality of financial institutions' asset quality.

Retail banking products, traditionally simple and easy to understand, grew in complexity, incorporating characteristics that increased their risk, making them more difficult to understand and assess, thus accentuating the asymmetry of information between customers and institutions. In a context of greater access to credit by households and the management of their savings through the banking markets, exposure to these risks and their effects became even more dangerous.

The financial crisis and its consequences made it inevitable that these issues took on great importance in the agendas of legislators and supervisors. Their discussion was intensified in various international fora, leading to the systematisation of recommendations as to which best practices should be adopted in the sale of banking products and the preparation of regulatory legislative initiatives.

This additional regulation has led to a process of change in the scope of intervention and way in which the retail banking market supervisor acts, with frequent discussion of the transition to a new paradigm in conduct supervision.

In this new paradigm, as well as the traditional concerns related with the transparency of information and conduct obligations that the institutions are obliged to observe in their relationship with customers, banking conduct supervision intervenes in new areas.

The conduct supervisor acts upstream in the contracting process, by assessing compliance with the internal procedures adopted by the institutions within the scope of the creation and distribution of banking products and services, guaranteeing the suitability of such products and services and their chosen distribution channels, to the characteristics, needs and aims of their respective target markets.

Rules have been created for the institutions to implement approval and monitoring mechanisms for the remuneration policies of their employees involved in the preparation, sale and granting of mortgage credit and the credit intermediaries with whom they have contracts, aiming to prevent the occurrence of conflicts of interest.

Complementarily, specific knowledge and skills requirements have been established which the aforementioned staff must possess. These aim to ensure that, in addition to the information that is provided to bank customers, the institutions' employees possess a level of knowledge and skills that enable them to provide the required information to customers so that the latter understand the characteristics and risks of the products they aim to contract.

At another level, and considering the impact of their role in the credit market, the supervision perimeter of credit intermediaries has also been widened through the regulation and supervision of their activity through the recognition of the importance of their role in ensuring the responsible contracting of credit.

From 1 January 2018, credit intermediaries have been included in requirements for access to and the exercise of credit intermediation as well as duties of conduct and provision of obligatory information to consumers.

In parallel, the promotion of financial education has been recognised as an essential component in conduct supervision action, aiming to guarantee in the medium term, a public more empowered to make financial decisions. It is not enough to act from the product supply side. It is also necessary to act from the demand side.

Accompanying this evolution, the conduct supervision strategy adopted by Banco de Portugal is based on three vectors, which constitute the themes of this Conference's panels:

- **(i)** The regulatory framework that covers and regulates the conditions to sell the products and services of retail banks;
- **(ii)** The requirement for institutions to comply with this regulatory framework, through oversight and the promotion of best practices; and
- **(iii)** The financial education of bank customers.

Ten years on from the financial crisis, it is evident that the conditions under which banking conduct supervision is carried out are profoundly different.

The regulatory framework has been greatly reinforced, requiring a more intrusive and complex supervision. There is a new regulatory approach that grants supervisors a greater margin of discretion in their activity, contrasting with even greater responsibility and level of demand. Public scrutiny is also more intense.

However, even more important is the fact that all this has taken place in a context of profound and accelerated transformation of the retail banking markets thanks to technological innovation and a multiplication of marketing channels.

The progressive digitalisation of the commercialisation channels of retail banking products and services has brought about new products and services, frequently through new entities, and new business models.

The growing supply of financial products and services online or through mobile applications, the entry of new actors in the market (such as fintechs or social media companies), as well as the use of new technologies (blockchains and big data) are not only changing the relationship companies have with their customers as creating new challenges for supervisors.

It is important to highlight that the new technological tools can and should also be used as a facilitator of regulatory compliance, thus reducing their cost to the institutions.

In reality, supervisors have to give themselves the human and technological resources necessary to undertake effective supervision in a digital environment. Only then are they able to promote trust in the use of digital channels and contribute to a responsible supply by institutions. It is fundamental that either the marketing of innovative banking products and services, or that carried on in an innovative mould, does not jeopardise compliance with the regulatory framework or leave the bank customer unprotected. Guaranteeing security is perhaps the greatest challenge because of the difficulties it creates and for being a decisive factor in creating confidence.

It is not difficult to recognise that the current stage of the financial sector's development is extraordinarily demanding for banking institutions; so many are the challenges to be overcome: some the result of a past we all want to leave behind, others the result of a future that arrives every day. Knowing whether current regulatory measures are right or whether they are overzealous is a legitimate discussion and will always result in contradictory conclusions.

According to a famous aphorism, "If you think that education is expensive, consider the cost of ignorance!" I believe that the same logic can be applied to regulation: it is true that it has costs that are sometimes very high, but an absence of or insufficient regulation can have a much higher cost, as the 2008 crisis demonstrated, in the first place to the banking institutions themselves.

Is it better to pay the costs necessary to comply with more demanding regulation or carry the costs – no less elevated – with sanctions, litigation, loss of reputation and business?

The strongest argument that the banking sector can provide in favour of reducing the intensity of regulation is that the sector itself takes on an unequivocal commitment, perceived as such by the customer, to adopt a culture oriented towards regulatory compliance and customer satisfaction.

The culture of an institution must be rooted in exemplary management, valuing and rewarding suitable behaviours and penalising incorrect ones. Simple things that are in reality sometimes difficult to achieve.

Institutional culture is an immaterial concept which cannot be regulated. It must be understood as a central priority and not as an impressive adornment. It must be absorbed and seen as natural. It must be carried out systematically and coherently. It must be implicit in the business plan. And it must be extended, without exception, to every area of the institutions, as we all know examples of inadequate sectorial conduct that in itself led to collapse. It must be considered for the specificities of the institution. Therefore, despite the similarity between these proposals, institutional cultures do not have to be identical.

A strong institutional culture, based on solid values, protects banks, including from failures in governance. It can even be considered a risk reduction mechanism.

The creation of an institutional culture is a task for the boards of banks and not for regulators and supervisors, although they can have a supporting role in creating a suitable culture.

Changing the culture of an institution is a difficult, long-term task. An old Dutch adage says that trust arrives on foot but leaves on horseback. It is even worse these days: trust can be lost at digital speed, but for it to return, it continues to take a long time.

Conduct failings are obviously not exclusive to the financial sector. The problem is that the consequences are more damaging.

Ten years after the financial crisis, the most enlightened protagonists from the financial sector have understood well how conduct failings can be costly at various levels. This is why it is in their interest and that of the institutions they manage to travel unambiguously towards recovering trust and rejecting the culture that was the basis for the 2008 crisis.

We all hope that this happens as we will all benefit. There cannot be economic development without a strong banking sector. The proof of this is precisely what happens when it fails.

We are therefore following a common path from different positions. To be successful each of us has to complete their mission. On behalf of Banco de Portugal, I reaffirm our total commitment to fulfilling the public mission entrusted to us.

Thank you very much.