

Evolving Banking Regulation Part Five

Culture and Conduct

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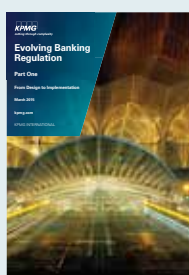
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Evolving Banking Regulation – Parts One, Two, Three and Four



This publication is the fifth and final part of the *Evolving Banking Regulation* series for 2015. This report examines the **culture and conduct challenges** facing banks.

The first part outlined the **regulatory pressures on banks**. The second part focused on bank structure, and the **search by many banks for a viable and sustainable future** in a world where regulatory and commercial pressures are driving business model change. The third part covered the **data, technology and cyber security challenges** facing banks. The fourth part focused on **governance issues**.

Although written from a banking perspective, the reports in this series are also relevant to other financial institutions.

Foreword

Culture has moved rapidly up the agenda of financial institutions, their regulators and their supervisors in recent years. The primary driver of this has been the multiple instances of misconduct in wholesale markets, including the actions of some banks in the setting of interest rate benchmarks and other indices. These behaviours may remain front of mind for longer than the losses that emerged during the financial crisis.

The growing focus on culture and behaviours also goes much wider than this – to misconduct in retail markets, with multiple episodes of mis-selling across multiple products and countries; to the aggressive risk-taking by many banks and some other financial institutions ahead of the financial crisis; to the need to rebuild public trust in banks and in the financial system more generally; and to some financial institutions using good culture and behaviour as a means of establishing a competitive edge.

It is therefore not surprising that we are seeing responses across the globe to culture and conduct issues. The Financial Stability Board and other global standard setters are focusing increasingly on culture and conduct issues. A plethora of EU legislation is directed towards improving standards of conduct in wholesale and

retail markets. And at a national level we see initiatives such as the US Federal Reserve linking an improvement in culture in financial services to the financial stability agenda; the emphasis of the UK authorities on the personal responsibility and accountability of senior managers in financial institutions, and on the standards required to support fair and effective markets; the work of the Netherlands central bank in supervising culture and behaviour in the financial sector; and the tougher approach of regulators in Hong Kong and Singapore to retail conduct issues.

In this publication we set out the challenges for banks – and other financial institutions – arising from the commercial, regulatory and wider societal pressures on them to improve their culture, behaviour and standards of conduct. This goes well beyond legalistic conformity to detailed rules to a much wider and deeper consideration of culture and behaviour. Banks and other financial institutions need to ask themselves some fundamental questions about their desired culture and values, and how these are reflected across all levels and parts of their organisations – and to be prepared before their supervisors ask them much the same questions.

Although this publication focuses predominantly on Europe there is a clear read across to other regions. We see a

regular pattern of local initiatives being expanded around either the region or globally. The focus in the UK on senior manager responsibilities has generated considerable interest elsewhere and will be considered by IOSCO's global task force on market conduct; the various EU legislation relating to retail market conduct covers all sectors and provides a comprehensive model against which other countries can assess their own retail conduct regimes; and supervisory authorities in many countries are looking closely at how their counterparts in other countries are assessing culture in regulated firms. A global direction of travel on culture and conduct is emerging here, across countries and sectors, even if this will not result in a wholly consistent set of standards, or of how these standards are implemented across countries and across sectors.



Giles Williams
Partner, Financial Services
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Executive summary

“Banks and their supervisors are struggling to come to grips with culture – what it is, where it needs to improve, and how its impact can be measured.”

The abiding memory of the financial crisis will not be the losses made by many banks, but their behaviour – excessive risk-taking ahead of the crisis and multiple instances of misconduct in both wholesale and retail markets. This has left banks¹ vulnerable to a series of commercial and regulatory pressures.

The **commercial pressures** on banks include the need to rebuild reputation and trust, not least by demonstrating good cultures and behaviours; to establish commercial benefits from taking a more customer-centric approach; to respond to growing competition from non-banks and from other banks; and to avoid or minimise the financial costs of misconduct (criminal actions, fines, remediation and civil actions).

The **regulatory pressures** on banks arise in part from the magnitude of regulatory change in both wholesale and retail markets, some of which has been implemented but much of which is still under development. Banks – and other financial institutions – are having to respond to a step change increase in the number of detailed rules.

In addition, there is increasingly a much broader supervisory focus on whether banks are delivering good customer and client outcomes, and whether this is supported by the **culture, values and behaviours of banks**. Banks and their supervisors are struggling to come to grips with culture – what it is, where it needs to improve, and how its impact can be measured.

In **wholesale markets**, the regulatory emphasis over the last few years on OTC derivatives and on the trading lifecycle is being supplemented by new requirements on benchmarks and indices; standards of trading practices; and the alignment of remuneration with conduct risk. There is an increasing regulatory emphasis on ‘seller beware’ rather than ‘buyer beware’, which places obligations on banks to consider more carefully – and to be able to demonstrate that

they have considered – the interests of their professional clients and wholesale market counterparties.

In **retail markets**, the earlier regulatory emphasis on disclosure and transparency is being extended to product governance requirements on manufacturers and distributors; market structure interventions such as the banning of commission payments; a wider-ranging and tougher regulatory approach to the selling of complex products; and the banning of products that are judged to be too complex and too risky for retail consumers.

Banks also need to **rebuild trust with their regulators**. Indeed, the reduction in trust between regulators and banks that has resulted from conduct issues has had an impact beyond the introduction of tougher conduct rules, and has resulted in regulators being less accepting of banks’ judgement in areas such as the use of capital models, the soundness of internal capital and liquidity targets and the adequacy of governance and internal controls.

Implications for firms

The **implications** of these commercial and regulatory pressures differ significantly across firms, across markets and across jurisdictions. This reflects the diversity of the markets themselves, with products, distribution channels and customer maturity significantly different across countries. But despite this patchwork there is a growing trend towards a more harmonised global framework of ‘acceptable’ behaviour in wholesale and retail markets.

All firms need to:

- Respond to the various commercial and regulatory pressures to take a more customer-centric approach, recognising both the multitude of detailed regulations and the bigger picture of how all the regulatory reform initiatives fit together;

¹ Although this Report is focused primarily on banks, many of the issues it covers are also relevant to other financial institutions.

- Step back from a legalistic approach to detailed rules to address the overarching culture and behaviour issues in both wholesale and retail markets, embedding the desired culture and values at all levels of the firm, and driving this forward through strong leadership and metrics that measure the outcomes of the culture and values of the firm; and
- Consider the implications of both the broader cultural issues and the detailed rules changes for their strategy, business model and risk appetite, and for compliance, systems and processes, data management, and internal and external reporting.

Implications for the wider economy

Firms' responses to commercial and regulatory pressures will have an impact on

their **wholesale market counterparties and retail customers**. The impact of prudential regulation on corporate bond market liquidity shows how easily regulation introduced for one purpose can tilt the balance in unanticipated ways. Similar reactions are likely to emerge from conduct regulation, as a result of shifts in the ability and willingness of banks and other financial institutions to remain active in some markets, or in the price at which they are prepared to do so.

In **wholesale markets** some banks have already withdrawn from, or scaled back their activities in, some markets and products, leaving counterparties facing less competitive and more concentrated markets, and higher priced products. Such 'de-risking' has already taken the form of some banks pulling out of activities such as correspondent banking and money transmission services, because they regard them as too risky, or because it has become

too difficult or expensive to do proper due diligence on counterparties. The rolling out of further regulatory reforms may accentuate this as banks respond to the higher costs of doing business.

In **retail markets**, it is not clear where the balance will eventually be struck between the benefits of improved conduct standards and the risk of heading towards the 'stability of the graveyard'. Many consumers need to be encouraged and helped to save and invest more, to take out adequate protection, to draw down financial assets sensibly during retirement, and to take unbiased and informed financial advice. Regulation may lay down a bedrock to build on here, but it may also reduce the supply and increase the price of these products and services.

All of this raise important issues for society as a whole, including the possibility of greater financial exclusion, inadequate protection, and inadequate provision for retirement.

Misconduct and the costs of misconduct

The list of misconduct cases continues to lengthen, in both wholesale and retail markets. Many of these cases have resulted in widespread financial harm to customers and markets, and significant monetary and reputational costs to banks.

In **wholesale markets** the involvement of some major banks in the manipulation of financial markets – in particular of interest and exchange rate benchmarks and indices – and in the mis-selling of financial products to professional and wholesale counterparties has emerged in the last few years, while some banks have also been found to have breached national and international tax, anti-money laundering and anti-terrorist financing rules, and economic sanctions.

In **retail markets** misconduct has continued to take familiar forms, including the design and mis-selling of structured and other complex products, insurance products linked to lending, lending denominated in foreign currency, and poor complaints handling.

Data from the CCP Research Foundation shows that the costs of fines and remediation for misconduct by the largest US and European banks totalled around EUR200 billion cumulatively between 2009 and 2014. The European Systemic Risk Board (ESRB) estimates that the EUR50 billion of this accounted for by large EU banks is equivalent to a 2 percentage point reduction in their CET 1 capital ratios.

Provisions against future costs and the emergence of successful (in the sense of banks offering settlements) private lawsuits against banks in the US suggest that these costs could double over the next few years.

Indeed, the ESRB is beginning to focus on the potential systemic impact of misconduct by EU banks, taking into account the costs imposed on society and the potential for fines and remediation to generate systemic risks within the financial sector. The ESRB recommends that as well as trying to prevent misconduct, national authorities should be covering misconduct risks as part of the assessment of Pillar 2 capital add-ons, and in stress tests (the UK already does this).

Culture

“A ‘good’ culture is likely to be driven by strong leadership and genuinely held values – integrity, trust, and respect for the law – carried out in the spirit of keeping the customer’s best interests at the heart of the firm’s business model, and a social responsibility toward maintaining market integrity and financial stability.”

Culture is a complex but highly valuable asset for firms operating in competitive markets. It is therefore important for firms to observe, monitor and change their culture over time to support the successful realisation of the firm’s vision and strategic priorities. The focus here is on the risk culture of a firm and related behaviours, not on all other aspects of a corporate culture.

The culture of a firm is difficult to define and measure. The values, goals and priorities of a firm will create a culture, which in turn will be reflected in the behaviour of the firm’s employees. Moreover, most firms will have multiple cultures across divisions and departments.

A ‘good’ culture is likely to be driven by strong leadership and genuinely held values – integrity, trust, and respect for the law – carried out in the spirit of keeping the customer’s best interests at the heart of the firm’s business model, and a social responsibility toward maintaining market integrity and financial stability. A good culture will recognise that there are many

dilemmas to be reconciled in balancing customers’ interests with shareholder return, and in defining how a firm and its employees will behave in the ‘grey areas’ where judgements need to be made.

However, some firms have exhibited clear signs of a ‘poor’ culture, as evidenced by:

- The succession of misconduct issues, in both retail and wholesale markets, ranging from compliance failures through to (in a few cases) criminal actions; and
- The excessive risk-taking ahead of the financial crisis.

This has weakened the public’s trust in the integrity of banks in particular. As discussed in Part Two of *Evolving Banking Regulation*, banks need to regain the public trust. They need to rebuild and enhance their relationships with customers, regulators and shareholders, not least by their managers and staff behaving according to sound ethical principles that are nurtured and supported by a strong, positive culture.



Factors contributing to cultural problems

- **Inconsistent or inappropriate behaviours and decisions by senior leaders**, which send a strong message about what is rewarded in a firm, regardless of the stated culture and values;
- **Harmful norms, habits and established ways of working**, encouraging employees (through cultural norms and incentives) to behave badly towards customers, and to exploit various conflicts of interest;
- **A lack of clear corporate values**, leaving employees unsure about the firm's values and expected behaviours;
- **Competing objectives**, under which short-term financial performance dominates long-term sustainability, or a focus on revenue and profitability overrides consideration of the impact on customers, markets or wider consequences;
- **Governance gaps**, under which some employees are rewarded (or not penalised) for behaviours that are inconsistent with the stated values of the firm, for example where micro-cultures operate within specific groups or business lines according to different values, or where multiple management layers block clear lines to the firm's high level values;
- **Increased competition for skilled employees and increased employee mobility**, which can generate a focus on short-term benchmarking for performance and compensation and inhibit the development of employee loyalty and the protection of the firm's brand;
- **Increasing complexity** in the size and scope of firms, and in the types of products and services they offer; and
- **Shifts in the business model**, including a shift away from a client-based orientation that focuses on building long-term relationships to a transaction-based orientation that reduces customers to the role of a trading partner or counterparty.

“Regulators are looking to hold Board members and senior management, as the leadership of their firms, directly responsible for establishing, maintaining and communicating their firm's culture and values and for leading their firms toward cultural and ethical change.”

Regulatory and supervisory response

The regulatory and supervisory focus has turned to shortcomings in the prevailing culture of financial institutions as an important root cause for continued misconduct and excessive risk-taking. This extends beyond a concern that there may be some 'bad apples' within a firm to a concern that, in some cases, the whole container may be rotten – that undesirable actions stem from the prevailing attitudes and behaviours that are rewarded within the firm more widely.

Regulators are therefore looking to hold Board members and senior management,

as the leadership of their firms, directly responsible for establishing, maintaining and communicating their firm's culture and values and for leading their firms toward cultural and ethical change.

Firms need to demonstrate that the root causes of the behaviours precipitating the financial crisis and instances of misconduct are being taken seriously and will be fully addressed. Firms cannot simply rely on lengthy compliance manuals but will need to distil down in a very practical way to their staff the behaviours that are acceptable and those which are not. Staff need to be engaged in this process, and to be aware of their roles and responsibilities at the individual level.



The direction of travel is clear – towards placing the interests of customers (retail, commercial and wholesale), the integrity of markets and financial stability ahead of profit maximisation. At times this is expressed in terms of firms doing the ‘right’ thing, and doing what they ‘should’ rather than what they ‘can’.

Supervisors will need to see what actions firms are taking to assess and improve their risk culture as well as the commitment of the Board and senior management to execute the necessary changes. Supervisors will also look closely at the degree to which line and middle managers, who are frequently responsible for implementing organisational changes and strategic initiatives, are committed to adopting and manifesting the required cultural and behavioural changes.

However, beyond this broad direction of travel, limited regulatory guidance has been made available (see box on page 12) and firms are largely responsible for defining their own parameters of a ‘good’ culture.

Indeed, in countries with a very rule-driven approach the issue of ‘culture’ has not generally moved from being a well-sounding principle to a documented and detailed legal concept, other than through related concrete rules on conduct (MiFID 2) or compensation (CRD4 and EBA guidelines).

How are firms responding?

Culture has moved up the agenda. Indeed, in some banks it is clearly at the top of the agenda, not least where a bank was part of the misconduct of recent years or where a bank is actively using its culture as a competitive differentiator to promote its brand in the market.

However, as observed in a G30 paper on banking conduct and culture (July 2015), many banks remain stronger on putting bold assertions in place than in genuinely embedding values and codes of conduct into how employees behave.

The G30 paper concludes that “Banks are, to varying degrees, still failing to implement desired ethics, values and behaviours, and weaknesses in embedding values and codes of conduct for all staff are widespread.”

The G30 calls for a fundamental shift in approach, with banks taking a more proactive approach, viewing conduct as structurally important to a bank’s long-term success and viability, not just as a way to minimise future redress and enforcement actions.

What should firms be doing?

Boards and senior management need to understand the culture that exists within their firm and, to the extent they determine there is need for improvement, develop a plan for making improvements. This requires Boards and senior management to:

- **Define** their desired culture – be clear about the culture they want to cultivate;
- **Assess** the current culture within their firm, with the assistance of line and middle management;
- **Analyse** whether cultural drivers could be strengthened to promote more strongly behaviours that support the desired culture; and
- **Address** any identified gaps.

The broad concepts of tone from the top, ‘tone at the middle’, accountability, effective challenge and incentives are critical to this effort and should be reviewed closely by the Board and senior management. These indicators of ‘good’ culture will also guide supervisory reviews. Consideration should also be given to the opinions of customers and other stakeholders.

To be sustainable, a firm’s values, goals and expectations should be reflected throughout the business, including corporate strategies, risk governance frameworks, business models, affiliations and alliances, product and service offerings, recruitment and retention, the workplace

environment, and the management information and metrics used to monitor all these aspects of a firm's business.

For many firms this represents a massive **change management** issue, requiring considerable determination, resources and time to deliver.

Firms should also be prepared to demonstrate the progress they have made. Firms should consider what evidence they could produce here, both to provide their own internal assurance and to satisfy at some point their supervisors, anticipating that supervisors will want to understand what firms have done and what outcomes this has delivered.

Key areas for improvement

Work undertaken by KPMG member firms with clients indicates that firms are struggling to deliver improvements in culture, values and behaviour in five key areas:

Embedding the desired culture and values at all levels of a firm

- Defining the desired culture and values
- Developing capability and embedding behaviours in core organisational processes such as recruitment, talent management and learning and development
- Ensuring that all relevant staff really understand what the culture and values means for them in their individual roles, and that they are engaged and act accordingly
- Reinforcing this through individual accountability – key performance indicators relating to the desired behaviours, remuneration and promotions
- Assessing and monitoring whether changes in the 'tone at the top' make a difference to how staff behave, in particular middle management, traders, and customer-facing staff

Dealing with the 'grey areas'

- Deciding and communicating what 'doing the right thing' means in areas where judgement is required, and where there is a trade-off between customer and counterparty treatment and the profitability of a firm
- Helping staff to make appropriate decisions when a number of options are available to them

Learning lessons

- Learning and applying lessons from other areas of the business, and from the failings of other firms

Metrics

- Establishing robust metrics from within the business that might provide positive and negative indications of the outcomes of the culture and values
- Looking at existing metrics in different ways to measure culture
- Developing new metrics based on how stakeholders view a firm (from supervisors and shareholders to social media)
- Harnessing new techniques such as unstructured data analysis to monitor culture in real time

Assurance that change is effective and permanent

- The efforts by firms to set the right tone from the top, remediate past conduct issues, improve detection controls and train staff could all unravel in a period of rapid growth of the business
- Firms (and often their supervisors) have preferred to focus on processes and controls rather than customer outcomes – genuinely embedding cultural change requires greater focus on the risks to good customer outcomes and how those risks can best be addressed.

“ Ensuring that all relevant staff really understand what the culture and values of the firm means for them in their individual roles, and that they are engaged and act accordingly ”

The journey to cultural maturity

DESIGN

Reinforce the desired culture and values by embedding them in goals and incentive structures

Practicality – the goals and targets set for the firm, business lines, teams and individuals correspond to the risk appetite and the culture and values of the firm

Incentives – the system of rewards should be directly related to the values and goals of the firm

Involvement – employees feel accountable and responsible for upholding the firm's values and for promoting the firm's goals and strategies

DEMONSTRATE

Demonstrate the desired culture and values throughout the firm

Role modeling – the Board and senior management should live the values and lead by example

Middle management – the 'tone at the middle' (and at the front line) is just as important as the tone at the top

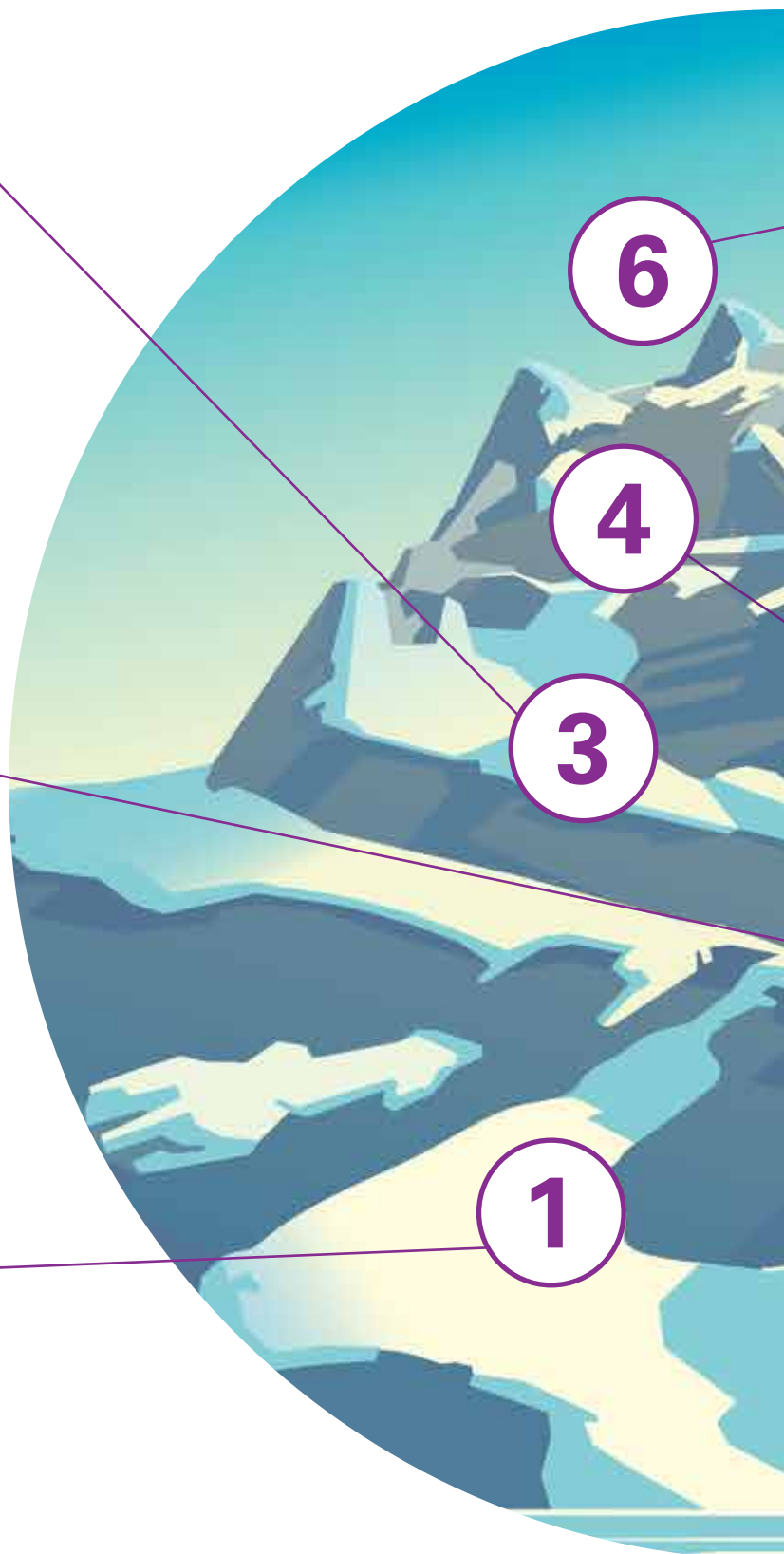
DEFINE

Define the desired culture and values

Communication – define and communicate the desired values throughout the firm

Clarity – employees at all levels need to understand what is expected of them

Visibility – employee behaviour needs to be transparent





DELIVER

Knowing and demonstrating what has been achieved and seeking continuous improvement

Assurance – metrics and other assessments demonstrate that the desired culture and values are in place

Continuous improvement – problems are identified early and addressed promptly

DEVELOP

Continuous development to embed the desired culture and values

Learn lessons – from the evaluation of instances of misbehaviour and ‘near misses’

Improvement – employees feel that they learn from their mistakes and can share ideas for improvement

Alignment – of intent, execution and outcomes

DEEP ROOTED

Encourage an open approach to issues and dilemmas related to culture and values

Openness – employees at all levels feel comfortable to discuss issues and dilemmas that arise in an atmosphere that is accepting of challenge and assures mutual respect

Trust – employees feel trusted and involved, and believe that their views will be heard

Capability – Employees are enabled to do what is requested of them

Regulatory guidance on culture

Basel Committee corporate governance principles

The revised Basel Committee corporate governance principles (July 2015) include some guidelines on culture:

Fundamentals – the Basel Committee views a corporate culture that reinforces appropriate norms for responsible and ethical behaviour as a fundamental component of good governance. These norms are especially critical in terms of a bank's 'risk culture' – its risk awareness, risk-taking behaviour and risk management.

Tone at the top – to promote a sound corporate culture, the Board should:

- Set corporate values that create expectations that all business should be conducted in a legal and ethical manner;
- Confirm that appropriate steps have been or are being taken to communicate throughout the bank the corporate values, professional standards or codes of conduct it sets, together with supporting policies;
- Oversee the adherence to such values by senior management and other employees;
- Confirm that employees, including senior management, are aware that appropriate disciplinary or other actions will follow unacceptable behaviours and transgressions; and
- Promote risk awareness within a strong risk culture, conveying the Board's expectation that it does not support excessive risk-taking and that all employees are responsible for helping the bank operate within the established risk appetite and risk limits.

Code of conduct – a bank's code of conduct (or code of ethics, or comparable policy) should define acceptable and unacceptable behaviours. It should explicitly disallow illegal activity; and it should make clear that employees are expected to conduct themselves ethically and perform their job with skill and due care and diligence in addition to complying with laws, regulations and company policies.

Effective challenge – a bank's corporate values should recognise the critical importance of timely and frank discussion and escalation of problems to higher levels within the organisation:

- Employees should be encouraged and able to communicate, confidentially and without the risk of reprisal, legitimate concerns about illegal, unethical or questionable practices, including communicating material concerns to the bank's supervisor;
- The Board should have oversight of the whistleblowing policy mechanism – ensuring that senior management addresses legitimate issues that are raised, and that staff who raise concerns are protected from detrimental treatment or reprisals; and
- The Board should oversee and approve how and by whom legitimate material concerns are investigated and addressed.

FSB on assessing risk culture

The FSB has issued Guidance to supervisors on assessing the risk culture of financial institutions (April 2014) to help supervisors to understand a bank's risk culture, and in particular whether it supports appropriate behaviours and judgements within a strong risk governance framework.

Supervisors are expected to increase their interaction with Boards, and to undertake high-level sceptical conversations with the Board and senior management on the bank's risk appetite framework, and on whether the bank's risk culture supports adherence to the agreed risk appetite.

The FSB expects supervisors to focus on four key 'risk culture indicators', to look in particular for behaviours or attitudes that are not supportive of sound risk management, and to intervene early to address the potential build-up of excessive risk. The four indicators of a 'good' culture are:

- **Tone from the top** – The Board and senior management set the core values and expectations for the bank and their behaviour is consistent with those values and expectations.

- **Accountability** – All employees know the core values and expectations as well as that consequences for failure to uphold them will be enforced.
- **Effective Challenge** – At all levels, decision making considers a range of views, practices are tested, and open discussion is encouraged.
- **Incentives** – The financial and non-financial compensation available to all levels of employees rewards behaviours that support the core values and expectations.

EBA SREP Guidelines

Although the EBA's SREP Guidelines (December 2014) are directed primarily at banking supervisors, they also provide a clear statement of the standards that banks should be able to demonstrate. On culture, supervisors are expected to include in their risk assessment whether:

- The bank has a sound corporate and risk culture that is adequate for the scale, complexity and nature of its business, and is based on sound, clearly expressed values that take into account the institution's risk appetite;
- The Board sets governance principles, corporate values and appropriate standards, including independent whistle-blowing processes and procedures;
- The bank's ethical, corporate and risk culture creates an environment of effective challenge in which decision-making processes promote a range of views; and
- There is evidence of clear and strong communication of strategies and policies to all relevant staff and that the risk culture is applied across all levels of the institution.

However, supervisory assessments of culture remain at an early stage of development for most supervisory authorities. Supervisors are uncertain about how to review and assess a bank's culture and how to integrate this into their overall risk assessment of the bank.

Regulatory reform: wholesale

In response to misconduct in wholesale financial markets **the focus of regulation has shifted to the procedures for setting benchmarks and indices, and to the culture and behaviour of banks and other market participants**. There is an overarching theme here of applying the broad principles of governance and transparency to the world of wholesale market conduct.

The Financial Stability Board (FSB) has established a work plan on measures to reduce misconduct risk – including regulation, codes and national experiences with enforcement – and in November 2015 the FSB issued its first progress report on these measures.

Key themes in wholesale conduct

	Standards of conduct	Trading	Personal accountability	Robustness	Transparency	Pricing	Data and reporting
MiFID 2/MiFIR	✓	✓			✓	✓	✓
EMIR		✓			✓		✓
MAD/MAR	✓						✓
Benchmarks	✓		✓	✓		✓	✓
IOSCO and FEMR	✓		✓				
FX review	✓						

MiFIR and ESMA technical standards

MiFIR addresses wholesale conduct through the transparency of pricing, trading and payments². The much wider scope of MiFIR (compared with MiFID 1) and the detailed implementing technical standards being developed by ESMA pose major challenges for banks and other market participants around the scale and nature of the governance, systems, data handling

and reporting changes required to meet the various new obligations, in particular for non-equity instruments.

These new requirements relate to trade strategy and pricing structures, position controls and limits, transparency of pre- and post-trade price information, enhanced disclosure to clients, transaction reporting, commodity position reporting and risk management.

² The MiFIR EU legislation was summarised in *Evolving Banking Regulation*, KPMG International, February 2014.

“MiFIR poses major challenges for banks and other market participants around the scale and nature of the governance, systems, data handling and reporting changes required to meet the various new obligations.”

The complexity of these requirements, and in particular the implications for the information and data handling systems of banks and other market participants, has led the Commission to propose a delay of a year to the coming into force of MiFID 2 and MiFIR, until 3 January 2018.

One key aspect of the challenge for banks is to harmonise the new standard practices across multiple asset classes and multiple business lines. MiFIR and MiFID 2 require banks (and trading venues and regulators) to gather, collate and use a vast quantity of data. This data set is considerably larger than the data required under MiFID 1, whose scope was limited mostly to equity products.

Banks are increasingly realising the magnitude of the changes required, and the challenges and threats involved. Implementing the new requirements will not only be a very voluminous and cumbersome compliance exercise, but will in addition raise questions as to the viability and sustainability of their business models.

The draft technical standards published by ESMA in September 2015 on areas such as transparency, market microstructure, data publication and access, trading venues, commodity derivatives and market data reporting required banks to review (and to prepare to implement) hundreds of pages of detailed requirements.

In addition, a range of issues remains to be resolved around the interpretation of MiFIR, such as the boundaries between OTFs and MTFs, the data needed to assess designation as a systematic internaliser, and various reporting requirements.

Market abuse

ESMA has also published a series of technical standards under the Market Abuse Regulation (MAR) and second Market Abuse Directive (MAD 2), which will replace the earlier (2003) Market Abuse Directive from July 2016.

MAR is designed to ensure that regulation keeps pace with market developments such as the growth of new trading platforms, OTC trading and high frequency trading; extends regulation to a wider range of financial instruments such as commodity and related derivative markets; explicitly bans the manipulation of benchmarks; and introduces an obligation to identify attempted abuse through monitoring orders, not just completed transactions.

MAD 2 requires member states to provide for harmonised criminal offences of insider dealing and market manipulation, and to impose maximum criminal penalties for the most serious market abuse offences. Member states will have to make sure that such behaviour, including the manipulation of benchmarks, is a criminal offence, punishable with effective sanctions.

Benchmarks

In response to the emergence of evidence of market manipulation by some major banks and brokers, regulators have focused on making benchmarks more reliable and robust. This has included IOSCO standards for benchmark submitters and administrators (July 2013), FSB reform recommendations for major interest rate benchmarks (July 2014) and FX benchmarks (September 2014), and an agreed EU Regulation on indices used as benchmarks in financial instruments and financial contracts.

The combination of global standard-setting and investigations across Europe, the US and Asia is spreading global standards across all these regions, albeit not always completely consistently.

The main focus of all these initiatives has been on:

- Governance and controls in submitting banks, including the identification and management of conflicts of interest and the introduction of codes of conduct for submitting banks;
- Governance and transparency requirements for benchmark administrators;
- Personal accountability of submitters and administrators;
- Rate setting processes – anchoring the process on underlying transactions, and improving the quantity and quality of input data and methodologies;
- Identifying and developing potential risk-free benchmark rates, including beyond overnight maturity; and
- Effective oversight of benchmark setting, including through regular reviews or external audit reports.

The main issues raised by the development of the EU Regulation are symptomatic of the issues faced across many jurisdictions, including:

- Scope and proportionality – the choice here is between applying regulatory requirements to a wide range of benchmarks (the EU Regulation covers all benchmarks referenced in financial instruments admitted to trading on EU trading venues, in consumer credit and

mortgage contracts, and used to value the performance of investment funds) or focusing on a narrower set of critical benchmarks;

- Definition of critical benchmarks – the quantitative and qualitative criteria used to define the criticality of benchmarks, given the diversity of benchmarks (including commodity benchmarks) and the varying potential vulnerability to manipulation;
- Standard setting – governance and assurance, including the role of internal oversight and monitoring frameworks and external audit;
- Transparency – the information required to ensure that users of benchmarks and investors understand the composition and methodology related to a benchmark;
- Third country regimes – ensuring the continued availability of overseas benchmarks to local entities; and
- Supervision – who should be the national supervisor (and in the EU whether ESMA or national competent authorities should directly supervise critical benchmarks).

Banks have responded to these initiatives primarily through ‘bottom up’ improvements on a benchmark by benchmark basis, rather than top-down through wider cultural change. This has resulted in variable progress both within and across banks, with only limited read-across to other areas and limited root cause analysis beyond individual benchmarks. There is a risk that banks will end up with a ‘gold standard’ in benchmark submissions that is not reflected in less scrutinised business activities.

“ The combination of global standard-setting and investigations across Europe, the US and Asia is spreading global standards across all these regions, albeit not always completely consistently. ”

“ The UK authorities launched the FEMR in 2014, following a number of high profile abuses in the wholesale Fixed Income, Currency and Commodity (FICC) markets. ”

IOSCO on market standards

IOSCO has established a global Task Force on Market Conduct to examine standards of conduct for individuals and firms in financial markets; regulatory tools and approaches; and mechanisms to enhance personal accountabilities of senior managers and other key individuals. High conduct standards are viewed as essential to promoting fair and efficient markets. This global review of conduct standards is likely to be closely aligned with the international issues identified by the UK's FEMR.

IOSCO has also published a paper on credible deterrence (June 2015), aimed at increasing international cooperation and raising standards in national enforcement strategies.

Foreign exchange markets

In the FX market, banks are finding it challenging to control a fluid, voice driven trading environment, including how to monitor all aspects of trading. There is also a clear link here to the wider issue facing banks in terms of what they need to do to satisfy the fair pricing and disclosure obligations under MiFIR – for example the challenge of what banks need to put in place to justify the tiering of rates using objective criteria, and what should be disclosed to clients so that they can observe and understand how banks are behaving.

A BIS working group on strengthening code of conduct standards and principles

in foreign exchange markets commenced work in July 2015. Its main objectives are to facilitate the establishment of a single global code of conduct and to promote greater adherence to these standards. The code is intended to cover all parts of the global wholesale FX market, with appropriate consideration to local circumstances.

UK Fair and Effective Markets Review (FEMR)

The UK authorities launched the FEMR in 2014, following a number of high profile abuses in the wholesale Fixed Income, Currency and Commodity (FICC) markets. The final report in June 2015 concluded that the professionalism and accountability of individuals in FICC markets remains low; key FICC markets lack effective mechanisms for agreeing and adhering to common standards of market practice; significant gaps remain in the coverage of regulation; and more is required to be done to raise standards in global markets, including those for spot FX.

The review made 21 recommendations aimed at restoring trust and fairness in FICC markets, while also enhancing their overall effectiveness.

There is a wider global read-across here, since most of the findings apply to all participants in FICC markets, while some of the recommendations are addressed to international standard setters.

Fair and Effective Markets Review: main recommendations and implications for banks

The FEMR recognised the multiple regulations already in force or in progress to reform FICC markets, including EU legislation such as MAR, EMIR and MiFIR; the design and oversight of benchmarks; risk-based remuneration; and governance and accountability (including the UK Senior Managers Regime). However, a need for further progress was identified in four main areas:

- **Holding individuals to account for their own conduct**

- Extending UK criminal sanctions for market abuse to a wider range of FICC instruments to be covered by MAR;
- Lengthening the maximum sentence from 7 to 10 years' imprisonment;
- Extending significant elements of the UK Senior Manager and Certification Regimes to a wider range of regulated firms active in FICC markets, including asset managers and interdealer brokers; and
- Mandating qualification standards to improve professionalism.

- **Firms taking greater collective responsibility for market practices**

- Creating a new FICC Market Standards Board to address areas of uncertainty in trading practices and promote adherence to standards.

- **Closing gaps in regulatory coverage**

- Creating a new statutory civil and criminal market abuse regime for spot foreign exchange, drawing on

international work towards a global code; and

- Extending the UK regulatory framework to cover seven additional major UK FICC benchmarks (this was accepted and implemented by HM Treasury on 1 April 2015).

- **Taking coordinated international action to improve fairness and effectiveness**

- Encouraging IOSCO to consider developing a set of common standards for trading practices that will apply across all FICC markets;
- Agreeing a single global FX code to provide a comprehensive set of principles to govern trading practices around market integrity, information handling, treatment of counterparties and standards for venues; and
- Examining ways to improve the alignment between remuneration and conduct risk at a global level.

Implications

Banks and other firms operating in FICC markets are already on full alert that they need to raise their standards of conduct. However, this is complicated by:

- The wide range of regulatory reforms being implemented or designed. Firms may have to adopt regulatory reforms in a piecemeal fashion, before the full picture is available to them, especially as some of the FEMR recommendations will depend on the development of global standards;

- The focus on a single set of markets and the introduction of further detailed measures specific to these markets may distract firms from the wider-ranging need to improve culture and behaviours across all their activities. Although the FEMR encourages firms to continue on this journey, it clearly does not see this as the solution to the issues identified;
- Firms undertaking multiple activities will need to understand and respond to the development of a potentially disparate and confusing set of regimes – the UK senior management regimes for banks, insurers and FICC firms will each be different;
- It remains to be seen how far the new FICC Market Standards Board creates much needed global guidance to market participants on expected trading practices, and improves the consistency and effectiveness of markets;
- As the Review recognises, regulatory reform may already have contributed to the marked reduction in liquidity in some FICC markets. Further reform could accentuate this trend, with implications for all market participants; and
- It remains to be seen whether the intended global outreach will be achievable. Other regulators have already expressed a commitment to similar principles, but differences in the detail of national implementation could lead to operational challenges for the firms affected and potentially open up opportunities for regulatory arbitrage.

Regulatory reform: retail

International standard-setters, the EU and many national authorities have all taken moves to strengthen consumer protection, with significant political pressure to deliver change.

The **G20/OECD task force on consumer protection** has continued its work on elaborating the OECD's ten high level principles on consumer protection, which it published in 2011. These principles are cross-sectoral, illustrative and non-binding: national authorities are invited to consider their current approaches in the light of international experience and to consider whether there are areas where they need to do more, or to take a different approach.

The latest OECD paper (September 2014) covers six of the ten principles, providing slightly more detailed – but still high level and rather general – statements that expand each principle; a longer set of 'common approaches' that list a series of steps that countries have taken under each principle (but with no discussion of which of these common practices have proved to be the most valuable in practice); and a shorter list of 'emerging and innovative' approaches introduced by some countries (but again with no assessment of their effectiveness).

Meanwhile the **Basel Committee, IAIS and IOSCO** have ventured slowly into the retail conduct field, both individually and collectively as the Joint Forum. The most recent revision of the Basel Committee's corporate governance principles (July 2015) calls upon the Board and senior management of a bank to define its conduct risk in the context of the bank's business; and to oversee management's role in fostering and maintaining a sound corporate and risk culture and in developing a written code of ethics or conduct.

The most active standard setter in the retail conduct area has been **the EU**, with a series of proposed or enacted legislation covering investment services³, collective investments,

key information documents, mortgage credit, insurance credit, payment services and insurance mediation.

Beneath this legislation the three **European Supervisory Authorities (ESAs)** have been busy developing technical standards, in particular the work of ESMA in developing technical standards ahead of the application of MiFID 2, which the Commission has proposed should be delayed until January 2018.

The ESAs have also been encouraged by the European Parliament and by the European Commission's Review (August 2014) of the European System of Financial Supervision to take a more active and higher profile role in consumer and investor protection, including the adoption and use of greater powers to intervene (for example by banning products).

In response, the ESAs have, individually and collectively, begun to interpret **how the high level requirements of EU legislation should be translated into a 'product life cycle' or 'consumer journey' that delivers better consumer outcomes**. They have issued guidelines on product governance (the responsibilities of manufacturers and distributors); selling practices; clearer information for consumers; product suitability; product warnings; and complaints handling. Most recently, they have issued a joint discussion paper on the automation of financial advice, while the EBA is consulting on guidelines on remuneration policies and practices related to the sale and provision of retail banking products and services.

This work of the ESAs is intended to drive further harmonisation of retail market conduct and customer treatment across sectors and across the EU. But achieving this goal in practice will require compromise and cultural change.

For now, at a **national level** the most striking aspect of consumer protection regulation continues to be the marked differences of approach across countries.

“International standards, EU legislation and the work of the ESAs will force greater convergence, and therefore significant changes in regulatory requirements in some countries.”

³ The MiFID 2 EU legislation was summarised in *Evolving Banking Regulation*, KPMG International, February 2014.

Some countries, such as the Netherlands and the UK, have already developed a national approach around the product life cycle, market structures and consumer outcomes. Other countries, such as Germany, have tended to view consumer protection as a relatively narrow compliance issue.

Similar issues are apparent elsewhere in the world. In Asia, for example, the mis-selling of Lehman's mini-bonds and structured products such as accumulators has prompted Asian regulators (particularly in Hong Kong and Singapore) to crack down on conduct issues, urging banks to settle with complainants, to be more transparent on product risks, and to be more rigorous on customer risk assessments and suitability.

International standards, EU legislation and the work of the ESAs will force greater convergence, and therefore **significant changes in regulatory requirements in some countries**. This in turn raises questions about the **viability and sustainability of banks' business models**, in particular with respect to how retail products are priced and distributed.

Product governance arrangements

The core elements of product governance set out in MiFID 2 have been amplified by the ESAs, initially through the Joint Committee high level principles on product governance published in 2013, and more recently through ESMA consultation under MiFID 2, EBA final guidelines on product oversight and governance arrangements for retail banking products (July 2015), and EIOPA proposed guidelines on product oversight and governance (October 2015).

The EBA guidelines will apply to a broad range of retail banking products (although structured products fall under MiFID 2) from January 2017, including significant changes to existing products after this date. National authorities can accelerate this timetable,

and can apply these guidelines to a wider set of firms (for example consumer credit intermediaries), and to a wider range of consumers (for example SMEs).

The key features of product governance that banks will have to meet when designing and distributing retail banking products include **product approval procedures, identifying a target market, distribution strategy, and monitoring consumer outcomes**.

Banks will need to review whether they meet these standards, how they can demonstrate this to their supervisors, and how any shortfalls can be addressed.

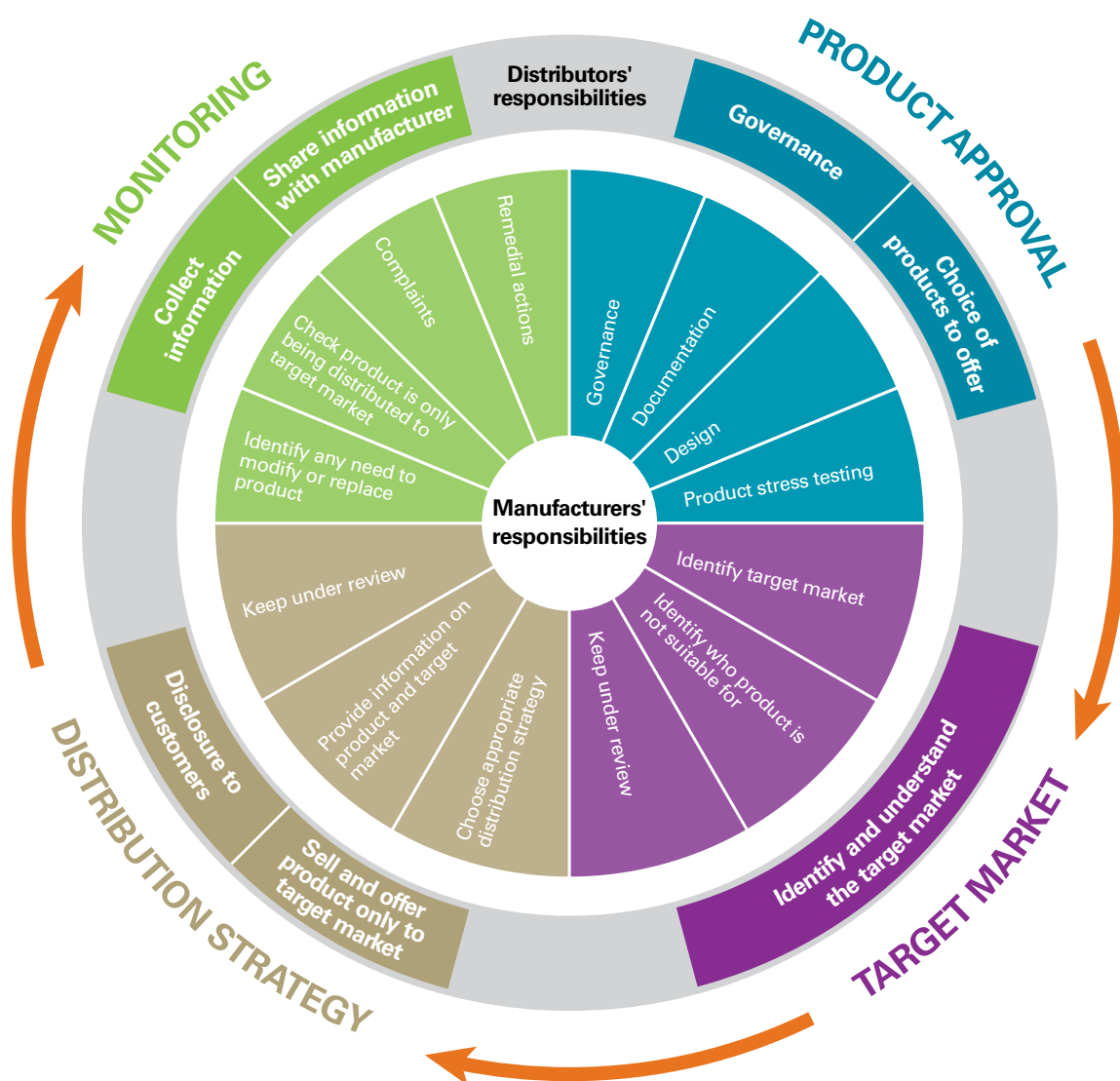
Clear and transparent interactions with customers

Fair, clear and not misleading information

Banks are likely to be subject to additional requirements on disclosures to customers, if only as a result of national authorities reading across from requirements that apply mostly to other parts of the financial sector. These requirements are intended to drive consistency and comparability, increase the transparency of 'all in' costs, and simplify and harmonise information on products, risks and performance.

- The EU Regulation on key information documents for packaged retail investment and insurance based investment products (PRIIPS) requires disclosure of a wide range of costs and charges, including third party payments to investment banks, and transaction costs and charges relating to ancillary services (such as custody and research);
- ESMA technical advice under MiFID 2 on disclosure focuses on consistency in the use of languages, the provision of up to date information, the prominence of risk warnings, using a range of simulations for performance projections, and highlighting illiquidity risks and structured product risks; and

Product governance



- The Joint Forum principles on point of sale disclosures (April 2014) seek to reduce – albeit at a high level – differences across products, sectors and countries in the format and content of point of sale disclosure requirements.

Complaints handling

The ESMA technical advice under MiFID 2 is based on the ESMA and EBA joint guidelines (June 2014) for handling consumer complaints, including the importance of firms:

- Establishing and maintaining a complaints handling policy and function;
- Publishing details of the process to be followed when handling a complaint;
- Communicating clearly to complainants, and explaining how any alternative dispute resolution option operates; and
- Ensuring proper oversight of the operation of the complaints handling process, for example by the firm's compliance function.

Complex products

Debt instruments and structured products

MiFID 2 allows firms to undertake execution only client orders, without the need to obtain information about the knowledge and experience of the client, only for non-complex products and where products do not contain features that make it difficult for the client to understand the risk. An ESMA consultation paper (March 2015) suggests additional guidelines on:

- Types of debt instruments that are deemed to embed a derivative (and therefore automatically considered to be complex);
- Types of debt instruments that are deemed to be complex because it is difficult for customers to understand the risks (for example asset backed securities, subordinated and/or perpetual debt, instruments that do not provide for full repayment of the principal amount, debt issued by a special purpose vehicle, and instruments with complex guarantees);
- Types of debt instruments that are deemed to be non-complex (step-up notes, floating rate notes, covered bonds); and

- Types of structured deposit that are deemed to be complex because it is difficult for customers to understand the risks (return based on more than one variable, complex relationship between relevant variable and return, unfamiliar or unusual variable).

Self-placement of capital instruments

The Joint Committee of the ESAs issued a 'reminder of responsibilities' to financial institutions in July 2014, following concerns that some firms, including banks, were engaging in 'self-placement' – placing financial instruments with their clients that they or their group companies had issued in order to meet new EU capital rules and requirements. These instruments included long-term debt that could be subject to 'bail-in' in the event that the bank was put into resolution.

ESMA issued a separate additional statement on the potential risks associated with contingent convertible instruments, which are highly complex in terms of trigger levels, necessary capital buffer levels and loss absorption mechanisms, while in the UK the FCA has introduced product intervention rules to restrict the promotion of, sale of, or advice on, contingent convertible capital instruments (defined by the FCA as an alternative tier 1 capital instrument or a tier 2 capital instrument that can be written down or converted into equity on occurrence of a trigger event) to retail consumers.

This also illustrates wider themes – how a single practice can potentially be judged to breach multiple principles and rules, and how practices that were accepted in the past can be identified as being unacceptable from now on.

Conflicts of interest

The ESMA technical advice to the Commission on conflicts of interest goes further than MiFID 2 in focusing on how firms

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“ In the UK the FCA has introduced product intervention rules to restrict the promotion of, sale of, or advice on, contingent convertible capital instruments to retail consumers. ”

can eliminate, or at least manage, conflicts of interest, rather than over-relying on disclosure. One particular area of relevance to some banks is the ESMA advice on managing conflicts of interest in underwriting and placing activities. Where conflicts of interest remain, ESMA calls for disclosure to be sufficiently meaningful to allow a firm's clients to take an informed decision.

ESMA advice on commission payments and inducements also addresses conflicts of interest. Under MiFID 2, an investment firm should not accept a fee, commission or non-monetary benefit for independent advice unless this enhances the quality of the advice. In its advice to the Commission, ESMA took a narrow view of how firms could meet this requirement, suggesting that the relevant conditions in MiFID 2 should apply cumulatively; firms should take appropriate measures to ensure that these provisions have been met on a case-by-case basis; and a non-exhaustive list of circumstances and situations should be introduced to indicate when the conditions would not be met (for example, where the inducement does not result in any tangible benefit to the client).

The ESMA advice on inducements takes a relatively narrow view of whether research provided to a portfolio manager can be regarded as a minor non-monetary benefit. ESMA suggests that this should be charged as if it is a third party service if the research is provided specifically to a single portfolio manager.

Knowledge and competence of investment advisers

ESMA issued in December 2015 the final version of its minimum standards for the assessment of the knowledge and qualifications of investment advisers. Recognising the significant differences in standards across member states, these standards focus on firms ensuring (and verifying) that relevant staff possess the necessary knowledge and competence; advisers understanding the key characteristics, risks and

features of investment products being offered or recommended, and the wider macroeconomic, market and regulatory context; and advisers keeping their knowledge up to date through continuous professional development.

Market structure: Payment services

The 2007 Payment Services Directive (PSD) is being updated by PSD 2, which has been adopted by the European Parliament and the Council, and will come into force two years after it is published in the Official Journal. The objective of PSD 2 is to lower costs and increase security and transparency for consumers; increase competition within the industry; and facilitate a seamless payments environment throughout the EEA. The main features of PSD 2 are to:

- Widen the scope of PSD by covering new services (such as internet and mobile payments), and new types of payment service providers (in particular third party providers such as account information consolidators and payment initiation services that do not manage the account of the payment system user);
- Require banks to allow third party payment service providers access to bank accounts via application programming interfaces, which could potentially separate payments from banking;
- Require enhanced security measures to be implemented by all payment service providers, including banks;
- Prohibit surcharging for consumer credit and debit cards, where card charges on merchants are capped under the Interchange Fee Regulation; and
- Support a harmonised Single European Payments Area (SEPA) within which euro payments can be made through a common framework using standardised information, removing distinctions between domestic and cross-border euro transactions.

Abbreviations

BIS	Bank for International Settlements
CET1	Common Equity Tier 1
EBA	European Banking Authority
EEA	European Economic Area
EIOPA	European Insurance and Occupational Pensions Authority
EMIR	European Market Infrastructure Regulation
ESA	European Supervisory Authority
ESMA	European Securities and Markets Authority
ESRB	European Systemic Risk Board
FCA	Financial Conduct Authority (UK)
FEMR	Fair and Effective Markets Review
FICC	Fixed Income, Currency and Commodity
FSB	Financial Stability Board
FX	Foreign Exchange
IAIS	International Association of Insurance Supervisors
IOSCO	International Organisation of Securities Commissions
MAD	Market Abuse Directive
MAR	Market Abuse Regulation
MiFID	Markets in Financial Instruments Directive
MiFIR	Markets in Financial Instruments Regulation
MTF	Multilateral Trading Facility
OECD	Organisation of Economic Cooperation and Development
OTC	Over-the-Counter
OTF	Organised Trading Facility
PSD	Payment Services Directive
SEPA	Single European Payments Area
SMEs	Small and Medium Enterprises
SREP	Supervisory Review and Evaluation Process

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