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Banking in a challenging environment: Business models, ethics and approaches towards risks

by
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The current crisis with its on-going banking sector problems has brought to the fore various cases of financial fraud and banking scandals that have additionally undermined the already low confidence in the sector. This has raised concerns about structural flaws in the way banks operate and are being regulated and supervised. Restoring investor confidence may require new approaches to redesign the incentives, rules and regulations for the financial sector. This was the backdrop for the discussions at the October 2012 OECD Financial Roundtable that this article summarises. Topics covered the current outlook and risks for banks as well as banking business models, ethics and approaches towards risks. Participants pointed out that, while downsizing and adjusting their business models, banks had already made improvements in their risk management. At the same time, the now observed renationalisation of assets could worsen the situation particularly in the European periphery. This could be attenuated by a European Banking Union that would also help to break the detrimental link between banks and sovereigns. As banks are deleveraging, non-banks are substituting for part of the reduced bank lending, but to do so would need regulatory support – while the shadow banking sector more generally will come under closer regulatory and supervisory scrutiny. Consumer groups in particular regard financial consumer protection as important to help improve the social value of financial activities that had often been unproductive, if not destructive. Bank representatives opposed regulatory separation of bank business on the grounds that it is insufficient to address problems of risk taking and control. Finally, it was pointed out that regulatory reforms need to be targeted and harness market forces by balancing penalties and rewards. Governance of regulation should also be enhanced, and regulation should be proactive and be complemented by strong macro and micro-supervision. Co-ordinating reforms should ensure a level playing field, but a one-size-fits-all approach should be avoided.

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I. Overview: Background and summary

The prolonged crisis with its on-going banking sector problems, liquidity and sovereign risks, unprecedented policy interventions and protracted low interest-rates has altered the market environment in which financial firms and investors operate. Financial fraud and recent banking scandals (*e.g.* rogue trading, Libor fixing) have additionally undermined the already low confidence in the sector, and raised concerns about structural flaws in the way banks operate and are being regulated and supervised. Misconduct is still widespread in the financial services industry. Restoring investor confidence is crucial to overcome this crisis, but remains difficult at the current juncture. This may warrant new approaches to redesign the incentives, rules and regulations that govern the "system of promises" upon which the financial sector is built. It was against this backdrop that the discussions at the October 2012 OECD Financial Roundtable took place that are summarised in this note. The topics of this dialogue between government as well as central bank officials and private financial sector representatives covered the current outlook for banks, risks and their management in the first round and banking business models, ethics and approaches towards risks in the second.

Regarding the current outlook for banks it was pointed out that they had already made improvements in their risk management while down-sizing and de-risking their balance sheets. As deleveraging in the banking sector goes on, it is not clear where this process will stop and in how far some (temporary) regulatory forbearance could help restore lending that has substantially declined. At the same time, non-banking sectors (shadow banks) are becoming more important and will therefore have to face more regulatory scrutiny (the ETF sector was highlighted). The asset management industry in particular was seen as being in a good position to provide alternatives to bank lending, but for this to work no new regulatory impediments (*e.g.* Solvency II) should be introduced.

In the process of deleveraging banks put more focus on home markets, especially in Europe where a renationalisation of assets is particularly damaging as it worsens the situation in the periphery. For this reason and, more generally, in order to break the detrimental link between banks and sovereigns, participants broadly supported plans for a Single European Supervisory Mechanism (SSM) and a European Banking Union, although concerns were expressed regarding the possible timeframe of its implementation.

Consumer groups pointed out that financial consumer protection had not yet received appropriate attention by regulators. The building blocks for financial consumer protection are access, safety and resilience, fairness and integrity, performance and efficiency, redress and accountability, and value for society. Too many actions by the financial sector have been destructive, even cynical, leading to negative returns for pension funds, misallocation of resources, and scandals (as those related to Libor). A main cause of the crisis was a wrong regulatory paradigm, relying too heavily on self-regulation, but there have also been shortcomings in corporate governance and ethics. Therefore, regulatory reforms need to harness market forces, foster a healthy balance between penalties (that need to be better

enforced) and rewards, and establish a proper relationship between (own) risk-taking and return.

Regarding banks' business models bank representatives felt that it is the type of activity rather than size that matters for an institution's soundness. Some participants defended retail banking, others universal banking as resilient model, and most bankers strongly opposed bank separation arguing that it would not prevent excessive and poorly controlled risk-taking that should be addressed by more targeted measures.

There was also a call on regulators to be proactive, to take into account issues of governance and compliance cost of regulation and, as well, to address problems of regulatory capture. Co-ordination of regulatory reforms should ensure a level playing field, however some leeway for national specifics should be allowed and a one-size-fits-all approach should be avoided. Strong macro as well as micro-supervision that detect risks early on were seen as important complements to regulation.

II. Current outlook for banks, risks and their management

Private sector participants noted that the crisis – also because of its secular character – has led banks and the asset management industry to make profound improvements in their risk management. Banks have adjusted their activities and business models (Figure 1 indicates some planned changes for major European banks),[1] and while risk capital models have become more sophisticated, the scarcity of capital more generally has made regulatory capital rules more binding and important in risk management considerations. Contingency planning is also playing a more vital role in risk management.

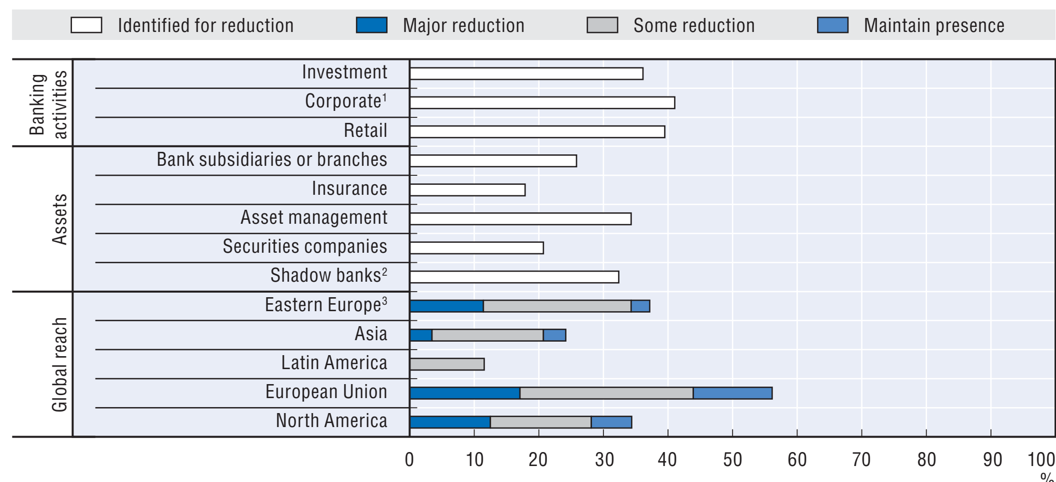
There has been a permanent down-sizing in banks' balance sheets in the course of the crisis and as markets started de-risking in 2009 the cost of equity finance has risen. Banks now accept that return on equity will be significantly lower for the time to come – and some sectors and banks in some regions will not be profitable at all. While many banks are facing funding difficulties, these cannot – and should not – be generalised. Some participants thought that banks could become more like utilities – a perspective welcomed by consumer groups, but disagreeable to most bank representatives present. Some of these developments have also been driven by changes in the resolution regimes.

As banks deleverage assets have been moved to the "shadow banking" sector that should now be on regulators' radar. One area where risk has risen is the exchange traded funds (ETF) sector which regulators should monitor closely. It was mentioned that there are cases where an ETF's underlying assets show low correlation with the headline assets (*e.g.* Japanese equities underlying a US equity ETF) which reflects poor risk management. Likewise, money market funds face significant challenges in this low-interest rate environment with exceptionally low returns. In 2006/07 these funds had problems because of subprime CLOs and inappropriate duration risks, and while improvements in risks management were made these efforts need to be kept up.

Deleveraging was seen as the fundamental backdrop of the current situation and it is neither clear where it will finish nor what the optimal level of leverage would be. It was also seen as not evident that new rules and regulations would attain such an objective, or what would be the transition costs, given the many unintended consequences of the reforms. Regulatory uncertainty was felt to be still high which makes it difficult for banks to take strategic decisions. Regulatory efforts (including risk-compatible compensation systems[2]) are not globally aligned and certain elements are not yet well defined (*e.g.* SIFI and

Figure 1. **Announced changes to business strategy by major EU banks**

Share of institutions surveyed in 2011 planning to engage in indicated strategy over the following two years



Notes: The sample includes 23 major banks from Austria, Belgium, France, Germany, Ireland, Italy, the Netherlands, Spain, and the United Kingdom. See sources for details.

1. Includes interbank lending and commercial real estate loans; and working capital, project, and specialised finance, including leasing, equipment, trade, and commodities finance.
2. Includes companies that specialise in car, aircraft, shipping, leasing, project, and structured finance; investment banks; and municipal bond agencies.
3. All EU and non-EU countries in Eastern Europe, including Poland, Russia, and Turkey.

Source: Company websites and IMF staff estimates, as quoted in IMF (2012).

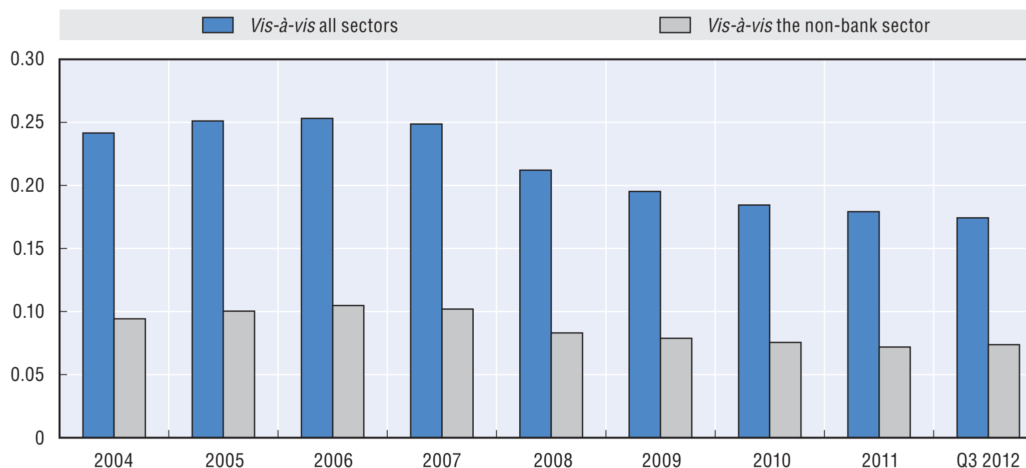
countercyclical buffers, LCR, bail-ins). Also, long-term regulatory objectives are not compatible with short-term economic realities and the need to restore lending. It was also noted that asset encumbrance poses problems for investors because it is difficult to get data that would be important for determining credit risk.

As banks are deleveraging they put more focus on home markets, especially in Europe where such a move has been supported by governments and regulators (and the "Troika" in programme countries). But it was also argued that this increase in home bias (as indicated in Figure 2) is not so evident outside the euro zone; for example Chinese and Russian banks have increased their cross-border exposures. However, depending on the way global banks are being regulated, ring-fencing of bank assets can also be observed outside the euro zone. Supervisors may appreciate such country ring-fencing because it reduces interconnectedness and contagion risk, but there is a trade-off: because excess liquidity cannot flow to countries where it is scarce, bank lending is being restrained and, from a macro perspective, the resilience of the banking system is being reduced. In this context it was also pointed out that at the beginning of the crisis cross-border flows were a stabilising force. In Europe in particular the renationalisation of bank assets was seen as damaging as it worsens the situation in the periphery.

There was also broad support for the proposed Single European Supervisory Mechanism (SSM) and a European Banking Union, although doubts were expressed that it could be achieved within a reasonable timeframe, including given the concerns about it becoming a transfer union. There was also a plea for more solidarity that was deemed necessary to solve the crisis, and more political courage to put this new system in place. Lack of political resolve has a cost, it was argued; the ECB cannot solve all the problems. A banking union would be important to more permanently break the damaging link between

Figure 2. **Banks' foreign currency exposure has declined**

External asset positions of banks in foreign currencies as a share of total banking assets



Note: Total banking assets are approximated by global listed banks' assets as available in Datastream bank indices.
Source: *BIS Quarterly Review,* Banking Statistics; Thomson Reuters Datastream.

banks and sovereigns as it alleviates pressures of a stressed sovereign on its banking system. In this context, there was also a call on ratings agencies not to mechanistically link the rating of a sovereign to its banks.

The asset management industry was seen to be in a good position to provide, at least partially, alternatives to bank lending; the industry is only very slightly leveraged. There is also about USD 4 trillion of corporate surplus cash globally that could be deployed, and corporations have begun to lend directly, especially to SMEs. There is also a potential for long-term investment, for example from pension funds that have been increasing their allocation to illiquid assets to match their long term liabilities. In this context it was also pointed out that applying Solvency II regulations for that sector would be very damaging.

III. Banking business models, ethics and approaches towards risks

Consumer representatives pointed out that financial consumer protection has not yet received appropriate attention by regulators (see Box 1 for OECD efforts in this respect). Three clear objectives for financial market reforms had emerged in the aftermath of the financial crisis: *i)* enhancing financial stability and managing systemic risk (macro-prudential regulation); *ii)* rebuilding financial institutions (micro-prudential regulation); and *iii)* making the financial sector work for the benefit of financial users and society as a whole. While the first two objectives are very important and thus in the focus of regulators, the third objective has received comparatively little attention – even though making markets work is of equal importance to ordinary financial users and the real economy. Moreover, it was said that policymakers and regulators have failed to understand that financial consumer protection is only one part of the wider challenge of making markets work – along with efficiency and real competition, socially useful innovation, confidence and trust and so on.

It was argued that conventional economic models were unsuited to assessing the value provided by financial markets. Policymakers and regulators need to evaluate financial markets according to real outcomes such as: access, safety and resilience, fairness and integrity, performance and efficiency, redress and accountability, and trust

and confidence. Policymakers have also failed to understand the "transmission effects" in the supply chain: market failures in the wholesale (institutional) markets are transmitted back down the chain to ordinary financial users, while misselling of financial products to 'retail' users feeds back to impact on balance sheets, in a feedback loop.

Too many activities in the financial sector were regarded as extractive and destructive, and not productive. Misconduct seems to be still widespread in the financial services industry (Box 2). Repeated scandals and market failures have occurred not just in retail financial services but at each part of the supply chain (for example, conflicts of interest,

Box 1. **The OECD and Financial Consumer Protection**

The global financial crisis resulted in widespread disruption to financial markets and institutions. As a consequence, policy makers and supervisors took steps to improve regulatory interventions in order to support financial stability. Trust is the very cornerstone of the financial services industry but this trust has been eroded, not only as a consequence of the financial crisis but by a growing catalogue of examples of mis-selling, malpractices and poor market conduct behaviour by individual financial institutions across the sector. This lack of trust has made the general public extremely cynical over the very values, the self-interests and the excessive rewards that still characterise the industry.

Financial Consumer Protection is important to this debate because it can restore consumer confidence and trust in financial markets. To that end and first initiated by the OECD Committee of Financial Markets in 2010, the G20/OECD Task Force on Financial Consumer Protection, along with G20 members, the Financial Stability Board (FSB), and several relevant international bodies, developed *High-Level Principles on Financial Consumer Protection*. The High-Level Principles are designed to assist G20 and other interested economies in enhancing financial consumer protection within their own jurisdictions. At the Cannes Summit in November 2011, the G20 leaders endorsed the High-Level Principles (OECD, 2011b) and reaffirmed the view that integration of financial consumer protection polices into regulatory and supervisory framework contributes to strengthening financial stability.

Under the Mexican G20 Presidency, the OECD was requested to prepare an action plan for the development of further work on consumer protection. This approach was endorsed by the G20 Deputy Finance Ministers meeting in Mexico in January 2012. The action plan highlights the relevance of identifying effective approaches to support the implementation of the High-Level Principles. These approaches will be evidence-based and rely on both existing and ongoing international, regional and national examples. Priority will be given to areas related to the Principles which have been identified as having the greatest need for such effective approaches. These Principles are related to:

- disclosure and transparency;
- responsible business conduct of financial services providers and authorised agents; and
- complaints handling and redress.

The action plan was endorsed by the G20 Leaders at their meeting in Los Cabos in June 2012 and the Principles were adopted by the OECD Council as a Recommendation in July 2012 (OECD, 2012). Results of this work will be presented in September 2013 to the G20 Leaders Summit in Russia.

Enhancing financial consumer protection is an essential part of the process to restore trust in financial markets and bring back consumer confidence for retail financial products. However, it can only go so far to protect consumers from, and perhaps prevent, unethical behaviour in the financial industry; the fundamental changes in behaviour that are required for financial providers to become more consumer centric – and more ethical – must come from the providers themselves. This is why improving the reputation of financial service providers through appropriate consumer-focused values, ethics and standards will in the end complement, not hinder, any future regulatory interventions.

massive inefficiencies and value destruction in investment banking, institutional fund management, Libor manipulation[3] and so on). A damaging trend in financial markets has been the oversupply (of providers and products), overintermediation (too many layers of intermediaries), and overcomplexity (of products) extracting and destroying value in the supply chain.

Box 2. **Bad behaviour in the financial industry: results from a survey**

Misconduct is still widespread in the financial services industry. A recent survey of the industry in the United States and the United Kingdom, *Wall Street, Fleet Street and Main Street: Corporate Integrity at a Crossroads*, revealed interesting data on corporate ethics, the regulatory landscape, and individuals' willingness to blow the whistle on wrongdoing. The survey was conducted in June 2012 via 500 online interviews with senior individuals within the financial services industry (250 in the UK and 250 in the US). It was commissioned by the law firm Labaton Sucharow which, jointly with the survey release, on 10 July 2012 launched its SEC Whistleblower Eligibility Calculator.[1]

Among the key findings of the survey are:

- 26% of respondents indicated that they had observed or had first-hand knowledge of wrongdoing in the workplace.
- 24% of respondents believed that financial services professionals may need to engage in unethical or illegal conduct in order to be successful.
- 16% of respondents would commit a crime (insider trading) if they could get away with it.

The survey also revealed the following:

- 39% of respondents reported that their competitors are likely to have engaged in illegal or unethical activity in order to be successful.
- 30% of respondents reported their compensation or bonus plan created pressure to compromise ethical standards or violate the law, while 23% of respondents reported other pressures that may lead to unethical or illegal conduct.
- 30% of respondents feel that the SEC/SFO effectively deters, investigates and prosecutes misconduct – despite the stepped-up enforcement actions and new reforms; 29% of respondents feel the same way about FINRA/FSA.

The survey also found that:

- 94% of respondents would report wrongdoing given the protections and incentives such as those offered by the SEC Whistleblower Program;[2] but only 44% of respondents were aware of this programme.
- Scepticism and uncertainty about employers' handling of claims of misconduct persist. One in five of the professionals surveyed were not sure of, or had serious doubts about, how their employers would handle a report of wrongdoing. In addition, in the United States, gender was a factor in attitudes toward retaliation: 22% of female respondents believe that they would be retaliated against if they reported wrongdoing in the workplace, compared with 12% of male respondents.

More details and the full report can be found at *http://labaton.com/en/about/press/Labaton-Sucharow-announces-results-of-financial-services-professional-survey.cfm*.

1. The SEC Whistleblower Eligibility Calculator may be found at *www.secwhistlebloweradvocate.com/eligibility/* and is a web-based tool that lets users assess their eligibility for the SEC Whistleblower Program (see note 2).
2. The SEC Whistleblower Program has the aim to help report violations of the US federal securities laws and apply for a financial award, implementing the Dodd-Frank Whistleblower Program. It has broad extraterritorial reach and offers eligible whistleblowers, regardless of nationality, significant employment protections, monetary awards and the ability to report anonymously. The programme is administered by the Office of the Whistleblower (*www.sec.gov/whistleblower*).

Sources: Labaton Sucharow, LLP (2012); and US Securities and Exchange Commission.

As a worrying aspect it was mentioned that the major sectors (banking, insurance, and asset management, including pension fund management) had failed to deliver value in relatively good times and the question was how legacy models in these core sectors will cope with the new economic reality (defined by low economic growth, low financial returns, squeezed household incomes, and greater regulatory scrutiny).

An understanding of why financial markets have failed so badly was seen as necessary. It was argued that one of the root causes of this failure of the financial system was a flawed regulatory paradigm relying too heavily on conventional, “rational” but “naïve” economic models and theories (for example, the information asymmetry model) which do not explain the root causes of financial market failure. Therefore it was seen as unsurprising that conventional regulatory interventions such as information solutions have had very little impact on consumer behaviour and market behaviour. There have also been serious shortcomings in corporate governance and ethics in the financial sector.

Therefore, it was argued, regulatory reforms need to harness market forces, foster a healthy balance between penalties (that need to be better enforced) and rewards, and establish a proper relationship between (own) risk-taking and return. Reforming financial markets would require a combination of *i)* a new model of regulation based on early intervention targeted at the root causes of market failure such as conflicts of interest and robust sanctions; *ii)* enhanced corporate governance and business ethics; and *iii)* effective market forces. The objective should be to create a system that penalises detrimental behaviours and market inefficiencies and rewards good behaviour and real competition and innovation.

Little evidence was seen that the necessary improvement in governance and ethics or real competition would result without tougher regulation. Thus the question is how far the industry is willing to go on a voluntary basis and how much regulatory force is needed. Self-regulation was regarded as no longer credible and as having been abused, therefore banks should not oppose regulatory reforms.

Some bank representatives claimed, though this was contested, that retail banking has not failed in this crisis. The question is not one of size but of activity. It was argued that universal banks have been less affected by the crisis due to their strong relations with clients that leave little room for asymmetric information, as well as due to their conservative remuneration policy (“boring banking is good banking”). However, the universal banking model is under threat by new regulations, and bankers present strongly opposed bank separation and argued for implementing existing regulations before making new ones.

Some argued that banking crises are not linked to one particular banking model. Stability and resilience would be the result of many measures, and regulatory bank separation (Volcker, Vickers, Liikanen)[4] is probably not needed to achieve these goals. It was said that the problems of excessive and poorly controlled risk-taking cannot be solved by bank separation. More targeted measures that change, for example, banks risk profiles would be preferable, as would be solutions that take into account the specifics of countries and banking models. New regulation should also not endanger the bank-client relationship.

It was noted that there is no perfect regulatory system, but some principles of governance of regulation should be observed (work by the OECD in this area was mentioned positively). Regulation should be ahead of developments. It should also take

into account and address problems of regulatory capture, be simple to implement and take into account the cost of compliance. Regulation also needs to assess alternatives to achieve its goals. Regulatory reforms should create a level playing field, be co-ordinated and implemented step by step and side by side, while leaving some leeway for national specifics and avoiding a one-size-fits-all approach. Most importantly, regulation needs to be complemented by strong macro as well as micro-supervision that detect risks early on.

Notes

1. See also Visalli *et al.* (2011) as well as IIF and Ernst & Young (2012).
2. See also IIF (2011).
3. Various initiatives were taken by regulators to address these manipulations; see *e.g.* H.M. Treasury (2012).
4. See Blundell-Wignall and Atkinson (2012), especially Table 6, Regulatory Approaches to Bank Separation, comparing the Vickers (ICB, 2011), the Volcker Rule (US Congress, 2010), and the Non-Operating Holding Company (NOHC) approaches. For the EU proposal see Liikanen (2012). See also other references listed below for presentations and discussions of various approaches to bank separation.

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