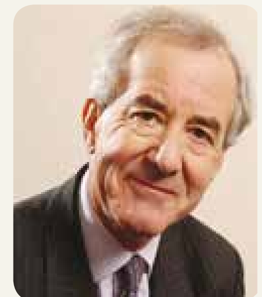
Conduct, culture & compliance

How does the FCA plan to regulate conduct, and how should conduct be evaluated? **Garry Honey** and **John Thirlwell** consider the questions raised by the new regulatory architecture



The FSA will divide in April 2013 into two distinct supervisory bodies: the Prudential Regulatory Authority (PRA) and the Financial Conduct Authority (FCA). Since April 2012 the FSA has been planning for this split through operating a "twin peaks" regulatory approach, so the transition should be almost seamless. The role of the PRA is fairly clear cut: it concentrates on prudential regulation. However, the FCA is an experiment in "outcomes-driven" supervision, which will be an interesting challenge. There are three key questions this new regulatory body prompts. What do we mean by "conduct"? How does the FCA plan to regulate this? How should conduct best be evaluated?

What do we mean by conduct?

What is "conduct" and what should it mean to a compliance officer? Conduct is the way we behave as individuals and as groups of individuals, whether bundled under department, region or company name. Institutionalised behaviour is what we often call "culture". Behaviour and culture are like the chicken and the egg: it doesn't matter which came first. Conduct is what organisational behaviour specialists study to understand our response mechanism to given stimuli. For example, a sales-driven culture relies on rewards from incremental sales; it is not focused on service quality or customer protection, it is focused on commission.

Conduct is more than just protecting customers from over-zealous selling activity. Conduct is about behaviour as it impacts policy. For example, evidence is emerging of lucrative and secretive revenue generating activity by banks which is not strictly illegal, but politically embarrassing. At least one major bank had a "tax avoidance" department. This raises the question of whether it is right to deny HMRC income through complex offshore vehicles whose only purpose is to minimise tax. The governance structure of international firms makes this legal but is it something the FCA will consider worthy of a "thematic review" of conduct?

Conduct inevitably has a moral dimension, and thus it demands an understanding of ethics. Many corporations think their conduct is acceptable if it is not illegal, yet some conduct – like, for example, selling pay day loans at 4,000% interest – is morally indefensible, especially where it exploits the poor and vulnerable. It could be argued that if demand exists for loans then in providing these when other lenders won't take the risk you are meeting market demand and not exploiting customers. This is where it helps to have a robust definition of "acceptable conduct" in order for a regulator to penalise the unacceptable.

For those steeped in a sales culture, the watchword is "caveat emptor": buyer beware. In other words if the customer is stupid enough to buy something he doesn't need or can't afford then that is his problem. For many engaged with selling, a regulator trying to protect buyers is just interfering with human nature. It is one thing to protect the vulnerable buyer (or perhaps "mug punter"?) from a rapacious and unethical salesman, but who then protects the buyer from himself and his own stupidity? Where should it end?

The conduct of a sales culture is single-minded. Risk appetite is generally quite high and sales figures dictate the level of bonus. It is ultimately an unsustainable culture and once buyers desert the marketplace it must transform itself. Typically this will be into a more risk averse compliance culture where growth is restricted and the risk of non-compliance is a career limiting threat. The carrot has been replaced by the stick. Nevertheless, this is >>

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ultimately also unsustainable as businesses cannot grow in a risk averse environment. Ultimately conduct will reflect marketplace conditions, but behaviour cannot be instilled by rules.

How does the FCA plan to regulate conduct?

The FCA has a *"vision to make markets work well so consumers get a fair deal. It will be responsible for requiring firms to put the well-being of their customers at the heart of how they run their business, promoting effective competition and ensuring that markets operate with integrity."* This appears to be about putting the customer first and addressing the downside of a sales culture. The FCA has not yet published standards with which it expects firms to comply.

The FCA does not wish to be prescriptive, but absence of a clear definition of acceptable conduct makes the job of regulation more difficult as there is no objective benchmark or published standard. It also makes the job of a firm's compliance officer more difficult as he is more familiar with pre-determined "sound practice" guidance as reference point. The FCA has nevertheless stated what it considers unacceptable conduct and how it will act to police it.

A speech given by Martin Wheatley, Chief Executive designate of the FCA, last year cited some of the worst excesses of the industry as evidence for a need to improve culture. He listed four things he wanted to see: correct targeting of products against customer needs; testing of products before launch; robust approval processes; and systems for monitoring product performance. These are not news to marketing people any more than the three reasons given by Clive Adamson, Director of Supervision, Conduct Business Unit, FSA, at the same conference, for provoking "product intervention" by the FCA: a flawed product, unsuitable product advice, and the capacity for mis-selling.

It sounds as if this approach is based on customer complaints and reads like a knee-jerk response. Protect the consumer by all means, but first state what makes conduct acceptable to the regulator. Intervening once a product is launched seems unhelpful and arbitrary. It appears as if the FCA is creating a new risk, "conduct risk" out of elements that should already be covered within operational risk.

The FCA, in common with regulators in other industry sectors, must authorise the major players, set standards for the industry, supervise the service provision, and enforce through appropriate censure. Regulators are set up by governments keen to appear in control. There is a political aspect to regulation.

The Parliamentary Commission on Banking Standards, chaired by Andrew Tyrie, has yet to report and the Banking Reform Bill has yet to enact some of the Vickers report recommendations, so the subject of culture change is already receiving some political attention but remains undefined.

How should conduct be measured?

In this fluid world, where does this leave firms and their compliance officers? Conduct as we have seen is about behaviour and this inevitably is between two or more parties. Conduct requires a counter-party or recipient to judge whether it is satisfactory; it is much harder for a third party to determine whether that conduct is acceptable, it being up to the two trading parties to decide. A buyer and seller carry out a transaction and the conduct quality is judged in this context.

Consider the buyer and seller of a residential property. The seller's conduct will be deemed unacceptable if he increases the agreed price prior to contract and tries to pressure the buyer into a higher offer; similarly the buyer's conduct will be unacceptable if he reduces the agreed price or tries to withdraw from the purchase prior to contract. The key measure of acceptable conduct is trust. This can be translated into reputation where a trading firm is concerned, for trust is the basis of doing business.

The reputation of a firm is a good indicator of conduct as a good reputation will indicate that the party can be trusted, whereas a bad reputation will introduce caution to any transaction. Reputation for many firms in the financial services industry is important, with more worried about being caught doing the wrong thing rather than the accolades which come with doing the right thing. Reputation tends to be viewed in terms of bad publicity resulting from a fine.

An independent reputation audit would help a firm to qualify its conduct and such an audit could also help the FCA with objective benchmarking. There are many parties (stakeholders) with whom a firm engages, not just customers, and reputation quality should be measured with each one: employees, suppliers, partners, investors, regulators and of course customers. Does fear of "product intervention" really concern the major players in the industry? More likely the fear is that of being held up as an example to the industry and the reputation damage among peers that follows regulatory censure.

It was Albert Camus who said *"integrity has no need of rules"*. The FCA needs to secure meaningful culture change across an industry with a tarnished reputation, and all without being too prescriptive. This is a big ask. The two most significant barriers to success are the impracticality of regulating by outcomes and the narrow focus on products sold to customers.

For the FCA to achieve meaningful success it will need quickly to develop sound practice guidance clear to all players in the market and it will need to explore conduct among a wider stakeholder universe. Without these it will struggle. Furthermore, once the full extent of what conduct really implies is recognised, then we may see the net thrown wider to include audit firms, tax advisors and investment brokers not just insurers and banks.

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