Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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It's Time for a U.S. Banking Standards Board[*]

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Recent hearings on the cross-selling practices of Wells Fargo Bank, as well as continuing enforcement actions and settlements at other banks, have sparked bipartisan calls for Congress to "do something" next year under a new administration to address — at a minimum — issues of banking culture, conduct, compliance, and compensation. The Comptroller of the Currency, who regulates national banks, is conducting a horizontal peer review of the largest banks to assess their practices with respect to opening new accounts and cross-selling practices. The Director of the Consumer Financial Protection Board has promised his own review.

Meanwhile, the issue of the risk culture at banks has been a recurring theme of financial regulators around the world, including U.S. regulators, since the financial crisis. More than two years ago, two senior Federal Reserve officials made major policy statements on the importance of risk culture and ethical behavior. Federal Reserve Board Governor Dan Tarullo stressed the rising expectations of regulators for good compliance — not just "mere compliance." He dismissed the idea that there were just a "few bad apples" in the industry. Governor Tarullo warned that if firms did not do a better job of imposing more ethical cultures and ensuring better employee behavior, then regulators would intervene in ways that banks may not like.[1]

Federal Reserve Bank of New York President William Dudley took a similar stance, linking the need for financial stability with better banking cultures and behavior. He indicated that the Federal Reserve's attention would be on behavior, the output of a bank's culture, stressing the primary responsibility of senior banking leadership to correct bad cultures and ensure proper behavior in full compliance with the law. Among other things, he called for better financial incentives and compensation practices, including the wider use of deferred debt compensation (i.e., a performance bond).

[*] The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] Daniel K. Tarullo, Governor, Federal Reserve System, "Good Compliance, Not Mere Compliance," Federal Reserve Bank of New York Conference, "Reforming Culture and Behavior in the Financial Services Industry," New York, New York, October 20, 2014.

President Dudley also noted the new UK initiative between the Bank of England and the seven largest UK banks to establish a CEO-level Banking Standards Board (BSB). The purpose of the BSB is to "promote high standards of behaviour and competence across the UK banking industry."[2] After referencing this new initiative, President Dudley then issued his specific challenge to U.S. banks: "I would strongly encourage the largest institutions based here in the United States to work to develop collaborative solutions aimed at improving culture and rebuilding the public trust [emphasis added]."[3] He warned that if U.S. banks didn't act soon to correct cultural and ethical issues, then regulators and the public would assume they were too big to manage, which in turn could result in further regulatory intervention and rising public calls to downsize and simplify large banks in the name of financial stability.

Continuing Congressional interest and heightened regulatory scrutiny of the banking industry's culture, ethics, and practices will continue for the foreseeable future in the current political climate. Given the vital role that the banking system has for U.S. economic growth and job creation, it is critical that public trust in our nation's banking system is a national priority. Without visible industry action to ensure that public trust, U.S. banks are most likely facing new laws, more regulation, heightened supervision, and tougher enforcement actions next year in the areas of culture, conduct, compliance, and compensation. While it is difficult to predict what Congress might do specifically, the spectrum of issues that surfaced during recent Congressional hearings range from separating the role of chairman and CEO, to new restrictions on incentive compensation and claw-back provisions, to banning or restricting the use of arbitration clauses in consumer contracts for starters.

Consequently, to ensure unassailable public trust in our banking system in light of these potential legislative and regulatory actions next year, we recommend that the U.S. banking industry follow the UK's lead and take the initiative now to establish a U.S. Banking Standards Board in consultation with U.S. financial regulators. Its sole mandate should be to oversee and support high professional standards and ethical behavior by banks when they interact with their customers.

The UK's BSB is a non-statutory, independent body created in response to a recommendation by a Parliamentary Commission on Banking Standards. That Commission recommended that —

> ... work to establish a professional body should begin immediately as a demonstration that commitment to high standards is expected throughout banking and that individuals are expected to abide by higher standards than those that can be enforced through regulation alone. ... A unified professional body for banking should have no need of public subsidy, either directly or indirectly. We would expect such a body to be funded by participating banks and individual qualified members. However, it would also need to establish independence from the outset, through its forms of governance, its disciplinary procedures and through the personnel at senior levels. The body must never allow itself to become a cosy sinecure for retired bank chairmen and City grandees. Just as importantly, it must eschew from the outset and by dint of its constitution any role in advocacy for the interests of banks individually or collectively.[4]

[2] ***Banking Standards Board.***

[3] William C. Dudley, President, Federal Reserve Bank of New York, "Enhancing Financial Stability by Improving Culture and Behavior in the Financial Services Industry," Federal Reserve Bank of New York Conference, "Reforming Culture and Behavior in the Financial Services Industry," New York, New York, October 20, 2014.

[4] ***Changing Banking for Good: Report of the Parliamentary Commission on Banking Standards, Vol. 1: Summary, Conclusions, and Recommendations, p. 34.***

Several of the largest banks in the UK accepted this challenge. They agreed not only to fund the BSB, but placed control of the organization in a governing board controlled by directors from outside the banking industry. As such, this board is not a trade association; it does not represent the industry. At the same time, it is not a regulator. It has no statutory powers. Instead, it simply has a mission to raise the standards of behavior and culture at UK banks.

The UK's BSB started to accept new members earlier this year, and so remains a work in progress. Nonetheless, its establishment signals a commitment to behavior and culture by UK's largest banks, and its early steps show promise. It is developing a methodology for grading a bank's commitment to behavior and culture. It has sponsored a major study on professionalism within the banking industry, and the role professional organizations can perform in promoting best practices. It also is sponsoring a study on how standards of behavior and competence are set and shaped by law, regulation, codes and other standards, and whether this balance is working effectively, and what this might imply for the industry. In announcing this study, the BSB noted that it is not designed to conclude that less regulation would be beneficial. Instead, the study is "asking what needs to be in place alongside regulation to produce the highest standards of behavior and competence in banking; what is needed to fill the space beyond the boundaries of regulation,' for that regulation to be not only bounded, but to work effectively." Finally, it has announced plans to develop voluntary standards that will support a better service for customers and other relevant parties across the sector.

In sum, the establishment of a U.S. Banking Standards Board could go a long way to help U.S. banks address recurring issues of behavior and culture, and thereby repair their reputation and standing. Trust in the nation's banking system is a prerequisite for a strong and growing economy. Bankers have a self-interest in ensuring high integrity and trust in their institutions as well as a vibrant economy. Therefore, now is the time for bankers to act to ensure unassailable public trust in their industry, before Congress and regulators do so for them.

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