Frontiers in Finance
For decision-makers
in financial services
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KPMG
cutting through complexity

Letter from the editors

Over the last 5 years, *frontiers* has consistently expressed the view that the world in which financial services now has to operate is fundamentally changed as a result of the crisis. In one respect, this is obvious. Everyone involved in the industry will testify to the massive amount of regulatory change which is being imposed – and which is still increasing. We have analyzed the impact of many of these regulatory developments in previous issues. However, we believe that these developments actually serve to obscure the really significant changes: to coin a phrase, regulation is not the point.

The key point is that expectations of the financial services sector have changed fundamentally, on the part of political leaders and regulators, surely, but most importantly on the part of consumers and society at large. We believe that a real paradigm shift is occurring. The old, unconstrained world of risk, return, outperformance and constant capital growth is gone. In its place is developing an expectation of financial services that they should be safe, reliable, efficient, as boring as a utility; it's a picture which may even strike some as old-fashioned. Certainly, there will still be room for creativity, initiative and risk. But financial services companies which fail to understand the nature of the change occurring around them will struggle.

Unfortunately, we find that many in the industry are still living in hope. In one article, we argue, many of them still do not 'get it' in terms of what the new world looks like. The least sign of a return to profitability, small victories in resisting excessive regulatory proposals, positive movements in stock prices or bond yields, all encourage the view that normal service will be resumed shortly. But it won't. The financial services industry needs a fundamental change in attitude and culture to respond to the new environment. This is why we have chosen to devote much of this issue of *frontiers* to issues of culture. We believe culture is the new fundamental challenge.

The tone is set by Jeremy Anderson's keynote article, which argues that the reformed banking sector which needs to emerge will not result from regulatory reform alone, but from fundamental change in culture and in conduct. We look at the developing agenda of conduct and consumer protection which is underpinning a broad swathe of new regulatory proposals; at how risk culture is being evaluated; at the importance of organizational culture; and at the balance between hard and soft controls in inculcating the desired cultural attitudes in financial organizations. While the issue of culture is addressed in multiple articles, the topic for each article is different.

Of course we also look at other mainstream market and regulatory developments: trade surveillance in capital markets, the growing global debate over tax compliance, and the growing risk of protectionism and regulatory arbitrage. But most of these issues are seen through a perspective heavily colored by the culture agenda; and we would argue that *all* of them will be subordinated to the new cultural paradigm as they evolve.

We hope the articles in this edition go some way to illuminating these issues. If the views expressed by one or two of our contributors are provocative, this is because we believe they need to be.

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The banking world is changing. But there is a long way to go – further than many perhaps realize. New regulation aims to constrain unacceptable behavior and prevent future disasters. But the reformed banking sector which needs to emerge eventually will not result from regulatory reform alone: it has to embody fundamental change in culture and in conduct.

Conduct, culture and change

Jeremy Anderson
Chairman Global Financial Services

The banking industry is still in the process of navigating fundamental change from its situation in the mid-2000s to what it needs to look like by 2015-20. What that end-point will look like is still unclear: can banks return to their earlier dominance and profitability? To what extent will regulators demand structural change and the formal separation of investment and retail banking activities? The united political will towards regulatory reform is giving way to protectionism and competition between regulators: how will this change the balance between a local and a global focus for banks? The banking industry, and economies more widely, face significantly increased costs as the price of perceived increased safety – a perception which may well prove illusory.

More generally, the necessary changes in banking have to be undertaken against the background of major technological, social and economic trends – what we have elsewhere termed global megatrends – which themselves are impossible to foresee with accuracy. The continuing growth of digital technology, major demographic changes and the shift in economic power

Jeremy Anderson
Chairman Global Financial Services

to China and the East will all have powerful impacts on banks' business models and operations. How can banks, in this context, reorient and best position themselves to create strong and sustainable businesses for the future? Who will own the customer relationship? Will banks be more technology businesses than product depositors and distributors?

Conduct and culture

If banks are to recreate stable business models which will succeed in the new environment, a necessary condition is that these be *sustainable*, not simply in the financial sense but more fundamentally in that they recover, and retain, the trust and respect of all stakeholders. It is not clear that the majority of banking executives yet know how to achieve the extensive change required. This is not a matter of presentation or of a new set of operating procedures. Nor is it a matter of just adapting to the specific requirements of new regulation. What is required is a profound change in philosophy embracing corporate behavior, product development and marketing, customer relationships, complaint handling, reputation management and more. In their turn, these changes depend on far-reaching changes in culture.

Embedding change

Culture change may have become a corporate cliché, and often paid lip service rather than accorded genuine priority. But the evidence from cases where real culture change has succeeded is clear. Success requires a coherent, consistent tone and example from the whole of senior executive management. They have to share an absolute commitment to collective responsibility if there is a prospect of driving change through the corporate hierarchy, a responsibility which cannot be delegated to particular individuals. This tone and example has to form the foundation of a new language of day-to-day debate and conversation, providing a vocabulary and a taxonomy to allow people to talk about what are sometimes difficult issues to describe.

Second, the new attitudes and behaviors required have to be translated into, and expressed in, very practical changes at the operational level if they are to have tangible impacts on behavior, relationships and perceptions.

Third, the layers of middle management often come to be seen as the real barriers to change, and with good reason. Many times, senior executives realize the need for change as a strategic imperative; staff on the front line often see that particular operations or customer interactions need improvement. Middle managers, however, may be caught inbetween, hard-pressed to meet performance targets in the current regime and potentially feeling threatened by change. Winning them over is critical.

There are few quick fixes. What works in one organization may not work in another. But all effective culture change requires relentless, consistent reinforcement in words and deeds. The crisis of credibility in banking

The necessary changes in banking have to be undertaken against the background of major technological, social and economic trends – what we have elsewhere termed global megatrends – which themselves are impossible to foresee with accuracy.

is such that this is a core challenge facing the industry today.

Risk and reward

What makes the challenge even greater is the immense difficulty banks face in balancing risk and reward in an environment which has become almost paranoid about recognizing any risk at all. Of course, most political leaders and regulators would accept that it is impossible to eliminate all risk. And without risk there can be no reward, no progress and no economic growth.

The theoretical framework for treating financial risk and return remains clear, even if it was distorted and tested to destruction in the years leading up to the crisis. But there is a lack of consensus currently over how to express better risk appetite effectively at board level, (in particular potential tail risk) or how to translate that into how banks design, sell and deliver products. Furthermore, without an accessible approach and vocabulary, it is difficult to hold effective conversations about risk and reward with shareholders, customers and regulators, conversations which can put losses and failures, although regrettable, into an acceptable context. The danger is that sensible and economically-efficient risk taking will be abandoned for doctrinaire 'protection' and 'prevention'.

Excessive risk averseness can have severe and widespread consequences. It can strangle the provision of credit to industry and the economy, prevent growth and hold down living standards. It can drive economic activity further from developed economies to less-regulated and less-stable developing countries with poorer protections for workers and for the environment.

So finding ways of educating publics and of expressing risk effectively is crucial. But this task can hardly begin unless banks recover trust and rebuild reputations. And for this, addressing the conduct and culture agenda is essential.

The last 2 or 3 years have seen growing tension between US regulators, overseas multinational financial institutions and regulators in other jurisdictions. Current US proposals to change the treatment of foreign-owned banking operations are likely to impose substantial additional regulatory capital requirements, and carry serious implications for funding and liquidity in US markets. More fundamentally, US unilateralism is increasingly threatening to disrupt international regulatory cooperation.

Global regulatory cooperation under threat:

Tension over US bank capital proposals

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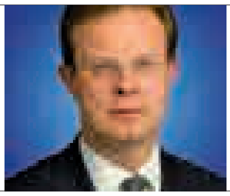

US broker-dealer subsidiaries of foreign banks account for nearly one-third of all US dollar denominated securities underwriting.

Successive US administrations have always allowed well-managed and well-capitalized foreign banks to operate in the US under conditions comparable to those applied to domestic banking organizations. The 1999 Gramm-Leach-Bliley Act allowed subsidiaries of foreign-owned banks to register as bank holding companies (BHCs), and this has been the typical corporate structure adopted by large multinational banks operating in the US: the foreign-owned domestic US banks – and any other operations – are owned through an intermediate BHC.

These foreign banking organizations (FBOs) now account for a substantial proportion of US financial business. A number of factors drive this: the status of the dollar as a quasi-global reserve currency; the fact that many commodities and assets, from gold to oil, are denominated in dollars; and the willingness of foreign investors to finance the US government's US$1.3 trillion budget deficit. According to the Institute of International Bankers (IIB), their members' US operations have approximately US$5 trillion in assets and fund 25 percent of all commercial and industrial bank loans made in the US. US broker-dealer subsidiaries of foreign banks account for nearly one-third of all US dollar denominated securities underwriting. FBOs make a critical contribution to the US Treasury repo market, constituting a majority of the primary dealers.[1]

Crucially, the US administration historically took the view that where the parent company was subject to standards of regulatory oversight and control in its own country which were comparable to those of the US itself, it would not also have to meet US capital requirements in relation to the BHC. This exemption was made explicit by the Federal Reserve in 2001.[2] Underpinning this policy was a philosophy of trust and cooperation between regulators in the major economies, and mutual recognition of the broad equivalence of domestic prudential standards.

Crisis and response

Among many in the US administration, confidence in this approach was seriously shaken by the financial crisis. As Daniel Tarullo, a Governor of the Federal Reserve, claimed: "The location of capital and liquidity proved critical in the resolution of some firms that failed during the financial crisis. Capital and liquidity were in some cases trapped at the home entity, as in the case of the Icelandic banks and, in our own country, Lehman Brothers."[3] This raised the spectre of 'ring-fencing' by local jurisdictions which would prevent US creditors recovering their capital. Sheila Bair, former chairman of the Federal Deposit Insurance Corporation, said, "When an institution becomes stressed, long experience has shown that foreign banks and their regulators are reluctant to send capital abroad to support US operations."[4]

In response, the Dodd-Frank Act[5] withdrew the exemption from BHC capital requirements for foreign-owned banks: as from 2015, they would have to hold regulatory capital in their US subsidiaries in the same way as domestic US banks. From a US perspective, this could be presented as establishing a level playing field, and applying the same standards to foreign as to US banks; for the former, however, it threatened to impose substantially higher costs on their US operations, reduce capital flexibility and potentially expose them to more stringent capital requirements overall, once the interaction with Basel III was taken into account.

Reaction

In their turn, the major global banks operating in the US considered how to respond. The first to move was Barclays, which in November 2010 deregistered Barclays Group US from BHC status, restructuring its operations so that they were no longer subject to the new regulations. Deutsche Bank followed suit in March 2012, moving Deutsche Bank Trust Corp out of its BHC to become a direct subsidiary. The move was reported to save DB up to US$20 billion in additional capital avoided.[6]

Raising the stakes

In turn again, US regulators have moved to head off such avoiding action. In a major speech in November 2012,[7] Daniel Tarullo proposed that the largest US operations of foreign banks should be *required* to establish a top-tier US intermediate holding company (IHC) over all its US bank and non-bank subsidiaries; and that the same capital rules should apply to these as to US BHCs. They would also be subject to liquidity requirements (as would US branches of FBOs) to ensure that they had sufficient high-quality liquid assets to meet expected net outflows in the event of a crisis in their US-based operations.

Justifying these proposals, Tarullo pointed to a major qualitative shift in the nature of foreign banks' operations in the US which had taken place since the late 1990s. Historically, these subsidiaries borrowed from their international parents and lent into the US

1 Comment Letter from the Institute of International Bankers to the Governors of the Federal Reserve, 30 April 2013
2 "Application of the Board's Capital Adequacy Guidelines to Bank Holding Companies Owned by Foreign Banking Organizations," Supervision and Regulation Letter 01-01 (5 January 2001)
3 Daniel Tarullo, "Regulation of Foreign Banking Organizations", Speech to the Yale School of Management Leaders Forum, New Haven Connecticut, 28 November 2012
4 Quoted in Deutsche Bank avoids US capital rules, Financial Times, 21 March 2012
5 Specifically, the "Collins Amendment" incorporated into s171, Leverage and Risk-Based Capital Requirements.
6 Wall Street Journal, 13 April 2011
7 ibid

market. However, this pattern began to reverse substantially in the run-up to the crisis. Many foreign-owned banks began *borrowing* dollars from their US subsidiaries to finance their global (dollar) operations: Tarullo claimed:

> "Foreign banks [in the US] as a group moved from a position of receiving funding from their parents on a net basis in 1999 to providing significant funding to non-US affiliates by the mid-2000s – more than US$700 billion on a net basis by 2008."

As a consequence, he argued, the US has become increasingly vulnerable since the crisis to the danger that US depositors' capital would be trapped overseas in the event of a further crisis. In Tarullo's view, "Although the Federal Reserve will continue to cooperate with its foreign counterparts in overseeing large, multinational banking operations, that supervisory tool cannot provide complete protection against risks engendered by US operations as extensive as those of many large US institutions." It is this risk to financial stability in the US which is now the driving force of US regulatory policy.

International concern

International concern is growing over the Federal Reserve's actions, and at the potential for unilateral protectionism it may represent.

The location of capital and liquidity proved critical in the resolution of some firms that failed during the financial crisis. Capital and liquidity were in some cases trapped at the home entity, as in the case of the Icelandic banks and, in our own country, Lehman Brothers.

Michel Barnier, the current European Commissioner for Internal Market and Services, wrote in April 2013 to Ben Bernanke, Chairman of the Federal Reserve, expressing his concern.[8] He reiterated the G20 position – which the US fully endorsed at the time – that the global nature of financial markets and the lessons drawn from the recent crisis clearly call for a globally-coordinated response. He pointed out that the Federal Reserve's current proposals: "seem to be in substantial contradiction to the global regulatory convergence and could have a negative impact on the implementation of Basel II, jeopardizing and/or delaying the process."

He warned that the US action could spark a protectionist reaction from other jurisdictions, and severely damage economic recovery. If the European Union retaliated by imposing similar requirements on local subsidiaries of US banks, the financial impact would be substantial.

At the same time, the IIB forwarded a detailed critique of the US proposals to the Governors of the Federal Reserve.[9] This argued that the proposed regulations raised fundamental concerns. In particular, they failed to reflect Congress's explicit direction to take into account the extent to which an FBO is subject on a consolidated basis to home country standards that are comparable to those applied in the US.[10]

In addition, the potential market impact could be profound. The significant, and growing, presence of foreign bank operations in the US is a double-edged sword. It may increase domestic risk – although this is unproven. Equally, it implies an increasingly significant contribution of FBOs to US capital markets which would be threatened if significant numbers of banks decided to curtail or withdraw from their US business.

The IIB argued that the proposed regulations would be "virtually certain to discourage many FBOs from committing to US financial markets". There were also serious concerns about the potential impact on the depth and liquidity of the US Treasury repo market – which

8 Michel Barnier, letter to Ben Bernanke, 23 April 2013
9 ibid
10 The reference is to Dodd-Frank § 165(b)(2)

is expensive on capital; FBO-owned primary dealers could withdraw from the market or scale back their US operations, adversely affecting pricing.

Turning to the wider potential impact on global economic recovery, the IIB argued:

> "…profound changes to current US supervisory and regulatory practices should be undertaken only with extreme care and after careful study of its (sic) implications for cross-border banking and US financial markets. This observation becomes even more important in light of the risk that other countries will adopt reciprocal measures in response to the Board's Proposal."

Additional serious concerns have been raised by the European Banking Federation – which has suggested that the reforms are illegal under both US banking law and WTO law; by Christian Noyer, Governor of the Banque de France; and by Jonathan Faull, DG Internal Market and Services, responsible for financial regulation.

Serious threat

The overall global approach to regulatory reform, mandated by the G20 and explicitly endorsed by the US, depends on coordinated and reciprocal action. Unilateral action – by the US or by any other country – in defiance of considered international concern, could trigger a slide into domestic protectionism and regulatory competition, damaging financial stability and international trade.

The developing controversy could have significant implications for the agreement of recovery and resolution plans (RRP) for global systemically important financial institutions. Key to these plans is the creation of 'bail-in' (enforced re-capitalization) or comparable resolution mechanisms to be triggered in case of failure. Broadly, there are two possible approaches:

- single point of entry (SPE), where the 'home' regulator of the group imposes resolution measures at the top of a global group;
- multiple point of entry (MPE), where resolution measures are applied by a number of domestic authorities to multiple companies in the group.

The Bank of England has commented that which strategy is more appropriate will depend on the structure of the group: "For an SPE resolution to be appropriate, loss-absorbing instruments must have been issued at the top of the group and be available to cover losses in the group's subsidiaries… For MPE to be appropriate, it needs to be feasible to separate the group financially, operationally and legally along national or regional lines."[11]

The developing controversy could have significant implications for the agreement of recovery and resolution plans (RRP) for global systemically important financial institutions.

The US Federal Deposit Insurance Corporation (FDIC) has argued in favor of a single point of entry. However, this is incompatible with the capital ring-fencing position currently taken by the Federal Reserve. The independent observer may reasonably feel that the right hand of the US administration does not know what the left hand is doing. And it is rather disappointing that, despite the public statements of the G20 and the efforts of the Financial Stability Board to put more effective regulatory frameworks in place, this issue seems to highlight a growing lack of trust between national authorities.

Before pressing ahead regardless, the US administration needs to consider four key questions:

- If the FBOs pull back from providing credit to the US market, is there sufficient capacity and appetite among domestic players to fill the gap?
- If the FBOs pull back from the repo market, what would this do the US bond market? And what might be the implications for the US government's ability to raise debt effectively and maintain an efficient, liquid and orderly market?
- Is the US prepared to see global trade – which is still dominated and priced to a greater extent in US dollars – distorted in the short term, or in the long term move away from the dollar? What might be the implications for world trade and also for the US's political influence in the world?
- What conclusions should be drawn about the attitude of the US to corporate governance and respect for national laws if shareholders in FBO parent companies lose a significant degree of control over their US assets? Policy-makers claim to want shareholders to become more engaged in companies they invest in, but the proposed rules seem not to acknowledge this.

If the principles which have historically underpinned cross-border financial supervision are seriously undermined, the consequences could be profound indeed.

11 Written evidence from the Bank of England, Parliamentary Commission on Banking Standards, Resolution and Ring Fencing: Changes to the statutory regime for resolution, 20 November 2012

Making a bank marriage work: Overcoming the cultural barriers

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The continuing transfer of economic power from the developed world to Asia, the growth in Latin America and the interesting future perspectives in Africa are changing the dynamics of financial investment and acquisition in the banking sector. Increasingly, banks are more interested in 'exotic deals', looking to expand to new markets and access new customers. In KPMG's experience, though, more than two-third of those deals are failing to deliver value; when asked for the reasons, the large majority of the banks are blaming cultural issues.[1] Why do these integrations run into such problems? What does it take to make them work?

Cultural mismatches can threaten the success of any transaction. But when, for example, a Chinese or European bank makes an acquisition in an emerging market such as South America or Africa, we are dealing with a much more complex situation and the cultural differences are more difficult to reconcile against a specific set of deal objectives. The culture of a bank defines its standard set of behaviors, how banks operate and think, and the way that they view risk, judges value, incentivize its people, and their relationship and mode of communication with clients and customers; without basic alignment on these issues, no wonder value is not being delivered.

Figure 1 shows the outputs for a cultural assessment we conducted in a transaction of for a leading Eastern bank buying in the West. There were clear variances along a number of cultural axes, highlighting differences in the openness of communication, incentivization and resistance to change. Foregrounding these cultural paradigms allowed the buyer to plan clear mitigation strategies to manage the effect of a cultural mismatch and focus resources on the main deal objective – not having any impact on customers.

Do we keep management on day one or not? Do we keep management at all?

The biggest challenge is to know how far to pursue integration and how far to maintain cultural diversity as a synergy driver.

The answers to these questions at the beginning of the integration process will define the value that can be extracted from the deal and help sustain the fine balance between synergy delivery, staff happiness and customer satisfaction.

Many banks have jumped into integrating, or alternatively decided to do nothing at all, without spending enough time thinking about the strategic objectives of the deal, what they want to achieve and their vision of the future. It is easy to make the wrong decisions and trying to fix a failed integration is very difficult: in our experience, people are only open to significant change for the first six months or so.

For example, in a recent bank integration, the acquirer replaced the entire management team with some of its top talent from abroad. However, they failed to understand the local market, and were not able to deliver the planned synergies: the buyer had to leave the market after a couple of years. In another example, a buyer explicitly announced that no changes in the target should be expected, only to change its mind and launch radical changes a year after the transaction. This caught staff by surprise, destroying trust, creating resistance to further change and compromising the delivery of the planned deal objectives and synergies.

Traditional M&A planning and analysis normally focus on legal and financial aspects: tangible and intangible assets, revenue synergies, cost savings, potential for product and market reinforcement. However, companies also need to understand that cultural factors can critically affect the achievability of planned benefits. They can, for example, expose an acquiror to fundamental risks from existing practices and behaviors, a key concern in today's regulatory environment. Regulators are asking banks for more focus on mitigating the impact of a deal on levels of customer service, making it increasing important to get alignment on how both sides look at their customers. Incorporating cultural analysis into the evaluation and planning phase of a transaction is key to success.

Culture can drive value in a deal and help meet deal objectives. Rather than regard it as an incidental consequence of a transaction, acquirers need to see it as a central issue, able to mitigate risk and drive synergies. Understanding how a company makes decisions, how collaborative or competitive their teams are

1 KPMG GLOBAL SURVEY – A new dawn: good deals in challenging times, 2011

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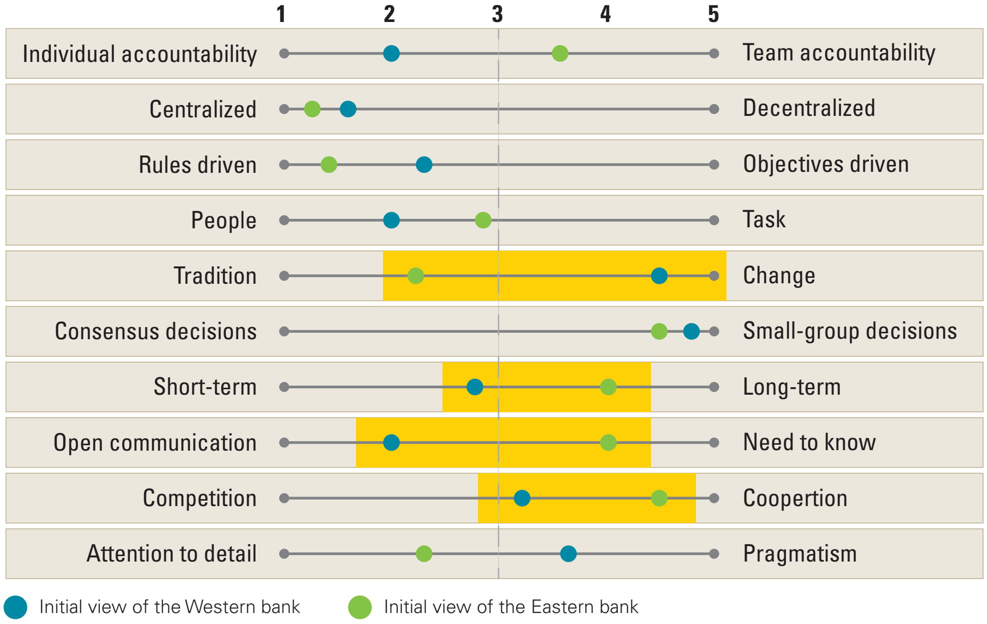
Figure 1 – Initial culture assessment of a leading Eastern Bank´s acquisition of a Western bank.



Source: KPMG International, 2013

or if they are driven by rules or objectives can actually determine whether cost synergies can be delivered, or whether a new product can be delivered into the market. Recently a Western bank acquired by an Eastern buyer mentioned to KPMG that, six months into the deal, they are still not sure who is actually in charge of making decisions.

Many respondents to KPMG's most recent global survey of M&A activity admitted with hindsight that they should have undertaken earlier and more robust integration planning, and paid more attention to human resources and cultural matters.

In short, three actions can help ensure value delivery on cross-border deals:

- upfront cultural assessment to identify and mitigate immediate cultural risks
- analysis of the potential impact of cultural issues on staff, linking it back to value, e.g. loss of key staff, followed by customers could lead to a delay in synergy delivery due to resistance to change
- use of culture difference as an explicit driver of value in the deal.

It is widely argued that fundamental culture change is needed in banks if the lessons of the crisis are really to be learned and if a more stable, publicly-acceptable banking industry is to emerge. But calls for culture change are commonplace. What is rarer is successful implementation. What are the key principles and practical steps which need to be followed? And what can we learn from applying a risk-focused lens to the people agenda to improve performance and manage reputational and talent risk?

Embedding real culture change and managing talent risk

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Five years after the crisis, the financial sector is still being hit by a series of revelations of unacceptable and inappropriate behavior, market manipulation and mistreatment of customers. It is clear that historical practices were wrong, and need to be changed. A fundamental change in culture and behavior is an essential step on the road to rehabilitation and the creation of a sustainable and safer financial sector for the future.

The misalignment of interests and flawed staff incentives that drove past behavior have come under intense scrutiny. Discussions in the media and elsewhere focus on the ethics of bankers and the need to reshape behavior, notably by reducing bonuses. For regulators, a priority is to ensure that banks deliver better outcomes for customers. In response to regulatory pressure, banks are beginning to undertake significant reorientation of their business models and their treatment of customers. The conduct agenda, especially in the European context, is driving a need for widespread culture change.

Hand in hand with cultural change comes the need for financial services organizations to more effectively understand, monitor and manage talent risk. For a sector so familiar with risk management as a discipline, the extension of the existing risk framework and practices to incorporate people and talent is a powerful way to underpin lasting cultural change.

Current landscape

Many global banks have started top to bottom cultural change programs. This approach often includes:

- clear and public commitments from the chairman and CEO that the old ways of working are not acceptable, and that the journey towards a 'new bank' will include major culture change
- new, high profile value statements and codes of conduct usually including a principle of ethical, responsible banking and the importance of fair and high quality service for customers
- A redefinition of the skills and behavior needed to deliver the business strategy: in an environment focused on risk management, transparency and ethical behavior, are the behavior and competencies that led to the global financial crisis the ones needed to revive the sector?
- reformed mechanisms (e.g. reward structures) to stop unwanted behavior being reinforced through misaligned reward and promotion processes.

What is needed?

Most importantly, banks need to regain trust with regulators, customers and the public. This involves building new relationships with customers and regulators. Laying the foundations of trust will depend on providing more transparency, simplified products and better quality advice, regardless of the sales channel.

In addition, banks need to show that the root causes of the behavior that caused the crisis are being addressed, by proving they are re-balancing stakeholder interests when making core business decisions. Previously, banks demonstrated a disproportionate focus on profit at the expense of benefits to the customer. In future, successful, sustainable business models will be built on the fair balance of stakeholder interests. Banks need to prove to the public and regulators that this principle has been embedded in the entire value chain from strategy to product development to sales and after sales.

Practical steps

What does achieving cultural transformation mean in practice? At a minimum, there needs to be:

- Senior commitment: a true commitment from senior executives to transformational change, including a review of the core beliefs and routines that exist within the bank. To be effective it is vital to have visible and authentic role-modeling of values, with leadership demonstrating decisive action to prevent the re-emergence of unacceptable behavior.
- A structured approach to managing people risk: what are the critical functions and roles – the areas of the organization with the biggest impact on performance or reputation? What is the succession pipeline (internal and external) like for these areas? Is the organization's key talent in the critical roles and functions?
- Incorporation of talent risk into wider risk management governance and reporting. Is people risk being monitoring in the same way and in the same forums as operational, market or credit risk? Does it have visibility outside the HR function?

Successful transformation

Successful and credible cultural transformation will depend on two important elements:

Statement of intent

The change journey should start with some high impact, symbolic actions that demonstrate that the bank is taking culture change seriously, and that there is no going back. These symbolic actions could include:

- cessation of certain business activities and/or the sale of certain products that are perceived to be contentious or unfair
- radical overhaul of traditional norms and routines (e.g. no longer paying bonuses or the introduction of the bonus-malus).

Conduct must be embedded

- articulate clear measures, making it easier for peers and the public to hold banks to account
- frame the behaviors that should be rewarded through incentive structures.

Conclusion

Financial services organizations are facing unprecedented pressure to change their culture. Half-measures will not be enough in today's environment. Real and lasting transformational change to re-establish trust in the banking sector and monitor and manage talent risk will require bold actions. It is essential that the industry does what it takes to achieve this so that it can continue to provide a valuable – and valued – role in supporting the economy and wider society.

Risk management is a core capability for all financial services organizations. Applying this discipline and framework to the monitoring and management of talent risk is a source of potential competitive advantage in a post-crisis world.

Case study

KPMG worked with a global financial services organization to review and redefine the core leadership competencies and behaviors required following a near-fatal collapse in performance. Pre-crisis the bank was demanding its leaders display innovation, a global mindset, and expansionist and ambitious behavior. All people levers – recruitment, promotion, remuneration – were structured around these competencies, which were clearly aligned to the global strategy.

Following the collapse, KPMG worked with the group to redefine the leadership competency framework. Gone was the now-hubristic behavior, and in its place were core skills relating to communication, cost management, risk management and change leadership: the skills, in other words, required to rebuild the bank. The wider people management framework, from recruitment, through performance management and incentives, was realigned to ensure that the new behavior was embedded across the group.

Regulatory reporting: Challenges for markets and for regulators

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Regulatory reporting: Meeting the challenge

The challenge for financial services firms is to find ways of handling the heavily increased reporting burdens effectively – ensuring compliance – and efficiently – at acceptable cost. Key questions they need to ask include:

- How should we monitor and interpret complex regulations?
- How will our business be impacted?
- How do we know if we are compliant with the reporting requirements?
- How can we capture the reporting information to the aggregated or breakdown levels?

A systematic and comprehensive approach is essential to developing a sustainable compliance and risk management program.

Understanding

Effective governance is important to ensure awareness of the data reporting requirements across the board, and to monitor regulatory developments for changes and their impact. An efficient regulatory watch function with defined communication lines should be established to remain abreast with regulatory updates and to disseminate impact analysis across the organization.

Where the implications of current or new regulations are unclear, systematic engagement with regulators, and with other stakeholders such as industry bodies, can clarify interpretations to develop appropriate solutions within the context of an organization's business, risk and information management structures.

It should go without saying that understanding the impact on business and operating models requires a holistic knowledge of the business and associated workflows – but this is often challenging where there are multiple geographies, jurisdictions, markets and product lines. The need is to create a complete characterization of the business, including a clear and updated view of cross-border business activities and their implications for reporting to local regulators.

Capability

Developing the necessary capability involves creating the right infrastructure and establishing appropriate governance mechanisms. Technology systems and processes need to be both comprehensive to capture all necessary data in an appropriate form and flexible to enable reconfiguration in order to meet new reporting requirements. Translation of data collected into the appropriate form for information reporting requires detailed understanding of both the letter and the underlying intention of the relevant regulation.

Effective governance is important to ensure awareness of the data reporting requirement across the board, and to monitor regulatory developments for changes and their impact.

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Senior executives and board members need assurance that the organization is meeting its obligations. The overall reporting framework and system needs to be monitored for performance and subject to independent risk analysis.

A single owner for each report required should be responsible for ensuring specific compliance, accuracy and coverage. Governance mechanisms need to be established at each organization level to ensure compliance and quality control.

Oversight

Senior executives and board members need assurance that the organization is meeting its obligations. The overall reporting framework and system needs to be monitored for performance and subject to independent risk analysis. Key risk and performance metrics should be used to monitor significant risk trends and the health of the control environment. Equally, regulatory feedback and reporting should be closely analyzed to confirm satisfaction and/or to identify evidence of potential shortcomings.

Sustainability

As with all critical business issues, the system and processes for regulatory reporting need to be dynamic and flexible, subject to some form of continuous improvement overview. This is all the more important in this case: first, because of the rate at which requirements are changing; second, because of the vital nature of compliance and the potential cost of failure. The continuous improvement cycle involves five steps (*see Figure 1*):

Outsourcing?

Given the scale of the challenge, it is understandable that many firms are looking to external specialist providers to take on some or all of their regulatory reporting obligations. Where a financial services firm has a shared service centre which is itself managed by an outsourced service provider, and through which most or all of the relevant data already flows, it can be a relatively simple step to extend the scope of the service to include reporting. Automation and the implementation of specialized regulatory reporting systems are a major growing trend, with companies such as Lombard Risk Management, AXIOM and FRS Global from Wolters Kluwer developing extensive market presence.

However, there are critical limits to the extent to which reporting responsibility can properly be outsourced. Crucially, the initial interpretation and analysis (cf *Understanding* above) has to remain in-house, as do the need for continued judgment and oversight and final responsibility for ensuring effective and efficient compliance.

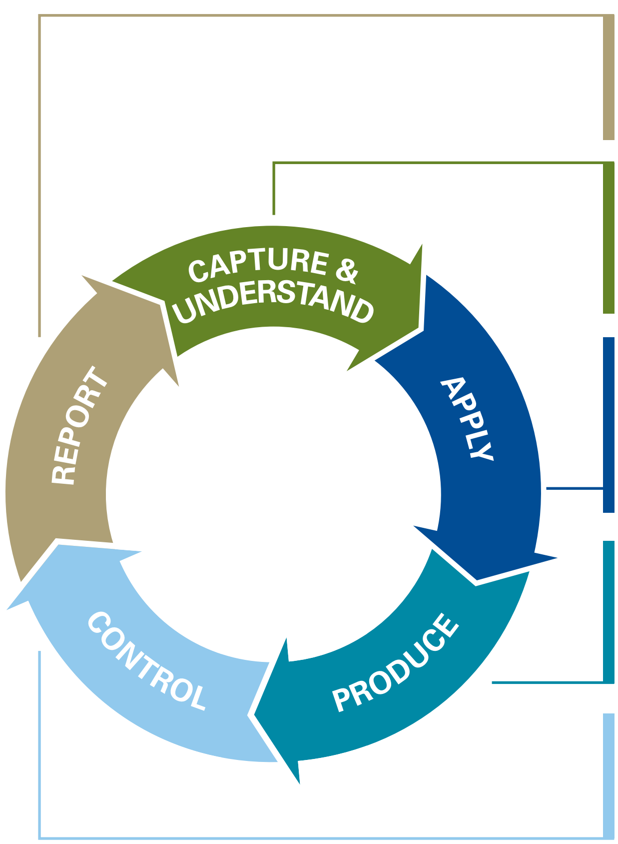
Designing a complete framework for regulatory reporting which balances all the requirements is itself a complex and specialist task.

Conclusion

Regulatory reporting has become not only a major data management issue but a key strategic challenge. While the primary burdens fall on financial service companies themselves, all organizations involved in the industry, including regulators themselves, are struggling to cope. Surmounting the challenge depends on buy-in and support from the most senior levels of the organization and is likely to require investment of time and money in new systems, processes and operating models. However, successful firms will secure the benefits in terms of more efficient processes, lower costs and the flexibility and scalability to deal with future challenges.

KPMG believes there is also the potential for really smart organizations to go beyond this, turning the situation to their benefit, providing themselves with deeper insights into their market and clients and creating new sources of competitive advantage.

Figure 1: Regulatory reporting and sustainability



- Report sign-off
- Submit the report within deadlines
- Archive the report and supporting documents

- Maintain the list of regulatory requirements
- Agree on interpretations across the bank
- Maintain oversight of business activities

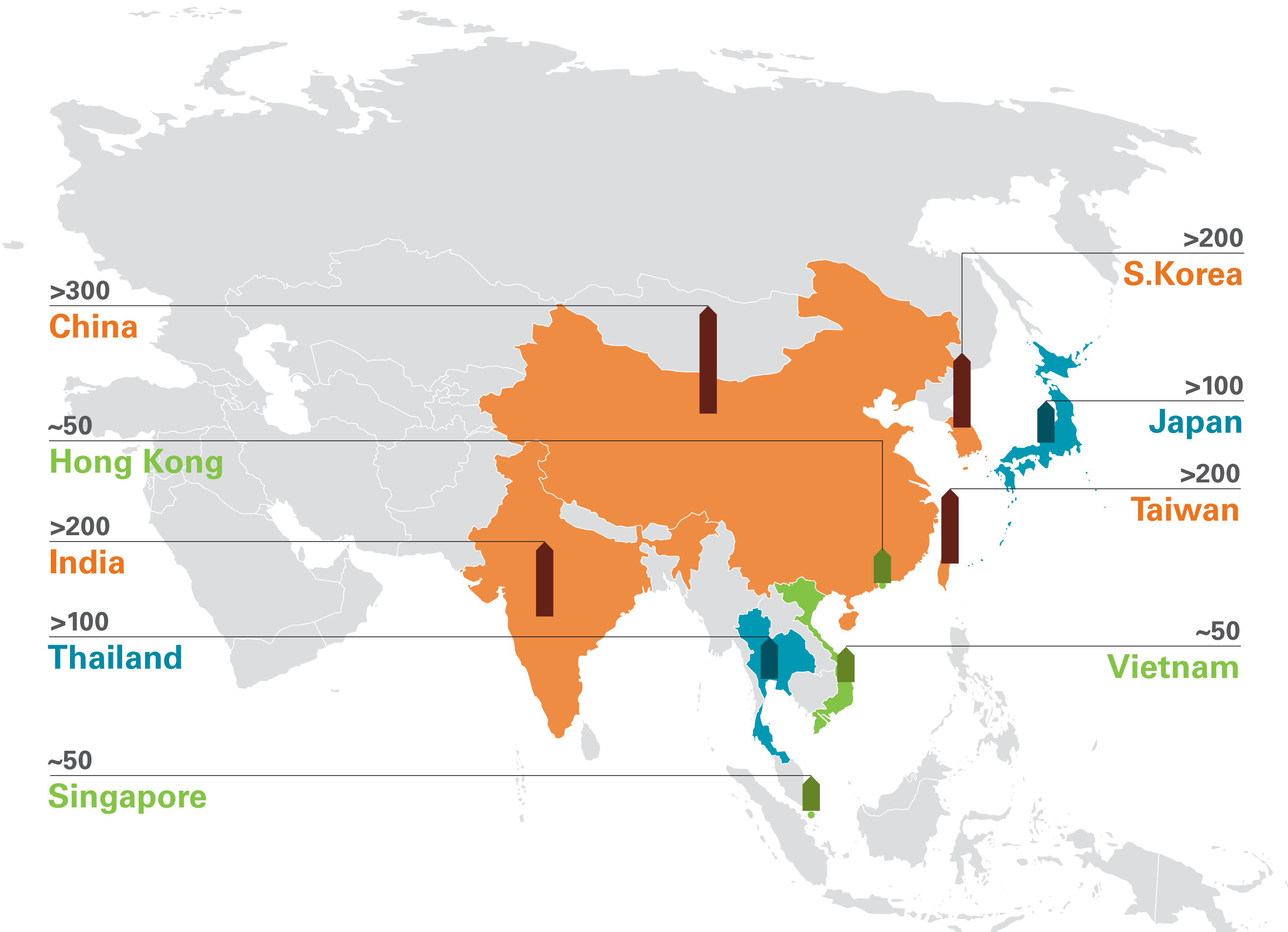
- Map the regulatory requirements to the business activities and financial instruments
- Identify the systems to be considered and the teams to be involved

- Extract and verify the basis data required to produce the report
- Perform computations, filtering, analysis etc. as required

- Perform controls to mitigate the risk of manual errors during the data extraction and report production steps
- Produce the final draft

Source: KPMG International, 2013

Figure 2: Regulatory Reporting Requirement Overview in Asia



Note: Averaged numbers of regulatory reports are based on those for a regional corporate and investment bank. Theses number may vary depending on the nature of a bank's business.

A growing burden in asian capital markets

The impacts of regulatory change on the reporting lifecycle are being felt particularly strongly in the Asia-Pacific region, where there are also heavy local reporting requirements. Very often, global cross-border regulations do not take into account the different reporting context in Asia-Pacific, and frame new requirements for a western environment, where the volume of regulatory reporting requirements is significantly lower.

Systems and process infrastructures in Asia-Pacific firms or branches/subsidiaries are often ill-suited to coping with the reporting burden. They have often been built in an ad-hoc fashion, mixing a wide range of local and global systems, across business lines. There are also a number of broader cultural constraints. In an environment that remains highly manual, the amount of time and effort spent on regulatory reporting in Asia is generally not properly assessed, and is often under-estimated. Cross-border activity can be less closely monitored and more difficult to manage, creating difficulties in satisfying local requirements in different jurisdictions.

All of this means that implementing effective governance frameworks to ensure the appropriate quality and extent of regulatory reporting is especially challenging. Banks in many Asian countries are facing heavy pressures from these changes in supervisory structures and from heavily increased reporting burdens. The numbers involved are huge (see figure 2): we estimate that a bank operating in the main Asian markets may have to submit more than 50,000 regulatory reports each year, which represents, of course, 50,000 individual potential points of failure.

Regulators struggling too

The massive increase in information reporting is not simply a burden simply for financial institutions. Regulators across the world are themselves struggling to cope. Commissioner Scott O'Malia of the US Commodity Futures Trading Commission (CFTC) recently said it needed drastic improvements in its technical capabilities in order to analyse the trading data it is now collecting in accordance with the Dodd-Frank Act:

"Since the beginning of 2013, certain market participants have been required to report their interest rate and credit index swap trades to a [Swap Data Repository] SDR. Unfortunately, I must report that the Commission's progress in understanding and utilizing the data in its current form and

50,000+

Number of regulatory report submissions per year in main markets in Asia

Up to 10

Number of authorities to report to per country

High regulatory requirements
Medium regulatory requirements
Low regulatory requirements

Averaged number of reporting requirements per country

with its current technology is not going well. Specifically, the data submitted to SDRs and, in turn, to the Commission is not usable in its current form. The problem is so bad that staff have indicated that they currently cannot find the London Whale in the current data files… Solving our data dilemma must be our priority and we must focus our attention to both better protect the data we have collected and develop a strategy to understand it. Until such time, nobody should be under the illusion that promulgation of the reporting rules will enhance the Commission's surveillance capabilities."

Scott O'Malia
US Commodity Futures Trading Commission[1]

The reporting burden: Principal international regulatory developments

AIFMD	• Initial disclosure on AIF to investors (e.g. strategy) • Ongoing disclosure (e.g. liquidity arrangements, risk profiles etc.) • Disclosure to regulators (trades, exposures etc.)
DODD FRANK	• Swap dealers and reporting into Swap Data repositories (SDR)
BASEL II & III	• Quality, mix and level of Capital • Leverage ratios • Granularity of cash flow reporting • Liquidity reporting (LCR)
FATCA	• Reporting on US Accounts to the IRS • Interests in assets for US persons
SOLVENCY II	• Balance Sheet and P&L • Own funds & participations • MCR and SCR • Technical provisions • Duration of liabilities • Lapses • Re-insurance
MIFID/EMIR	• Trade repositories for financial derivatives (scope to be gradually increased)
IFRS Changes, e.g.	• IFRS9 – Financial instruments • IFRS10 – consolidated financial statements • IFRS12 – Disclosure of interests in other Entities • IFRS13 – Fair Value Measurement

OTC derivatives: Existing and new requirements for trade reporting

ASIA	• Australia: The regulator is looking to consult on a licensed trade repository for all derivative classes (interest rate, FX, credit, equity and commodity). • China: IR/FX derivatives and credit risk mitigation tools are either traded on CFETS or need to be reported to CFETS (IR/FX derivatives) and NAFMII (Credit risk mitigation products). • Hong Kong: Legislative process has just been launched in Q3 of 2013. The intention is to take a phased approach, starting with IRS and NDF. • India: IRS/FRA and Forex derivatives currently need to be reported by banks and primary dealers to CCIL reporting platform. • Japan: Trades will be reported to a TR for a selection of products. For other trades , they will need to be reported to JFSA. • Korea: FSS already requires the reporting of all OTC derivatives. However, the current reporting platform will need to be enhanced to meet international requirements. • Singapore: A public consultation was launched on regulation drafts after the legislative amendments and further announcements are expected in 2013.
US	• The Commodity Futures Trading Commission (CFTC) published a list of requirements in terms of universal identifiers (Unique Swap Identifier, Legal Entity Identifier, Unique Product Identifier). However the system to handle these identifiers still needs to be developed. • Swap transaction data are to be reported to a Swap Data Repository (SDR) at the creation of the swap and during the life of the swap up to its termination/expiration. SDRs must include all "primary economic terms data and all confirmation data" and data needs to be readily available for 15 years after the swap termination/expiration. • Swap transactions in the scope of SDRs are all those transactions which were passed before and were still in place at the time of passage of the Dodd-Frank Act.
EUROPE	• The European Market Infrastructure Regulations (EMIR) are targeting a much wider scope than the Dodd- Frank Act and requires all derivative contracts, whether traded on an exchange or OTC, to be reported to trade repositories. A phased approach has been adopted starting with interest and credit derivatives – scope to be extended to other derivatives at a later stage.

1 CFTC's Implementation of Dodd-Frank – Grading Agency Transparency, Keynote Address to SIFMA Compliance and Legal Society Annual Seminar, March 19, 2013

US OTC trade reporting: A specific challenge

In the wake of the financial crisis, there was a new emphasis placed on the potential risks posed by over-the-counter (OTC)-traded derivatives. The leaders of the G20 called for a determined effort to regulate global OTC derivative trading to mitigate systemic risk, improve market transparency and protect against market abuse.

Policy and regulatory initiatives have since followed a twin-track approach to ensuring greater stability: encouraging the migration of 'standard' OTC swap transactions onto regulated exchanges; and imposing new reporting, surveillance and oversight on the remainder. In the US, Title VII of the US Dodd-Frank Act – the section governing OTC derivatives – created a new regulatory regime for this previously unregulated market.

In the securities market, while ultimate responsibility rests with the US Securities and Exchange Commission (SEC), the bulk of the operational burden falls on the Financial Industry Regulatory Authority (FINRA), which regulates broker-dealers that operate in the OTC market. FINRA is the largest independent regulator of securities firms doing business with the public in the US, and is authorized by Congress to take action to ensure that investors are protected. FINRA oversees about 4,250 brokerage firms, about 162,155 branch offices and approximately 629,525 brokers.

However, the challenge posed by these numbers alone is far from the whole of the story. The scale of the task is vastly complicated by the fact that these complex transactions routinely cross borders, and are potentially subject to multiple and competing sets of regulations and regulators.

There is also continuing debate over how far the global reach of the US regulatory requirements should extend. A key issue was articulated most clearly recently by the SEC Chairman:

> "…subjecting every OTC derivatives transaction that touches the US in some way to all aspects of US law – that is, the "all-in" approach – ignores the realities of the global marketplace. And yet, treating clearly different regimes as equivalent across all key policy areas risks will create regulatory gaps, regulatory arbitrage, and a potential regulatory race to the bottom."[2]

For the last decade and more, the imperative among equity market participants has been to pursue constant improvements in speed and access to markets. Trades and markets are highly automated, and react in fractions of a second. Capturing the massive amounts of data involved, at the required real-time speed, is a massive challenge. For firms engaged in this market, there are comparable challenges in satisfying the increasingly demanding regulatory requirements. As the market has developed, IT systems and infrastructures have evolved, often piecemeal, to serve the prime focus on speed and access. They have rarely been built for systematic data collection and transfer. The blanket emphasis on trading as rapidly and as efficiently as possible has crowded out the scope for developing the systems needed for systematic regulatory reporting. This does not necessarily imply that there are many broker-dealers failing in their obligations. But the increasing pressure from regulators is leading to a constant series of low-level penalties for technical infractions.

As a general conclusion, current reporting systems may be increasingly unfit for purpose. Patching and mending will eventually prove inadequate. If the regulatory agenda is to succeed in its objective of increasing the stability of markets and electronic trading, many market participants will need to implement major systems changes. Among the most important challenges for firms is to put in place robust change management processes (rules and IT enhancements) and an equally robust testing program to continually monitor reporting against rules and requirements. Lastly, reporting and escalation to management on key metrics (volumes, errors, system issues, audit issues, late trades, etc) need to be incorporated into the governance processes to ensure efficient attention and the right tone from the top.

Key points

Equities and Equity Options: exchanged traded, regulated by SEC and FINRA. Equity orders are captured and reported into OATS. OATS reporting is a real challenge for firms to get right as lots of data from multiple sources (order entry systems) have challenges when trades are allocated and updated (cancels and corrects).

Fixed Income: Bonds are all traded over the counter and are reported to FINRA via TRACE. Firms have challenges determining what needs to be reported; and over timely reporting, allocations and cancels and corrects.

Swaps: Most are now centrally cleared. Regulation is split between equity swaps (SEC) and all others (CFTC). In view of CFTC Commissioner comments and complexity in the rules, it is likely that these will be equally as challenging as OATS and TRACE.

2 Regulation of Cross-Border OTC Derivatives Activities: Finding the Middle Ground, Elisse Walter, Chairman US SEC, American Bar Association Spring Meeting, April 6, 2013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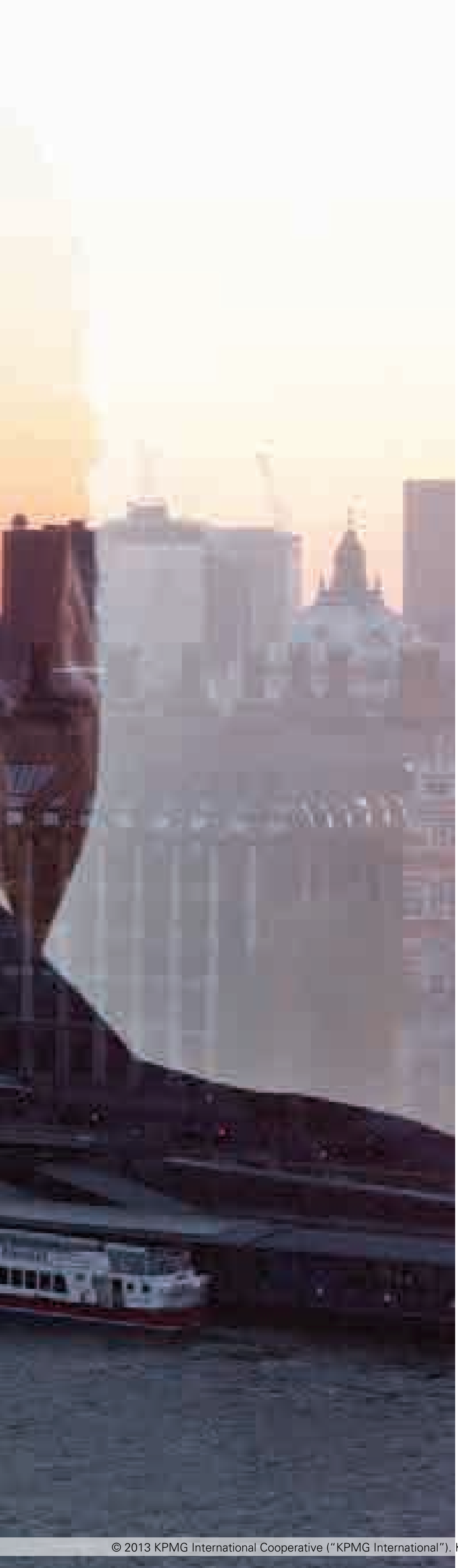
Moving on – Does the industry get it?

Giles Williams, KPMG in the UK

Giles Williams



One of the early responses to the crisis was anger that professionals in the financial services sector, especially bankers, appeared not to accept responsibility for the results of their previous behavior. In December 2009, President Obama famously criticized what he called "a bunch of fat cat bankers on Wall Street." He continued:

> "The people on Wall Street still don't get it. They don't get it. They're still puzzled why [it is] that people are mad at the banks. Well, let's see. You guys are drawing down $10, $20 million bonuses after America went through the worst economic year that it's gone through in decades, and you guys caused the problem… Why do you think people might be a little frustrated?"[1]

In KPMG International's recent paper *Moving on – The scope for better regulation*[2] we suggest that we have reached a tipping point where the cost of new regulation is beginning to outweigh the benefits. We argue that all stakeholders – the industry, investors, consumers and regulators – need to re-assess where they are going and whether greater balance is required. If the industry wants other stakeholders to engage, it needs to be very clear in demonstrating that it "gets it".

Further progress is needed by the industry to meet its side of the bargain. The truth is that nearly five years after the collapse of Lehman Brothers in September 2008, the world in which financial services must operate has changed radically. Financial services professionals will never see a return to pre-crisis conditions in the remainder of their working lives. So it is worth revisiting the question. Has the financial services industry learnt its lesson? Or do they still not get it?

Some do, some don't

There are many positive indications that senior bankers have understood how profoundly the environment has changed, and that there are fundamental implications for their business models. But many junior management, and the other segments of financial services – insurance and investment management – continue to act as if the crisis has no direct business implications for them. Of course they complain about new regulation – sometimes quite rightly – but in the context of the macro-objectives of stability, interconnectivity, customer trust and protection there seems a sense of denial about how society's demands on the financial services industry have changed. So in broad terms the answer is probably: no, on balance, many still don't get it.

To some extent, the different responses of banks and the rest of financial services are understandable. Banks were at the center of the crisis, and in the main it is banks which have gone bankrupt or had to be bailed out by taxpayers. So they are more likely to appreciate the scale of the change now occurring. By contrast, the insurance industry has been fighting a defensive battle to avoid being subject to restrictive new regulation. Some asset managers have argued forcibly that far from sharing responsibility for the crisis, they were the 'good guys', providing liquidity to the market and helping the price discovery process.

However, this differentiation within financial services is increasingly untenable. Virtually all of the fundamental forces reshaping the industry today apply to all sectors. The world is going to be as different for insurers and asset managers as it is for bankers. There is no going back for any of them. Those who hope for a return to 'business as usual' in its earlier form are likely to be disappointed. The question is why?

Politics and regulation – the one size fits all approach to life

There is a political imperative to be seen to be doing something, regardless of specific rationales and whether regulatory change will objectively increase stability and reduce risk. Since the G20 took the lead in orchestrating the response to the crisis, the appearance of action has been in some ways as important as actual action. In some cases, action may have been ineffective or even inconsistent: an unfortunate side effect of regulatory competition between jurisdictions in an environment of continued economic stagnation is increasing domestic protectionism which, if it becomes excessive, will both increase costs and reduce stability.

Regulators have to turn political direction into action. There is a serious concern as to whether the intensive level of political scrutiny is actually making the process slower, less optimal and inefficient – but this is a wider

1 www.cbsnews.com 13 December 2009
2 KPMG, May 2013

debate. Across the globe regulators are pursuing a number of core themes which will eventually have profound implications for all financial services firms, including:

- tighter controls on firms deemed to pose systemic risk (systemically important financial institutions – SIFIs), in whichever sector they occur both domestically and internationally; assertions by the insurance sector that their business models were fundamentally different from those of banks has not prevented a number of large multinational insurers being provisionally designated as SIFIs
- recovery and resolution planning requirements, allowing SIFIs which are in trouble to be restructured or dissolved without causing damaging contagion
- controls on remuneration: these are being targeted not primarily at the absolute quantum of remuneration – although political rhetoric remains seriously hostile – but at bonuses and their relation to performance; at the danger of excessive short-termism; and at the structure of incentives and conflicts of interest. It is difficult to see how the political imperative will not impact as much on insurers and asset managers as on banks in the long run
- the conduct agenda: all firms in the industry will be subjected to new regulation designed to ensure that they act fairly and transparently; while the details vary from one jurisdiction to another, the requirement to act in the best interests of customers is a profound modification of the free-market *caveat emptor* principle, which will impact on insurers, asset managers and bankers alike.

Consumers and the trust agenda

Consumer confidence in the financial industry has been seriously damaged. Survey after survey shows distrust, verging on hostility, directed at the whole of the financial services sector. We all struggle to appreciate how far and how deep this distrust extends. Bankers are perceived as stifling the economy through excessive deleveraging; insurers are piling on premium increases while doing everything they can to avoid paying legitimate claims; investment managers continue taking fees while delivering negative real returns. The press line is that all involved are seen to be more concerned with lining their own pockets than with serving customers fairly. Not fair necessarily – but we all know that perception is often the best test of reality.

Rebuilding trust will take many years, and requires genuine and fundamental culture change, not just lip service being paid to new orthodoxies. The challenge will be even greater as long as economic recovery remains subdued, and while consumers continue to suffer real declines in income, wealth and future expectations. Change is a long-term program. The Salz Review of Barclays' business practices emphasized this point:

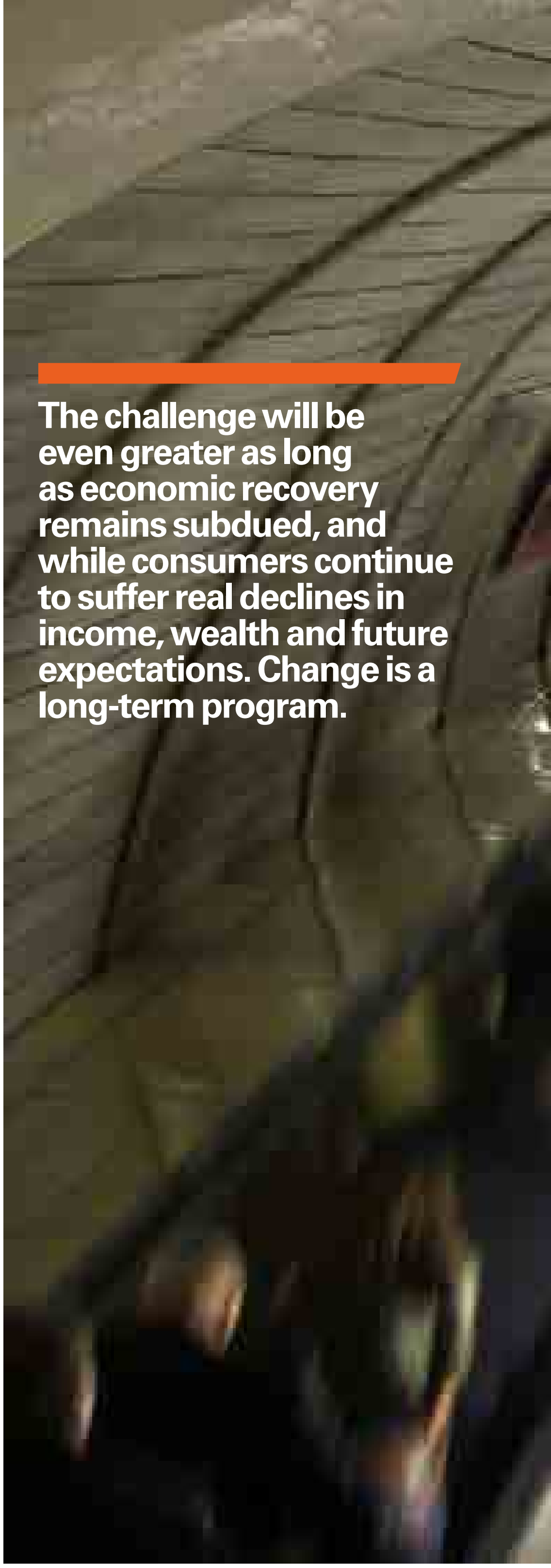
> "It will take time before it is clear that sustainable change is being achieved… It will take time to change mind-sets and [this] will need to be led clearly from the top. It involves two-way communications, both internally with all staff, management and the Board, and externally with all stakeholders – including, importantly, regulators. It involves better listening."[3]

Many good initiatives are underway already, but these will take years, rather than months, to turn consumer perceptions and trust around.

Interconnectedness

The nature of the industry itself is changing rapidly, blurring the traditional distinctions between sectors. There is much more interconnectivity, especially in the retail market, with products and services being marketed in integrated packages combining, say, banking and insurance or insurance and wealth management. The business model of life companies is moving closer to asset management. The large multinational companies are offering one-stop services, and increasingly looking to cross-sell as a route to increased volumes and profits. New entrants into mature markets will break down the traditional boundaries further.

In addition, markets and exchanges are increasingly interconnected. Custodian banks provide services such as safekeeping, compliance reporting and administration to the whole spectrum of banks, insurance companies, mutual funds, hedge funds and pension funds. Institutions of all kinds take advantage of the reinsurance market to manage risk. Financial infrastructure such as payments systems and clearing tie together all kinds of institutions. Third party service providers and outsourcing companies underpin the industry on a global scale.Despite patchy economic performance in a number of



The challenge will be even greater as long as economic recovery remains subdued, and while consumers continue to suffer real declines in income, wealth and future expectations. Change is a long-term program.

regions, the globalization of financial services continues as it did before the crisis, despite the fact that regulators are becoming increasingly "localized" in their outlook.

But it is the external context which has changed most fundamentally, in relation to politics, regulation and to public and consumer perception. All of the trends driving change here apply across the board, and investment managers and insurers need to understand

3 Salz Review, An Independent Review of Barclays' Business Practices, April 2013

and respond to them as much as bankers do. There seems little doubt that risk transfer and inter-connectivity across the wider financial services sector means that a serious issue in one segment will impact on the wider industry.

Changed expectations
It is difficult to measure whether finance professionals as a body realize that society's expectations of their business activities in the future have changed. The crisis has crystallized a vague unease at the perceived excesses of the industry into a clear determination that financial services will play a fundamentally different role in future, more akin to that of a utility than to a dynamic, high growth, high profit industry. Of course there will be niche players who will continue to operate in the margins, but core financial services and large players will continue to be in the spotlight. There will be no return to the 'good old days', whether for insurers, asset managers or bankers. Those firms that still don't get it will, at worse, fail and at best see their reputations with regulators and consumers damaged with the obvious consequences. If the industry does not play its part, the change in direction of regulatory policy we argue for in *Moving On* will not be possible, as the other stakeholders will continue to throw down the accusation of "they just don't get it".

The immediate anger at the excessively risky and unacceptable behavior of banks in the lead-up to the crisis has faded. In its place, there is now a determination to construct a more stable and sustainable framework for the future. Although improved regulation and supervision are important elements of that new framework, the essential foundations are banks' internal risk management systems and culture. There is a lot still to do.

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More effective risk culture in banking

David Sayer, KPMG in the UK
Mark Smith, KPMG in Canada
Julian Morgan, KPMG in the UK

Strengthening risk management

In principle, effective risk management should lie at the heart of financial services business. The proper evaluation, and pricing, of risk is essential to all forms of banking, insurance and investment management. Like all businesses, banks in particular are risk-taking and risk-managing organizations. But unlike other businesses, the leverage inherent in fractional reserve banking makes banks uniquely susceptible to mismanagement of risk; and this carries particular threats to the wider economy.

In practice, the financial crisis revealed in the starkest possible terms that banks were woefully incompetent in understanding the risks they were accepting and in responding accordingly. Despite the best efforts of regulators and supervisors, and no doubt the best intentions of senior managements, banks systematically under-priced risks; and in a number of cases they allowed unacceptable practices to develop which ultimately threatened the stability of the whole financial system.

In the wake of the crisis, the G20 Leaders identified as a priority a need for more intense and effective supervision in future, particularly as it related to systemically important financial institutions (SIFIs). Through the Financial Stability Board (FSB), they have set regulators the task of making the supervision of financial institutions more intense, effective and reliable. Their challenge is to define a revised threshold of sustainable returns for shareholders which also offers safety and soundness for the wider economy and society.

This work is being led by the FSB's Standing Committee on Supervisory and Regulatory Cooperation, which has set up a dedicated working group for the purpose (the FSB Supervisory Intensity and Effectiveness Group, chaired by the Superintendent of Financial Institutions).

Regulation is not sufficient

Supervision and regulation alone are insufficient to drive a significant improvement in risk management and overall financial stability. Indeed, excessive reliance on regulation and on rules to translate those regulations into practice may even *increase* risk. There are plenty of indications that in the lead up to the crisis banks and bankers were happy to abide by the letter of regulation, giving little real thought for the potential consequences. The fact is that an effective *risk culture* is essential to ensure that both the letter and the spirit of regulation are respected. In their November 2012 Progress Report on the issue, the FSB noted that 'Establishing a strong risk culture at financial institutions is an essential element of good governance.'[1]

In defining what determines appropriate and effective risk management, it is helpful to distinguish two contrasting elements. The first is the explicit design and operation of the risk management *system*. This includes definition of risk appetite, governance, capabilities and reporting (see Table 1). The second element is the nature of the risk *culture* in the organization – 'the way we do things round here' – and whether it is conducive to people behaving in the correct and desired manner independent of specific system provisions (see Table 2).

Contrasting approaches

Different banks vary significantly in the balance they exhibit between these two elements of explicit system and implicit culture. In many cases, these differences reflect contrasting corporate histories and current characteristics. Some banks have a very strong culture created over generations and passed down from senior executives to new recruits. People acquire an instinctive understanding of 'the way we do things round here' as they progress through the organization, so that they *instinctively* reflect and embody its specific corporate risk culture. Other banks are much more highly prescriptive and legalistic, with elaborate rule-books and less reliance on people doing the right thing naturally.

Every bank needs to target its desired position on the system-culture continuum. But in the end, an effective risk culture is paramount.

Both sets of characteristics have strengths and weaknesses. The implicit model works well in smaller, more localized banks. But since it depends on a rich understanding and internalization of culture, it cannot easily cope with rapid expansion, geographical dispersion or high rates of staff turnover. Globalization, and the transition from the partnership model to limited liability, have substantially weakened its power in recent decades.

Table 1: Elements of a good risk system

Risk appetite	Risk appetite statement
	Cascading statement and metrics
	Core businesses – linked to strategy and products
Risk governance	Mandates, responsibilities and accountabilities
	Committees/committee structure
	Overall organization structure
	Stature and authority (independence)
	Policies, limits, processes, controls
	Oversight of particular risks (market, credit, etc.)
	Performance management, incentives and HR reinforcers
Risk capabilities	Human
	Training/expertise
	Numbers of people in right roles
	Skill and experience
	System
	Infrastructure
	Tools
	Analytics
	Models
	Scenarios
	Stress testing
Risk reporting	Aggregation at multiple levels
	Dashboards – facilitate decision-making
	Transparency

Source: KPMG International, 2013

Table 2: Elements of a good risk culture

Culture element	Sample Question
Risk orientation	At (the Bank), we have the correct balance between achieving returns and managing risk
Ownership and accountability	At (the Bank), everyone feels a high accountability for identifying and managing risk
Leadership direction/ Tone at the top	Leaders make it clear in numerous ways that they and we must take the risk guidelines seriously
Risk judgment	People at (the Bank) tend to be aware of both current risks and emerging potential risks
Risk management behaviors: Openness, Transparency, Ethical practice, Proactive, Identify and escalate, Mutual respect, Challenge, Feedback	People at (the Bank) are willing to hold each other to account by pointing out issues and challenging current practices, even if it could lead to a confrontation. People are quick to escalate risk concerns
Work together	There is a healthy tension and mutual respect between the Front Office and Risk
Compliance	At (the Bank), people don't exploit inconsistencies or "gray areas" in policies and procedures
Sustainability	I believe (the Bank's) risk management system and culture will be sustainable even when new leaders and/or changing circumstances enter the picture

Source: KPMG International, 2013

1 Increasing the Intensity and Effectiveness of SIFI Supervision: Progress Report to the G20 Ministers and Governors, FSB November 2012.

The explicit, highly prescriptive model is more suited to large and dispersed banks; it can cope with high turnover and corporate expansion, and is superficially more appropriate to the contemporary world of rules-based supervision. But in practice it is too expensive to build a risk system which can cope with every eventuality, and impossible for such a system to keep pace with business developments. It also carries very real dangers: employees may come to feel that everything which is not forbidden is actually allowed. In this respect, it damages the personal integrity and moral code which should be at the heart of behaving properly.

In consequence, most SIFI-banks need to focus much more attention on developing good risk culture; and many smaller banks need to stiffen their systems to improve robustness and future sustainability. Every bank needs to target its desired position on the system-culture continuum. But in the end, an effective risk culture is paramount. An effective risk system is a necessary but not sufficient prerequisite for an effective risk culture.

Assessing risk system and culture

Multiple methodologies can and should be used to assess the current risk system and risk culture and determine the actions necessary to move to the desired position. These include:

- self-reporting: various risk and control self-assessments
- observations by Internal Audit: changes over time in type, severity and frequency of findings, completion rates, etc; comments on behaviors
- questionnaires: is the risk system perceived to be effective? is the risk culture perceived to be effective?
- focus groups: cross-geography, cross functions (LOB and support), multiple levels
- structured Interviews: senior executive, line and support functions.

In addition, scenario immersion and role-playing can be very valuable in exploring different behaviors in different circumstances, and can illuminate implicit assumptions and attitudes. They can reveal inconsistencies in incentives, targets and rewards and conflicts with desired risk behavior.

The result should be an assessment of the effectiveness of the risk system and risk culture in terms of:

- alignment/mismatches/outliers
- what's not said
- say-do gaps
- issues/areas of incompleteness
- areas of strength
- deeper dives
- confidential comments.

Embedding effective risk management

Changing a bank's risk culture is a fundamental change challenge. It should be clear that it involves developing aspects both of the risk management system and the risk management culture, and of rebalancing emphases between the two. Like all culture change, it requires inspiring people, and demonstrating commitment and compliance from the top.

What is also important, in the context in which risk management is developing after the crisis, is that external stakeholder expectations are managed in such a way that they are consistent with what is achievable and what is necessary if a more robust and stable financial system is to be created. Excessive short-termism, and demands for returns on equity which were incompatible with stable risk management, were among the prime conditions which allowed the crisis to develop. The transition to a permanently less risky, lower-return environment will be painful.

It will depend in part on admitting that after an era of disintermediation in both commercial and retail banking, and an excessive reliance on quantification and models, we need to relearn some of the lessons of the past, and focus on behavior and culture which encourage safety and soundness.

It will also depend as much on shareholders, rating agencies and analysts adjusting their frameworks of performance assessment as it will on boards and senior executives creating a more appropriate and sustainable risk culture.

New pressure on investment management: Regulating remuneration

David Ellis, KPMG in the UK
Rupal Patel, KPMG in the UK

It is generally conceded that inappropriate incentives and remuneration structures led to unwelcome behavior in the banking industry: this increased risk and contributed to the crisis. Regulators across Europe and Asia-Pacific are now focusing closely on this topic in relation to investment management firms, reflecting the political imperative to control excess and reduce risk. Firms will have to respond. But it will be important to preserve flexibility.

General anger, specific concern

Remuneration is one of the more politically sensitive issues to emerge as a priority from the financial crisis. When times are good, there appears to be little general concern over levels of remuneration in the financial sector. But when things go wrong, causing loss and damage to millions of people, there is an inevitable focus on the contrast between performance and reward. The sense that senior executives, in particular, have 'got away with it', and in many cases received massive rewards for failure, has been a powerful stimulus to political action.

While this kind of reaction is primarily an expression of generalized and unsophisticated anger, more considered analyses have also led to concern about remuneration arrangements in financial services. There is an increasingly widespread view among political leaders, regulators and supervisors that, in the period leading up to the crisis, remuneration structures created damaging and destabilizing incentives. At the least, they stimulated excessive short-termism at the expense of the long-term sustainability of business models; at worst, they created pressure to make profit at any price, if necessary through behavior which was improper or bordering on illegal.

Contacts (from left)
David Ellis
Rupal Patel

The apparently endless succession of mis-selling scandals now hitting the industry provides a stark demonstration that remuneration policies and incentives resulted in serious misbehavior. Many – though not yet all – leaders within the financial services industry itself are coming to feel with hindsight that the concerns now being expressed are justified. As regulators focus on prudential management, conduct of business and financial stability, they are also – for the first time – directly addressing the issue of remuneration.[1]

Europe

For investment managers in Europe, this focus on remuneration will mainly be felt through the new Alternative Investment Fund Managers Directive (AIFMD), which places remuneration policy firmly within a framework of promoting sound and effective risk management. The European Securities and Markets Authority (ESMA) published draft guidelines on the remuneration elements of the Directive in June 2012, followed by final guidelines in February 2013. AIFMD must now be implemented at national level by 22 July 2013.

The regulations implementing AIFMD will require investment management firms to make changes to the structure and governance of remuneration, and will introduce a new disclosure regime. In-scope firms will be required to have remuneration policies that 'promote effective risk management' and which align risks with their broad investment objectives. The remuneration requirements will primarily apply to employees whose role has a material impact on the risk profile of the firm or the funds under management ('identified staff').

There will be specific requirements in relation to the funding and delivery of variable remuneration. A portion of the variable remuneration for identified staff must be deferred for between 3-5 years (unless the lifecycle of the fund is shorter). At least half of all variable remuneration must be in the form of equity instruments linked to the performance of the funds managed. Variable remuneration should be determined by performance of the funds, of the business unit and of the individual combined. There will also be controls on guarantees, severance pay and personal hedging strategies.

In addition, there will be new regulations on remuneration committees, on internal controls and on reporting and disclosure.

ESMA has introduced various anti-avoidance measures to ensure that the regulations capture the intended firms, individuals and forms of remuneration. The provisions also introduce the concept of clawback provisions (or 'malus') for remuneration in the case of under-performance. These concepts will be familiar to many in, for example, the banking sector, where they have become a feature of remuneration packages since the crisis. However, it remains unclear how they will work in practice in other industries and for a wide population of staff.

Asia-Pacific

In Australia, the Future of Financial Advice (FOFA) reforms will introduce a ban on 'conflicted remuneration', including commissions, in the retail investment products market. Broadly speaking, licensees and authorized representatives will not be allowed to give or receive payments or non-monetary benefits if these could reasonably be expected to influence financial product recommendations or financial product advice provided to retail clients. As a result, all payments dependent on the total number or value of financial products of a particular type will be presumed to be conflicted, although it will be open to advisers to prove that they are not. These reforms are designed to encourage financial advisers to become more client-focused, with more of their fees being paid directly by the client rather than indirectly through product commissions.

In Japan, there are currently no specific regulations governing executive remuneration. However, the Japan Financial Services Authority retains the power to require changes to any remuneration system in a financial institution which it feels is creating excessive risk. There is also an obligation to disclose details of high salaries, requiring financial institutions to disclose both the number of highly remunerated individuals and the amounts involved.

Implications for investment managers

The thrust of the increasing regulatory oversight of remuneration in investment management is to limit risk and ensure that it is consistent with an organization's explicit risk appetite and risk management policy. Organizations therefore need to develop remuneration frameworks which connect performance and reward with the strategy, priorities and value drivers of the organization, and which incorporate effective risk management.

In turn, this depends on creating a culture of appropriate behavior and values and on expressing organizational priorities clearly and consistently – embedded using structure, process and training and passed on over time through stories of successes, failures, doing the right thing and doing things right – reinforced through incentives. These arrangements need to be underpinned by robust governance arrangements including appropriate control functions.

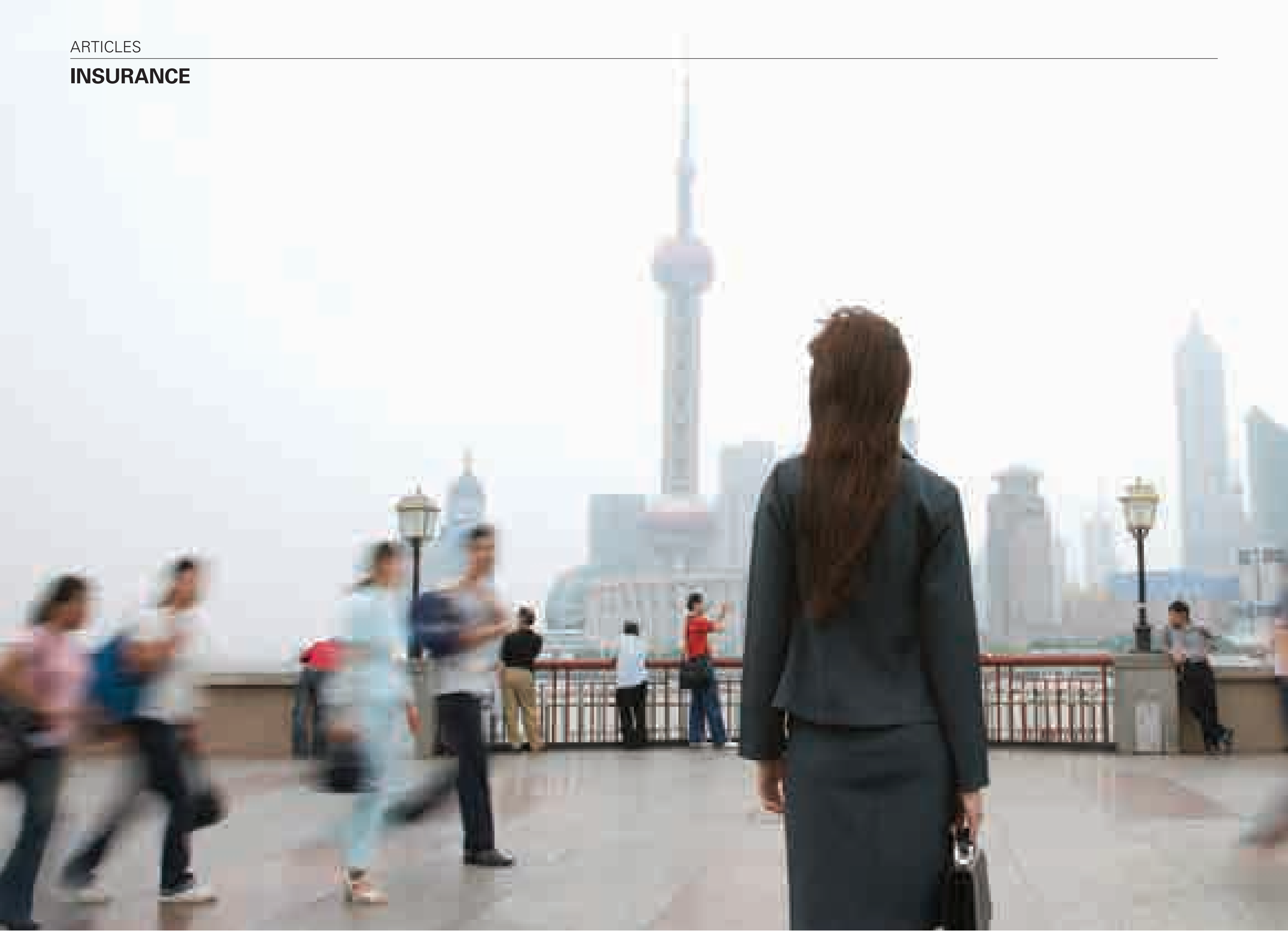
Embracing regulatory initiatives early on – seeking the opportunities rather than focusing on the challenges – can allow the organization to respond and act quickly ahead of the competition.

Getting the balance right

The remuneration policies of financial institutions are likely to remain high on the political agenda for the near future. As we have seen, the need to address issues from systemic risks to investor protection and to improve transparency, corporate governance and tax compliance will add to the pressure for tougher regulatory action in this area.

However, it is important to remember that incentive structures which involve a high proportion of variable remuneration, in the form of commission or bonuses, ultimately reflect a desire to improve the flexibility of cost structures, and tie remuneration more closely to performance: where remuneration is largely fixed and rigid, the ability to match costs to revenues and profits is severely curtailed. In the new era of low returns and increased cost pressure, flexible resourcing and remuneration models will be more important than ever in the investment management industry. The challenge for new regulation will be to restrict excessive and perverse incentives while allowing the industry the necessary flexibility to grow and to serve customers effectively.

1 The discussion which follows draws on the latest edition of KPMG's series Evolving Investment Management Regulation: Light at the End of the Tunnel? June 2013.



Insurers face challenges which are in many ways unprecedented: not simply as a result of the crisis, but also in the face of the major changes – the global mega-trends – which are transforming the business and social environment. What will help the winners pull ahead will be *genuinely* re-engineering their business around the customer. However, many insurers have yet to realize the scale of the transformation required. And fewer still are successfully achieving it.

Putting the customer first – For real

Mary Trussell, KPMG in the UK
Mark Straub, KPMG in the Netherlands
Jörg Günther, KPMG in Germany
Alison McDowell, KPMG in the UK

Last year, KPMG published a ground-breaking report on global mega-trends and their impact on the future of insurance.[1] This identified four dominant forces which will impact on the industry over the next 20 years – demographics, environment, technology, and social values and ethics. We mapped these mega-trends against the insurance business model, highlighting key opportunities and risks for insurance firms.

In our discussions with insurers around the world about the impact of these trends, we found that the firms which continue to be successful, even in a volatile, low- yield environment, exhibit specific attributes that set them apart from their competition. Above all, those firms that put their customers at the heart of their business are able to navigate through the storm and chart a new course for

1 The Intelligent Insurer: Creating value from opportunities in a changing world, KPMG International, 2012

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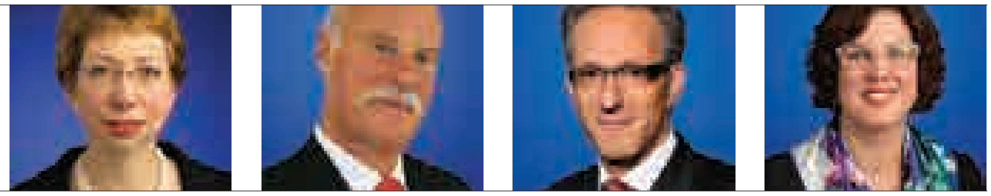


The current challenge is so great that doing nothing is not an option. The crisis has eroded consumer confidence in financial services institutions.

There are a number of factors inhibiting insurers from actually achieving the necessary transformation.

growth, while satisfying changing regulatory demands. Hence, *putting the customer first* must be the fundamental theme underpinning insurers' strategic response to the current and emerging challenges.

However, genuinely focusing on the customer (rather than simply paying lip service to the concept) in most cases requires fundamental change. It means stripping back the value chain to its essentials and focusing consistently on satisfying customer needs. Achieving this involves putting the business under the microscope, defining specific strategic objectives and single-mindedly focusing on delivering them. Many insurers are aware of the scale of the challenge: during June 2013, KPMG surveyed a number of leading companies, and found that only 36 percent feel that they yet have an agile business structure adaptable to changing customer and market needs.[2]

With change comes challenge

There are a number of factors inhibiting insurers from actually achieving the necessary transformation. Despite the frequently very long timescales involved in insurance, especially in the life sector, investors and management tend to have a short-term performance focus. In addition, there are specific characteristics of the insurance industry which militate against radical action. Insurance is not an industry renowned for radical thinking: insurers are more used to incremental evolution.

Regulation is typically imposed country-by-country, and different countries have quite distinct regimes for taxes and for retirement savings. This means that life insurance products are in general country- and market-specific, which imposes particular challenges to standardization, of products and of operations. Where other industries have aggressively pursued standardization and globalization, insurers have had to adopt different attitudes and priorities – and so regulation has acted as a brake on innovation.

Further complications come from the widely varying approaches to distribution in different markets. Some customers still expect face-to-face interaction with insurance agents, for example in South-East Asia; others, such as those in the UK and US, are more comfortable with online or mobile purchases. Partly as a result of this variation, the KPMG survey noted above found that only 33 percent of insurers feel their distribution network generates a consistent positive customer experience across channels.

There is also some confusion and complication over who the customer actually is. Insurers have typically treated their intermediaries and distributors – independent financial advisers and tied agents – as their customers. However, consumers are becoming more demanding; regulators are focusing much more clearly on promoting good consumer outcomes and demanding greater transparency in how much is paid for intermediation. As a result, insurers are having to change their attitudes. Systems, processes and mind-sets for dealing with some hundreds or thousands of intermediaries are completely inappropriate for dealing with tens of millions of end-customers who may require contact at any hour of the day or night.

All told, this makes achieving genuine customer focus increasingly challenging.

Transformation and profitable growth

In extending the argument developed in our earlier report, we have drawn three key conclusions about how insurance companies can successfully approach transforming themselves into genuinely customer-focused operations:[3]

- The current challenge is so great that doing nothing is not an option. The crisis has eroded consumer confidence in financial services institutions. Those companies which do not react, and pursue recovery strategies focused on putting the customer first, risk the loss of their franchise.
- Customer requirements and demands have changed dramatically, and under the influence of the global mega-trends will continue to change in the future. This places a premium on *adaptability*. A flexible corporate structure, ready to respond and evolve to maintain customer focus, will be critical to sustained success.
- Change has to be approached consciously, deliberately, and with a very clear understanding both of the objectives and of the environment in which they are being pursued. The greatest challenge is not identifying what needs to be done, difficult though this may be. The real key to fundamental transformation is strong leadership to ensure that the necessary action is taken.

Leadership is critical for sustainable transformation

This is because a genuine and determined focus on the customer often involves a radical reconfiguration of the business model:

- The insurance industry normally operates in terms of product silos, not customer needs, and companies tend to structure themselves accordingly. But customer needs cut across product silos, crossing underwriting and product lines.

2 Source: KPMG International, Valued Insurer pulse survey conducted at industry events, June 2013
3 cf The Valued Insurer: Leading the pursuit of sustainable growth, KPMG International 2013

- Business processes need fundamental overhaul to become genuinely customer-focused. In insurance, these aspects have traditionally been secondary to underwriting, and their significance under-played. But activities such as claims processing are at the heart of the *customer's* experience of dealing with an insurer. They need to be prioritized.
- Performance management rewards volume and not long term value creation. Few insurers yet understand how to reward on the basis of customer satisfaction, and how to incentivize staff to focus on the customer view. Good customer outcomes must become the primary criterion.

Taking the necessary action involves innovative thinking alongside a concerted drive to action from the top. The resource allocation choices can be a major challenge. None of this can be achieved without strong leadership.

The successful insurer

Against the background of the global mega-trends discussed in *The Intelligent Insurer*, we believe that there are four key attributes – focus, efficiency, agility and trust – which will characterize a successful and valued insurer, today and in the future:

- Focus: Best-in-class insurers articulate a clear strategy that reflects their vision and focus. Top firms have charted a precise course focused on a long-term view of their customers' needs.
- Efficiency: Successful insurers embrace a culture of continuous focus on efficiency that strips out unnecessary cost. They invest in scalable systems, processes and delivery channels to resolve legacy inefficiencies.
- Agility: Top insurers demonstrate the flexibility to adapt swiftly to a changing environment. An open mind-set characterizes their people from the boardroom to the front line.
- Trust: Top-performing insurers have built confidence and trust in the eyes of their customers, regulators, investors and the communities they serve.

Components of a customer-centric business model

Customer- centric business model	
Better knowledge of customers	• Do you understand the needs of customers and develop propositions to match? • Do you use predictive analytics and propensity modeling to target and cross-sell?
Relevant propositions at the right time	• Are your propositions based on customer needs and do your customers reward you through greater loyalty, referrals and retention? • Can you comply with more consumer-focused regulation?
Optimal distribution for each customer segment	• Do you understand how customers want to buy and have you aligned your distribution strategy? • Have you optimized the cost of acquiring your customers based on the value created by your propositions?
Optimal servicing for each customer segment	• Do you understand how your customers want to be serviced and through which channels? • Do you promote a positive customer experience at every touch point?

Governance and People	Enablers	Regulation and Capital Management

Source: The Valued Insurer, KPMG International, 2013

In an environment where competition is becoming ever more intense, it will become increasingly important for insurers to:

- develop differentiated propositions targeted at particular market segments
- focus on building loyalty to reduce customer churn and pressure on business volumes
- differentiate brands through enhanced customer service, and thus
- deliver maximum value for customers.

We firmly believe that those insurers which successfully commit to these objectives, with the four key attributes of focus, efficiency, agility and trust, will be the ones to survive and thrive, now and in the face of further major change.

Valued insurers: What they say[4]

"Becoming more customer-centric is first and foremost a mind-set. Regardless of role or function, every person across our businesses must have a clear sightline to the customer. Going forward, being a customer-centric organization will mean that, in everything we do, wherever we conduct our business, the customer will be at the centre of what we do and how we do it."

Alex Wynaendts
CEO, AEGON

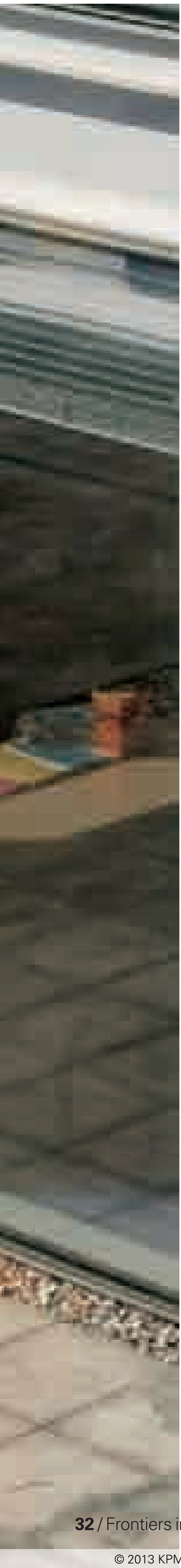
"By sharpening our customer focus, and staying ahead of the regulatory change curve, we are well equipped to take advantage of the changes around us. Through investment in business process management and customer relationship management systems we've also lifted service quality and efficiency."

Craig Meller
Managing Director, AMP

"Customer satisfaction is important to us for several reasons. Firstly, a satisfied customer has a multiplier effect because he recommends Allianz to friends and acquaintances. Secondly, he also provides business opportunities because he remains with us for a long time or becomes interested in other products. Customer satisfaction could be called the engine of our business."

Result for the Customer
2012 Allianz Deutschland

4 Sources: see The Valued Insurer, ibid

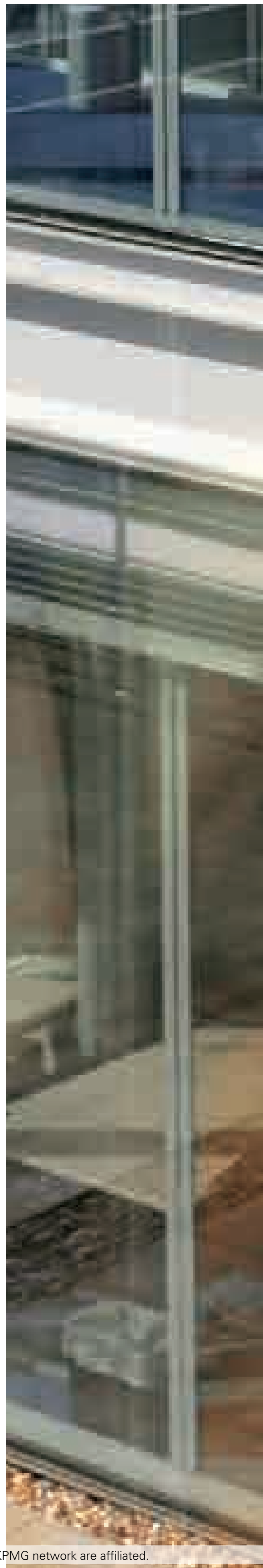


All organizations need to develop a robust set of soft controls if they are to earn the trust of stakeholders. For financial services firms, the challenge of rebuilding trust is currently especially severe. To rebuild trust, at least seven soft-controls need to be embedded within financial service firms.

The hard side of soft controls: The 7 elements of building a foundation of trust from the inside out

Muel Kaptein, KPMG in the Netherlands

Rebuilding trust
Restoring trust in the financial services sector is widely recognized to be a key priority. Trust has been severely damaged by the financial crisis; perceptions of financial companies, among the public and political leaders alike, are profoundly negative. Rebuilding trust is essential to restoring confidence in financial markets and to underpinning economic recovery more generally. For individual companies, creating or recreating relationships of trust – not just with customers, but with shareholders, regulators, ratings agencies, even their own employees – can hold the key to a return to growth and profitability and to sustained competitive advantage.



Muel Kaptein

Trust is an ephemeral, intangible quality. Many business leaders, in finance as elsewhere, proclaim its core importance. Fewer, however, understand what creates trust or how to nurture it within and outside the organization. But it is vital that they do better. According to the 2013 Edelman Trust Survey,[1] banking is globally the least-trusted of 18 major industries, and is the only industry that has seen no recovery in trust since the financial crisis; in the UK, almost 60 percent of the public rate the banking industry's performance as poor or very poor.

Banking and financial services scandals are a significant factor behind this lack of trust and perception of poor performance. A very recent UK Parliamentary Report on the banking system found that: "The UK banking sector's ability both to perform its crucial role in support of the real economy and to maintain international pre-eminence has been eroded by a *profound loss of trust born of profound lapses in banking standards*."[2] When Edelman asked people what causes these scandals, a range of reasons were cited: corruption; a compensation driven culture; and conflicts of interest. Crucially, nearly 60 percent of people identified causes as 'internal' and with the business' control. The Boards of financial institutions frequently debate about how to ensure their policies, and more importantly the intent of the policies, are properly carried out and followed throughout a sprawling global institution. How can they start to rebuild trust with investors, regulators, customers and other important stakeholders? With the right tools, and a proper understanding of the issues, it is within the power of financial companies to rebuild trust.

Understanding trust

Trust is a function of two complementary characteristics: competence and integrity. No organization will inspire trust if it is not competent, if it cannot get the basics right. But competence is not enough. To earn trust, an organization has to behave according to sound moral and ethical principles, and focus on truth and fair dealing, uprightness, honesty and sincerity. Like many other organizations, banks have long known that ensuring people behave with integrity and according to agreed values depends on instituting the right combination of rules and underlying culture, what we term here respectively *hard and soft controls*.

Hard controls include explicit policies, regulations and procedures, together with specific responsibilities, structures and targets, backed up by rewards and sanctions – most fundamentally dismissal – in the event of misbehavior. Soft controls embrace all those intangible aspects of an organization's culture which frame and condition individual's expectations of proper behavior. They include aspects such as client centricity, professionalism, team work and empathy. Neither hard nor soft controls alone is sufficient. In other words, hard controls can only be effective when they are supported by soft-controls – policies that employees understand and believe in are more likely to be followed. Conversely, without the necessary hard controls there is little opportunity for measurement and it becomes a theoretical (i.e. less productive) exercise. The challenge is have the right balance between hard and soft-controls.

1 Edelman Trust Barometer 2013 Annual Global Study, www.edelman.com
2 Changing banking for good, Report of the UK Parliamentary Commission on Banking Standards, June 2013 (emphasis added)

The UK banking sector's ability both to perform its crucial role in support of the real economy and to maintain international pre-eminence has been eroded by a profound loss of trust born of profound lapses in banking standards.

However, it is not enough merely to note that hard and soft controls need to work in harmony. Soft controls need to be specifically inculcated and nurtured. Cultural issues are often seen as 'fluffy' or intangible, not something for dynamic, decisive senior executives to be concerned with. In fact, soft controls need to be made as explicit – as 'hard' in their own way – as hard controls.

The key foundations

We have argued above that if a financial institution is to behave with integrity, an essential foundation for building trust, then it has to reflect explicit ethical principles. In common business-speak, it needs to develop and articulate a statement of its mission, backed up with what are variously described as core values, business principles and codes of conduct. Once these are in place, we have found in the course of a great deal of research on how soft controls influence organizational behavior and performance that there are seven critical cultural dimensions which differentiate good from poor organizations.

1. **Clarity.** People at all levels need to be clear what is expected of them, and what norms and values govern desirable and undesirable behavior. In the same way as football players not only need to know the rules of the game but how they are going to be enforced by the referee and how the coach wants them to play the game, employees have to learn the difference between what is acceptable and what is not as it applies in their specific organization, and understand the consequences of failure. The more clearly this is understood, the more likely – although this is not alone sufficient – people are to do the right thing.

2. **Role-modeling.** The right tone needs to start from the top, and be cascaded down through management and immediate supervisors. If senior executives set the right example, people will tend to follow suit and behave properly. Conversely, just one or two indications of hypocrisy or double standards at the top can be deeply corrosive, creating cynicism and deliberately transgressive action. Effective role-modeling is also the foundation for mutual respect between manager and managed.

3. **Openness.** People at all levels need to feel free to discuss issues and dilemmas which naturally arise in any business. However clear the guiding principles, there are always grey areas in practice. Coming to a consensus view on what is acceptable and correct behavior reinforces the culture and shares responsibility.

4. **Achievability.** The goals and targets which an organization sets for itself, and for specific departments, teams and individuals, need to be realistic and achievable. 'Stretch' targets are fine. But unrealistic objectives and targets stimulate cynicism and resistance or – worse – a culture of breaking the rules to achieve them.

5. **Commitment.** The organization needs to stimulate commitment on the part of its managers and employees. Do people feel trusted and involved? Do they feel that their views are taken into account?

6. **Transparency.** Behavior needs to be transparent and open, so that each individual understands the impact of his or her actions on others, and can correctly judge the actions of others. Behavior can only be effectively evaluated against core principles. Transparency also has a pro-active impact because what is expected will allow staff to properly make decision and act according to the core principles of the firm.

7. **Enforcement (and reinforcement).** The systems of reward and punishment need to be clear, explicit and directly related to the guiding principles and desired behavior. This sounds simple and obvious. But in many organizations rewards and sanctions are out of alignment with core values and avowed norms. Employees see immediately when this is the case. The behavior which is rewarded (and misbehavior which is tolerated) rapidly becomes the norm, destroying integrity at its root.

All of these foundations need to be built and reinforced if the organization is to behave with integrity, true to its principles, and earn the trust of its stakeholders. These foundations are to some extent less easy to measure than profit or loss. But many tools are now available which can identify the critical indicators which make them visible and real. Increasingly, financial services companies are commissioning a cultural audit alongside the financial one, as part of an assessment of its risk management systems and controls.

Making the change

Armed with this conceptual framework, and an understanding of the seven prime dimensions of integrity, boards and chief executives can make a practical difference to their organization's performance, beginning by asking the following key questions:

- Do we have the right mission? Is it clear, explicit and well-understood?
- Is the mission properly translated into a normative framework of core values, competences and behavioral standards?
- Do we have the soft controls in place which will drive people to behave correctly?
- Can we account for and demonstrate that, to ourselves and to relevant external stakeholders such as regulatory authorities?

The business of rebuilding trust has to begin with the right foundations.

These foundations are to some extent less easy to measure than profit or loss. But many tools are now available which can identify the critical indicators which make them visible and real.

Regulators across the world are focused not only on improving the robustness and stability of the financial system but also on ensuring that it delivers high quality outcomes to consumers. This increasingly significant agenda will carry progressively more fundamental implications that will shape the design, distribution and management of retail financial services, across the product lifecycle and for all aspects of companies' engagement with their customers.

The conduct agenda and its impact on the product lifecycle.

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Amy Matsuo, KPMG in the US
Johanna Day, KPMG in the UK

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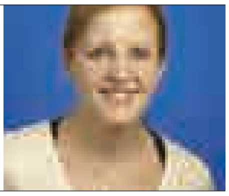

UDAAP: the other 'A' in US consumer protection

The US Federal Trade Commission (FTC) has for many years had the responsibility of preventing business practices that are unfair or deceptive to consumers. The terms *unfair* and *deceptive* are not defined in law, but are interpreted through case law and with the aid of FTC policy statements.

From UDAP to UDAAP

The Dodd-Frank Wall Street Reform and Consumer Protection Act ('Dodd-Frank') retains these basic principles, but adds a new term to the familiar UDAP acronym (unfair or deceptive acts or practices): *abusive*. Under Dodd-Frank, it is unlawful for any provider of consumer financial products or services or a service provider to "engage in any unfair, deceptive or abusive act or practice". Hence the new acronym UDAAP forms one of the guiding principles of the Consumer Financial Protection Bureau (CFPB) set up under the Act.

Although the new standard is not defined in the statute, there is commentary to the effect that an abusive act or practice is one which:

- materially interferes with the ability of a consumer to understand a term or condition of a consumer financial product or service; or
- takes unreasonable advantage of:
  - a lack of understanding on the part of the consumer of the material risks, costs, or conditions of the product or service;
  - the inability of the consumer to protect the interests of the consumer in selecting or using a consumer financial product or service; or
  - the reasonable reliance by the consumer on a covered person to act in the interests of the consumer.

It is clear, then, that a core part of the remit of the CFPB is to protect vulnerable consumers. To this end, Dodd-Frank established, within the Bureau, the Office of Financial Protection for Older Americans to protect 'seniors' from UDAAP in relation to current and future financial choices (see box: Case study: US retirement savings products), and the Office of Servicemember Affairs to similarly protect military personnel.

The elephant test

As yet, a significant degree of uncertainty remains over how the Bureau will develop and apply criteria to determine *abusiveness*. Pressed by the House of Representatives on this point, Bureau Director Richard Cordray said:

> "There is a gray area and then there is a core. And within the core, there is really no question that the people who are perpetrating acts that are within that core, they know that what they are doing is probably wrong, and yet they do it anyway. In the gray area, it is a little harder to judge…
>
> But I also think that there is enough misconduct that occurs in the core areas that we would be well-served to focus on that at the outset, in the first period of our Bureau. We want to get that cleaned up. Then, we can work on trying to define around the edges a little more clearly."[1]

Cordray is in effect appealing to common-sense and the 'elephant test':[2] we will recognize abusive behavior when we see it, and act to prevent it.[3]

This leaves some market participants in a state of confusion and anxiety. It could take some years for the criteria of acceptable, non-abusive behavior to be clarified through Bureau practice; in the meantime, many fear that they may have no defense against arbitrary Bureau proceedings. But in practice there are a number of sensible responses which US companies should be adopting.

Despite the concerns expressed in Congress and elsewhere, the common-sense, 'elephant test' is very powerful. Richard Corday has emphasized that the Bureau will focus on the core area where companies know that what they are doing is probably wrong. So the fundamental principle is simply not to do wrong by the consumer. Business practices need to be reassessed through the lens of UDAAP and compliance management systems and processes then need to be built on, and embody, this principle.

1 Evidence before the House of Representatives Committee on Financial Services, 29 March 2012.
2 A term often used in legal proceedings. Lord Justice Stuart-Smith described it as "the well-known elephant test. It is difficult to describe, but you know it when you see it". Cadogan Estates Ltd v Morris, 1998.
3 http://files.consumerfinance.gov/f/201305_cfpb_complaint_adss.pdf The CFPB announced its first enforcement action that included charges of "abusive" on June 4; http://www.troutmansanders.com/cfpb-files-first-abusive-practices-enforcement-action-06-04-2013/ related law firm announcement.

But of course there are additional implications. Compliance should not be limited to monitoring front-end marketing and sales activities: it needs to extend across the whole product life cycle, from product design and development, through marketing and sales and to after-sales monitoring, customer relations and complaint procedures. Consistency of product value proposition and consumer messaging throughout the whole period is essential to demonstrate fair treatment. Full, appropriate and accurate disclosure is critical: does the small print support the headline marketing pitch?

Beyond this, the UDAAP principle also implies appropriateness: is the product being sold right for the people to whom it is being marketed? Answering this question may require much more sophisticated customer analytics and segmentation tools (such as 100 percent call recording, advancing prompts for consumer interactions (i.e., real-time compliance) and business unit quality assurance and quality controls to incorporate compliance and UDAAP type assessments) than many companies currently have to hand.

The US market is sometimes caricatured as being based on the principle of *caveat emptor*. However, Cordray has emphasized:

> "It is the American way for responsible businesses to be straightforward and upfront with their customers, giving them all the information they need to make informed decisions. This is good for the honest businesses themselves and it is good for the overall economy."[4]

Companies which adopt this principle have little to fear from the additional A in UDAAP.

It is the American way for responsible businesses to be straightforward and upfront with their customers, giving them all the information they need to make informed decisions. This is good for the honest businesses themselves and it is good for the overall economy."

Europe focuses on consumer protection

In Europe, the European Union has led the way in proposing or introducing a wide range of new conduct-driven regulatory initiatives. In a recent article, the Financial Times listed around 25 significant current proposals which are under negotiation or pending.[5] While some are highly technical, and targeted at individual specialized elements of the financial services industry, others are major pieces of new legislation, explicitly focused on reforming retail markets for investments and other financial products. Among the most important of these are UCITS V (designed to allow authorized collective investment funds to operate and market their products freely across the European Union) and PRIPs (designed to create a level playing field for sales of retail investment products, for instance as between insurance products and UCITS funds).

Developments such as these are increasingly defining the characteristics of financial products within a framework of acceptable conduct and consumer protection. As a result, they are also increasingly influencing the nature of the product development process and management of the whole product life cycle. Previously, companies focused on developing a product which would target a wide market, which could be sold profitably and which would fit with the company's overall risk appetite. Now, this approach is being turned on its head.

The key questions being addressed in the product development phase are now whether the product answers a clear customer need; how its key features can be marketed and communicated in a fair and clear manner; what additional consumer education is necessary to ensure informed decision-making. In the past, a significant contributor to mis-selling was not so much malice and greed as a lax attitude to ensuring that appropriate products were being bought by the right customers. Today, much more sophisticated customer segmentation and profiling are necessary as a companion to effective conduct policies.

Similarly, while risk management was traditionally focused on financial risk and the impact of different products on profit and loss, a much broader perspective now includes key aspects of organizational and reputational risk: financial services companies are rapidly realizing that the negative impacts of a major mis-selling scandal can extend far beyond a hefty fine and threaten the brand value of the whole enterprise.

Adapting to the new regulatory environment carries costs, in terms of investment in new systems and processes, and the development of procedures and controls to manage the new obligations. But these carry potential benefits as well, in that they should lead to better-developed products, better aligned with customer needs and hence potentially less risky and more profitable.

National regulators, such as the new Financial Conduct Authority (FCA) in the UK, are becoming increasingly robust over conduct issues as they translate these new regulatory requirements into legislation. The FCA itself has begun to investigate issues such as the product development process and pricing policies, and has not hesitated to intervene at an early stage to prevent consumer detriment. Retail financial services companies need to act decisively if they are to preserve their license to operate in the new conduct environment.

Implications

Financial services companies not only face rafts of new and potentially onerous regulation; they have to come to terms with a fundamental change in attitudes to conduct and business practice. Put simply, it is no longer enough to be legally compliant and to leave to customers their decisions over product purchases or their evaluations of options and alternatives. Providers of financial products will increasingly have to take responsibility for ensuring that consumers are treated fairly, across the whole product life cycle, and that they are guided to the right products for their needs, delivering good value, at the right price. To echo the objectives of the US Dodd-Frank Act, products, services, or practices that are unfair, deceptive or abusive to consumers, however inadvertently or indirectly delivered, are no longer acceptable.

This change of mind-set brings fundamental challenges for companies' business models, for product design and distribution, for management of customer interactions across the whole product life cycle, and for corporate governance, monitoring and compliance. It requires almost a revolution in attitude and culture. Meeting this need on top of responding to the continuing regulatory agenda is a major challenge indeed.

4 Speech to the Consumer Bankers Association, Austin, Texas, 21 March 2012.
5 EU finance reforms: the great Lithuanian reckoning, Financial Times, 19 July 2013.

Case study: US retirement savings products

The Consumer Financial Protection Bureau's (CFPB) efforts to ensure that seniors are not harmed by violations of UDAAP when purchasing retirement savings products illustrates how one specific regulator working within the new framework of conduct risk management and consumer protection might influence prudential supervision or find jurisdiction over products for which it does not have direct authority.

The CFPB was established in the US by virtue of the Dodd-Frank Wall Street Reform and Consumer Protection Act 2010 ('Dodd-Frank'). Rich Cordray was appointed as the Bureau's first Director in 2012. The CFPB's mission, as defined by the law, is "to make markets for consumer financial products and services work for Americans" – whether this involves mortgages, credit cards, or any other consumer financial products.

This overt and explicit consumer protection agenda represents more of an innovation in the US market – substantially committed to the *caveat emptor* principle – than in other jurisdictions. Speaking shortly after his appointment, Cordray explained:

> "These products enable people to achieve their dreams. But as we all have seen in recent years, they also can create dangers and pitfalls if they are misused or not properly understood. One of our primary objectives at the Consumer Bureau is to make sure the costs and risks of these financial products are made clear… It is the American way for responsible businesses to be straightforward and upfront with their customers, giving them all the information they need to make informed decisions. That is good for honest businesses and good for the overall economy."[6]

Following the explicit aim of Dodd-Frank "to protect consumers from abusive financial services practices", the CFPB operates under the doctrine of prevention of unfair, deceptive or abusive acts or practices (UDAAP). This doctrine is evolving rapidly, and the Bureau's enforcement actions are already forcing significant transformations in business models and practice.

One area which the Bureau has considered is that of retirement savings products for older Americans ("seniors"). In principle, the CFPB has no direct authority over securities or insurance investment products, or financial advisors; hence its responsibility for overseeing retirement products is unclear. However, Dodd-Frank mandated the Bureau to create an Office of Financial Protection for Older Americans; and to make recommendations on the certification of financial advisers who advise seniors, to help ensure that they understand what their credentials mean when they seek financial advice.

The resulting Report concluded:[7]

- consumers are likely to be confused by the more than 50 'senior designations' used by financial advisers
- the financial services industry is complex and its professionals use multiple overlapping titles
- rigorous training standards for the approved use of senior designations would reduce risks to consumers
- rigorous standards of conduct for those using senior designations would reduce risks to consumers
- increased enforcement of existing laws and supervision of senior designees will help to deter misleading and fraudulent practices and protect older consumers.

The Report also considers a series of policies to help address what it calls "critical consumer protection issues" and help seniors "navigate the complex financial market place". Even where direct authority and enforcement powers over the retirement products sector may be lacking, the CFPB is actively working with other regulators to ensure that its objectives are pursued. In this respect, the CFPB may effectively influence the activities of other regulators with direct authority over retirement products and the Bureau could evolve as the de facto lead consumer protection agency in the USA.

The retirement savings industry, and the financial well-being of its senior consumers, will now be subject to heightened regulatory scrutiny. Companies will have to increase not only their assessment, but their control and compliance management systems for retirement products and services.

Bank and nonbank providers of retail investment and savings products and services should be proactively assessing the use of their products and services by seniors and evaluate any potential consumer protection issues in advance of possible regulatory changes or enforcement activities. Such reviews should be conducted over the life cycle of individual products. This includes how a product is developed, sold and all the customer interactions – in essence it needs to be contemplated throughout the enterprise – giving consideration to efforts to protect consumers through policies, procedures and controls.

Financial services companies not only face rafts of new and potentially onerous regulation; they have to come to terms with a fundamental change in attitudes to conduct and business practice.

6 Testimony Before the Senate Committee on Banking, Housing, and Urban Affairs, 31 January 2012
7 Senior Designations for Financial Advisers: Reducing Consumer Confusion and Risks, CFPB, April 2013

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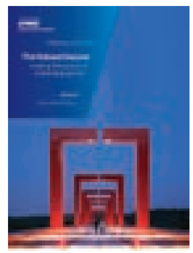

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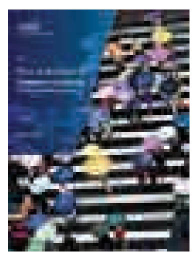

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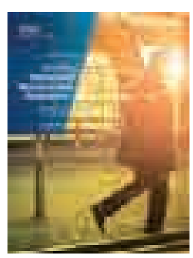

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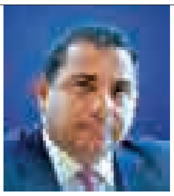

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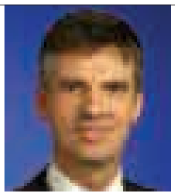

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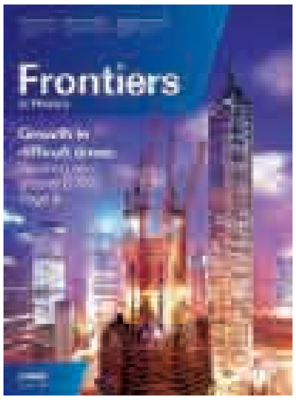

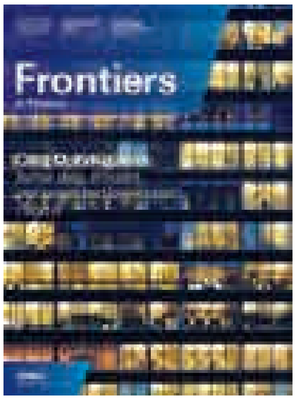

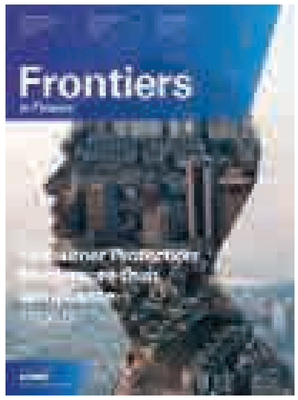

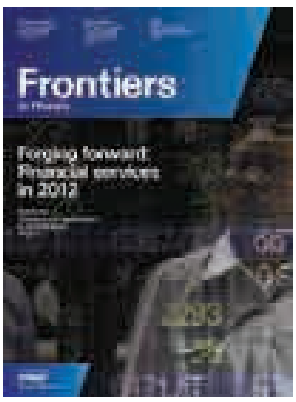

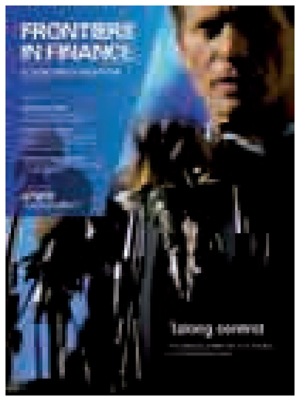

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