

## **Regulating Ethics: A Question of DNA?**

A regulator cannot impose an ethical culture if a bank does not have a foundation of ethics within its DNA to start with. That was the proposition made at the last in the four-part financial regulation seminar series run by the Centre for Ethics and Law.

The seminar was a think tank held with Andrew Bailey, who, it was announced that week, would take up the roles of Deputy Governor, Bank of England, for Prudential Regulation and CEO of the Prudential Regulation Authority (“PRA”) on 1 April 2013. Mr Bailey offered his insights on how the ethical dilemmas arising out of the 2008 financial crisis can be addressed. The seminar brought together contributions from a cross-disciplinary audience with experts from the judiciary, a variety of regulators, industry and academia. CEL’s Anna Donovan summarises proceedings.

The financial crisis can be separated into two distinct parts: one prudential and the other more conduct based. The first, prudential, stage of the crisis concerned the solvency of banks and the stability of the financial system and its institutions. These issues framed the dramatic events of 2007/2008 onwards. However, what has now come to light is the clearly distinguishable second stage of the crisis, typified by conduct concerns. That is, the culmination of unethical banking practices, which have been going on for some while but which are only now coming to a head. For example, practices involving product mis-selling (such as PPI), the more recent identification of the LIBOR scandal and anti-financial crime practices giving rise to recent US and international sanctions concerns regarding banking activities with Iran.

The LIBOR scandal itself has two stages, namely the low-balling of the rate and the trader manipulation of LIBOR, which demonstrate how organisational and individual motivations can be different but may operate to influence potentially unethical decision-making. The low-balling stage can be seen as a self-preserving activity by the industry at a collective level. The goal was arguably to minimise the liquidity effects of any public perception that one bank or another might appear relatively less stable or liquid than others, thereby provoking a run, and a contagious one, given the interdependence of banks in the inter-bank funding market. Banks, to avoid the financial consequences of standing out from the crowd, may herd together to maintain a potentially inaccurate rate. However, a by-product of the low-balling scandal resulted in a comprehensive data mining exercise to try fully to understand the LIBOR issue in more detail. It was during this exercise that the second part of the LIBOR concerns was undiscovered, the trader manipulation of LIBOR. If the first stage of the LIBOR scandal reflected the power of collective attitudes to risk then the second stage represents the power of individual motivations, as the trader manipulation was arguably fuelled by a desire to increase personal rewards. This second stage dominated the headlines, renewing calls for, *inter alia*, greater regulation of banking ethics and suggestions that the solution to the crisis lies in changing the culture in banks.

One difficulty that banks face when addressing demands for enhanced ethical cultures is that they are increasingly in the front line of enforcement of financial crime and in doing so they face changing expectations that society has of them in terms of ethical standards. History has shown that these demands are often cyclical, with greater tolerance extended during times of economic strength whilst demands for higher ethical standards are made during economic downturns. Nevertheless, these are standards that banks must meet, or else they face increasing calls for potential structural changes (such as separating banking functions out into smaller entities). But how can a regulator respond to these demands? Regulators cannot impose ethical cultures on banks (as some have suggested). They can utilise indirect mechanisms that encourage cultural change (notably concerning remuneration structures), but an organisation must have a bedrock of ethics from which to build its culture. If ethical conduct is not within the firm's DNA, the PRA cannot simply create or 'ordain' it.

One way that the PRA and FCA could establish ethical standards (and encourage normative change within the industry) is through the enforcement actions that it takes. However, outside of the PRA's remit is the ability to take disqualification action against individual directors, which is a powerful personal motivator and was a feature of previous scandals such as the Barings collapse. It is notable that currently no action has been taken against a CEO in response to the 2008 financial crisis, leaving them free from formal personal responsibility. Nor, it was argued, have we learnt the lessons of history. Earlier scandals, such as pensions mis-selling, show us how often history repeats itself. It is well known that this status quo arises from the difficulty in creating the causal link between CEO decisions and specific actions leading to the crisis. Yet in an age where "tone from the top" is recognised as a key component in creating and embedding culture within an organisation, this is a question that now surely needs revisiting. If a CEO were to create a culture in which the operational aspects of the organisation consider unethical conduct to be tolerated (as was suggested to be the case in the LIBOR low-balling scandal), then this needs to be addressed.

Thus, we enter the next stage of prudential regulation. One that anticipates cultural change not only within the banks that are regulated but in the regulator itself. As Andrew Tyrie, chairman of the Parliament's Treasury Select Committee said of Mr Bailey's recent appointment "His leadership will be instrumental in shaping a much-needed cultural change at the regulator, moving away from the failed box-ticking exercises of the FSA toward more judgment-led regulation" whilst acknowledging that "the size of this task should not be underestimated." However, we as members of the public must also play our part in learning from the history books. As we make these demands for a change in the wake of the recent crisis, it may be time for us to maintain these calls when we see an improvement in the economic climate. In doing so, we create a consistent message for banks to respond to, one which may support meaningful, sustainable change rather than simply *ad hoc* responses to cyclical downturns and/or disorder.