

# Changing financial services firms' behaviour through a duty of care

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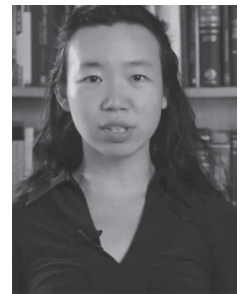
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## ABSTRACT

There have been a number of calls for regulators to impose a new and higher duty of care on regulated firms. These calls are evidence of a continuing mistrust of the financial services industry. The remedy largely rests in the hands of the latter to demonstrate that it is worthy of trust. The new duty of care will not achieve the aims of those that seek a significant improvement in the conduct of the industry. What is sought by all is a change in culture. This paper looks at the practical steps that a regulated firm can take to demonstrate its adherence to both the letter and spirit of financial services regulation and those specifically aimed at addressing cultural change. These actions include firms focusing on their strategy and business model and who, and



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*how, they employ people and operate their processes. This includes the regulatory Senior Managers and Certified Persons Regime. It also includes steps to measure culture and emphasises the importance of avoiding self-deception.*

**Keywords:** *culture, duty of care, regulatory compliance, treating customers fairly, senior managers, certified persons, gatekeepers*

### **THE FINANCIAL CONDUCT AUTHORITY CONSULTATION ON A NEW HIGHER DUTY OF CARE**

The Financial Conduct Authority (FCA) consultation on whether a new and more demanding duty of care should be imposed on financial firms closed recently.<sup>1</sup> The issue has arisen, since some organisations such as the FCA's Financial Consumer Panel, believe that the current requirements do not adequately protect consumers and they want the FCA to institute a new 'duty of care' obligation on firms. This is linked to continued evidence of poor cultures within some businesses and, consequently, they consider that a new standard will help address 'the extent and longstanding nature of consumer detriment [which] indicates that cultural change is required within firms and the market as a whole.'<sup>2</sup>

Specifically, the FCA Financial Consumer Panel doubts the effectiveness of the existing regulatory principles and see regulated firms flouting Principle 6 ('A firm must pay due regard to the interests of its customers and treat them fairly' (TCF)).<sup>3</sup> The Panel sees firms adopting a 'let's see if we can get away with it' approach.<sup>4</sup> The Panel has highlighted a number of examples, including 'in the savings market, banks can reduce interest rates on existing customers' accounts by declaring an account "obsolete"; however, the Panel claim that to be compliant with Principle 6 the bank only needs to inform the customer of the

change in interest rate.<sup>5</sup> The Panel states if an enhanced duty of care was imposed on banks the latter would need proactively to move customers to accounts paying the higher rate. In another example, the Panel quote an FCA thematic review that banks are not showing customers in financial difficulties sufficient forbearance. The Panel want firms to avoid conflicts of interest and to 'take their customers' best interests into account at every stage of their engagement.'<sup>6</sup> It sees the adoption of a new duty of care as a preventative measure and one that would be used by, for example, the Financial Ombudsman Service to measure the resolve of firms handling complaints.

The Panel propose to amend the Financial Services and Markets Act 2000 (FSMA) to impose this new duty' however, it is still unclear what specific rules for particular products and markets this would entail. 'The more complex or risky the product, the more stringent the duty would be on the provider to ensure the product was suitable and that the customer understood what they were buying, and the risks involved.'<sup>7</sup> The onus would be on the FCA to supervise and to enforce the duty, applying the right standards. If done properly, however, it could bring about the much needed cultural change in financial service businesses.

The Panel is concerned that although the TCF initiative to reinforce Principle 6 was launched in 2003/4 by the Financial Services Authority, the FCA's predecessor, it has failed to prevent the extensive mis-selling of payment protection insurance (PPI) and a range of other mis-selling scandals.<sup>8</sup> It lays the blame on the poor cultures existing within many financial services firms. This view has been supported by others including the Parliamentary Commission on Banking Standards (PCBS) and analysis by Professor Andre Spicer.<sup>9</sup>

The conclusion is that the TCF programme failed and there is some empirical

evidence to support this view. Sharon Gilad in her empirical research, found that firms, generally, have a considerable ability to self-justify and to rationalise their actions.<sup>10</sup> It is likely that any new duty imposed upon them will go the same way as the ‘treating customers fairly’ (TCF) initiative. Her work found that in many regulated firms ‘management communication of TCF messages through posters and training programs were cynical attempts at “cosmetic compliance” – posters appeared just before a visit from the regulator, and internal communications were ...focused on providing the regulator with superficial evidence of ‘cultural transformation.’<sup>11</sup> The research found that changes in regulation would not be ‘internalised’ within an organisation and that existing practices and cultures would ‘diverge from the ideal preferences of managers and from the expectations of regulators and external stakeholders.’<sup>12</sup> The central issue is the need to persuade regulated firms to reflect and to analyse their business model, their approach to corporate governance, risk management etc and who they recruit, train etc and their management style, targeting and remuneration.

### WHAT REGULATED FIRMS CAN DO

The phrase ‘duty of care’ is a term often used in law. Its use, and what it means, is based on the common law and the subject of many legal cases that have attempted to define it in a variety of contexts over the centuries. There is little to be gained by importing the term, and all the legal interpretations, into consumer protection in UK financial services when the real objective is a change in the culture of regulated firms. Indeed, the duty of care is only raised by litigants as a fallback when unable to rely on private litigation for breaches of regulatory duties.<sup>13</sup> In recent cases where a duty of care has been raised, such a duty has usually been found to have not arisen or expressly excluded.

Its efficacy as a customer protection measure that exceeds regulatory duties is very much in doubt. It is possible that the real purpose of the FCA’s Discussion Paper is to help to direct the dialogue in the direction of culture change, since it is important that businesses operate to the highest standards to protect their customers.

At the heart of the Consumer Panel’s concerns is the culture of the regulated firm. Without the right business culture all regulations are likely to be futile. In these terms, an organisation’s culture has been defined as ‘the tacit understandings, habits, assumptions, routines, and practices that constitute a repository of unarticulated source material from which more self-conscious thought and action emerges...culture thus mediates between structure and agency, that is, between formal compliance system and strategic action’.<sup>14</sup>

Nevertheless, there is a danger that culture is seen as too abstract a term. Consequently, it needs to be made manifest, in a form that can be seen and measured and weighed in the balance. The necessary work to do this can be divided up into the following areas:

- Strategy and business model.
- People, processes and governance, including the regulatory Senior Managers and Certified Persons Regime (SM&CR).
- Control functions as ‘gatekeepers’.
- Measuring culture.
- Reporting.
- Raising concerns.
- Remedial action.
- Back-book reviews.
- ‘Up-stream’ risks.
- Considering other stakeholders.
- Communicating the message and spreading best practice.
- The risk of self-deception.

These are addressed in turn, section by section.

### Strategy and business model

The board is responsible for the company's strategy and the wrong strategy can easily undermine the duty to treat customers fairly, if not a duty of care. Wells Fargo is a recent example of the wrong strategy producing very poor results for many customers of the bank. Here, the business model was based on cross-selling products. The then chief executive 'had initiated the "GR-8" program to pursue cross-selling. The aim of the programme was for each customer to have at least eight bank products memorialised in the sales slogan "eight is great"<sup>15</sup>. The senior management, including the non-executive directors, are responsible for ensuring that the strategy and business model reinforces the firm's general and specific legal duties. They also need to check that the strategy is not misinterpreted by the organisations' staff and that the right conduct prevails.

Included in this is the need to focus on where the firm earns its revenue and makes its profits. This is particularly important where a business cross-subsidises unprofitable areas. This was core to the mis-selling of PPI where a highly profitable insurance product made up for unprofitable lending to customers.<sup>16</sup> If a business line looks too profitable, boards should indeed query if it may be because the firm is not observing the right standards in its duty to customers.

### People, processes and governance

It is important that the business seeks to attract people with the right ethics who will not try to disadvantage customers. These individuals need to be inducted and trained accordingly. They must act professionally and the business needs to support this, including encouraging them to take the appropriate professional qualifications. This will develop their competence and ensure they do not breach any general or specific legal duties through ignorance and to provide an authoritative moral reference

point above and beyond those required by the business itself, including undertaking to adhere to high standards of conduct supported by ethical codes. Professional bodies also provide access to ethical guidance and confidential mechanisms to raise concerns.

Further, the Prudential Regulation Authority requires that a senior manager is specifically allocated the role of 'overseeing the adoption of the firm's culture in the day-to-day management of the firm'.<sup>17</sup>

### Control functions as 'gatekeepers'

Enhanced regulations after the recent financial crisis have raised both the detailed requirements for internal controls and the regulatory expectations of how these will operate in practice. This is an area that may benefit from more regulatory guidance. Nevertheless, it is clear that the business must ensure that they have competent, well-resourced control functions, including internal audit, risk management and compliance units. It is important that all these departments have sufficient authority within the organisation. This sends a message within the business and to other stakeholders, including the regulators, that the firm's general and specific legal duties are taken seriously. These functions also provide information to senior management and the board about what is happening in the business. They can provide a 'directed telescope'. The Prussian general staff arranged for officers to be posted among the armies with a remit to find out what was happening and to report back directly to the general staff. This 'directed telescope' saw into the smallest areas and helped control willful commanders.<sup>18</sup> Similar mechanisms can undertake a parallel role for complex and far-flung financial services firms.

### Measuring culture

It is important to measure culture in the business, since this may identify areas of risk

to the firm's duty of care. Recent analysis modelling bank cultures indicates a number of outcomes that can be measured, including the two roles played by bank's culture: 'one of which is a matching role, helping match employees with banks that share their beliefs, even when the beliefs of employees are unobservable. The second role is to possibly enhance the bank's focus on safety. A strong safety culture can temper the bank's competition-induced excessive growth focus'.<sup>19</sup> Firms' measurements of relevant indicators for their culture are highly non-standardised and can pander to self-interest. Measurement can include a range of factors such as those directly affecting customers (eg customer complaint levels and type of complaint); those relating to staff that may indicate significant issues (eg staff long- and short-term illness, staff repeatedly away sick, staff training and particularly those who miss training sessions, failure to carry out mandatory training, etc); operational failures (eg IT service outages); and procedural failings that may indicate underlying issues (eg dealing limit breaches, etc). These all require high levels of granularity, since issues may be masked by broadly satisfactory data.

It is possible that many measures used may be too simplistic, high-level and aggregated to be useful, and may be misleading.<sup>20</sup> This is particularly true of common indicators such as customer satisfaction and net promoter scores. Often, the only useful information in customer satisfaction surveys are the data extremes: customers who are extremely satisfied and those that are very disgruntled. This results from the fact that customers who respond to these surveys are normally indifferent and express no useful response; however, anger and bliss will be found at the extremes which, with sufficient detail, may be informative. These need to be followed through by an independent team and not just dismissed or regarded as a well-merited pat on the back.

Net promoter scores also have their problems. For example, a survey assessing patients who were asked if they would recommend a particular NHS hospital often gave inconsistent answers and 'some interviewees gave high scores despite describing very poor experiences to the interviewer, while others gave "passive" scores despite describing very good experiences'.<sup>21</sup> Such scores are used to test customer loyalty and propensity to repeat purchases.<sup>22</sup> Marketing departments are likely to collect this information for their own good purposes, but just because it is readily to hand does not make it suitable for determining if a company is satisfactorily carrying out its general and specific legal duties.

More useful are staff engagement surveys. Basic questions asking if staff trust their manager or those working in other sections in the business can be very insightful, but as always, the surveys need to be analysed to the smallest unit possible and the results followed through. These surveys also require high response levels of, at least, around 80 per cent. Low response levels may also indicate a range of problems including poor local management and a failure to see the importance of the survey. Poor engagement results may help to identify disaffected teams and distrusted leadership and, again, risks to customers.

### Reporting

It is important that significant issues are reported to the senior executive team and to the board very quickly. An efficient and effective escalation process is a test of a firm's culture and its ability and capacity to demonstrate active compliance. It helps to demonstrate a bond of trust between the various elements of the business including the board and towards the regulator.

The regulator needs to be confident that they will be notified of any significant issue very quickly and that the notification will be

honest and open. Any failure by the firm to be swift and fully transparent in alerting their supervisor will always make issues worse and undermine regulatory confidence. The regulator also needs to be able to trust the business to carry out a thorough 'root-cause' analysis and quickly to provide an unvarnished report on the issues and their resolution. These will be factors in deciding whether to appoint a 'skilled person review' and whether to refer the matter to enforcement.<sup>23</sup>

### **Raising concerns**

An open and effective process for employees to raise concerns is an important indicator of a firm's compliance culture. The FCA is keen to hear from 'whistleblowers'.<sup>24</sup> It makes sense to ensure that staff can safely raise the matter within the firm and be taken seriously, and be protected rather than having to contact the FCA. There is a specific requirement that a senior manager is allocated the job of 'ensuring and overseeing the integrity, independence and effectiveness of the firm's policies and procedures on whistleblowing and for ensuring staff who raise concerns are protected from detrimental treatment'.<sup>25</sup>

Firms must have effective internal systems for those who wish to raise concerns, which are supported by clear communications and training.<sup>26</sup> Staff need to be briefed so that they can raise their concerns directly with the FCA.<sup>27</sup> It is particularly important to note that, notwithstanding some of the criticism of the FCA's actions regarding the Group Chief Executive of Barclays, the regulator, 'would regard as a serious matter any evidence that a firm had acted to the detriment of a whistleblower. Such evidence could call into question the fitness and propriety of the firm or relevant members of its staff'.<sup>28</sup>

### **Remedial action**

If something is found to be wrong, for example, where customers are wrongly

charged or an error is found in the marketing material etc, the firm should also demonstrate its compliance culture by not waiting for the regulator to impose a set of remedial actions. The business should take the initiative and propose a remediation plan including the 'root-cause' analysis mentioned earlier. Depending on the significance of the issues and problems found, this work may need to be independently assessed and verified, with regular reports to both the board and the regulator.

Much of remedial work is process-based, but it also requires firms to take a customer-centric perspective. This includes explaining the process clearly to customers at the outset, asking for information without using jargon, updating customers throughout the process, and providing helplines staffed by real, well-trained and motivated people and not voice-activated responses systems. The importance of ensuring that complaints systems work well can be seen in the recent FCA enforcement action against Liberty Mutual Insurance Europe.<sup>29</sup>

### **Back-book reviews**

Even in the best run business there may be instances where past product sales have disadvantaged customers. The firm should have a rigorous risk-based programme of reviewing these sales, where economic conditions may have changed and regulatory standards and customer expectations may have developed. These reviews should be undertaken against the highest standards and customers recompensed if appropriate.

Again, these reviews should be undertaken from a customer-centric perspective. The information provided to customers subject to these reviews should not seek to gloss over any of the concerns and risks, but should be viewed as a frank conversation with the customer. Dialogues should be piloted to check the customer's understanding. There should also be a sample of calls to

customers, independently undertaken, again to check their understanding and ensure any issues are rectified, including recontacting any customers where there may have been a risk of misunderstanding.

### **'Up-stream' risks**

The business needs to watch for potential 'up-stream' risks. These are risks such as proposed primary legislation and regulations that are being considered and have not been enacted. This will allow the business to make preparations in time to meet any new obligations.

This is particularly an issue where new IT infrastructure will be required, with a considerable lead-time in undertaking the work; often of many years. Adequate preparation will avoid the need for many IT and manual work-arounds as the deadlines approach. This will help avoid increased customer risk.

### **Considering other stakeholders**

The business needs to consider other potential stakeholders. Besides customers, the firm needs to take account of the effect of its actions and failures on its staff, suppliers, the long-term interests of its investors and also its wider effect on the community.

For example, the launch of a new IT system needs to take account of the extensive need for staff training. Often firms will rely on computer-based training (CBT) for this task. This may not be adequate and more face-to-face and one-to-one training may be needed. There also needs to be scope for large-scale retraining if issues subsequently come to light. Unfamiliarity is likely to mean that many IT-based tasks take longer and this needs to be factored in as part of staffing rosters.

As always, the customer perspective is crucial. Websites that crash, system slow-downs, a lack of adequate help with over-loaded telephone lines, under-trained and over-pressured staff, and manifest errors

all undermine customer confidence and trust and threaten staff morale. Bank staff and customers, instead of being ambassadors for the bank and its brand will take to social media and the press, thus damaging the bank's reputation.

In the most serious cases the bank chairperson and chief executive will spend much time explaining and apologising, including to the Parliamentary Treasury Select Committee, the sessions of which are televised. Many will lose their jobs as a consequence.

### **Communicating the message and spreading best practice**

The control functions are all too often unobtrusive within a business. As part of the broader strategy of building trust with customers, regulators and other stakeholders, and also within the organisation itself, it is important that these functions have a high positive profile. This requires both proactivity on behalf of the 'gatekeepers' and the clear, prominent backing of others on the senior team and the board. It reinforces the authority of the control functions.

As already mentioned, trust is at the centre of a successful business and the latter must be seen as trustworthy. Regular and frequent support by the senior business team and the board for the control functions is essential to achieving this objective.

Nevertheless, fine words are not enough. The firm needs to demonstrate what it is doing. This includes highlighting, for example, its work addressing customer complaints, and proactive systems, process reviews and remediation. This sets a benchmark for other firms in the industry and promotes best practice. This will support the work of the regulators and help develop trust.

### **The risk of self-deception**

Self-deception is a major risk to complying with general and specific duties in an

active manner. It is possible that an inward-looking firm may develop its own set of 'tribal cultures', which together with elements of hubris and a narrow perspective, may result in blindness and self-deception. This often leads to the wrong actions being celebrated with 'star performers' becoming part of a 'mythology of success'.<sup>30</sup> This may desensitise the 'moral compass' of both individuals and the organisation as a whole. This may reinforce the self-deception with a view that what is right for the company is also right for customers, suppliers and so on.

This 'ethical fade' may be the result of too great a focus on the business itself without considering wider aspects. This self-deception 'allows the businessman to behave self-interestedly' while at the same time believing that they uphold their moral principles based on a process that 'routinises decisions' and employs a 'language of euphemism'.<sup>31</sup> It is common to see the task as the objective. It matters not whether the work is for good or ill objectives; the focus becomes the completion of the task itself from which the unthinking performer derives a sense of purpose: a sort of 'arbeitsfreude' (joy in the task). This process of following the herd without any self-reflection can be seen in the debasement of language. For example, Wells Fargo bank described its financial offering as 'solutions' to customer needs and not as 'products' to be sold; it also had a high pressure sales campaign marketed as 'a jump into January'.<sup>32</sup> In part, this is due to the employment of language that allows the business to 'keep thoughts at bay'.<sup>33</sup>

This can produce an over-optimistic culture. The process enables these individuals to rationalise 'wishful thinking' and to detach themselves 'from the emotions that would normally signify risks' and 'in a semi-delusional state of mind (or a corrupt state of mind) in which, rather than admit responsibility' it creates 'rational logical arguments which explain [their] actions'.<sup>34</sup> The report on the conduct failures at Wells Fargo Bank

notes a culture of senior management optimism in which problems are 'minimized'.<sup>35</sup>

The result may 'create a collective dynamic which reinforces perverse behaviour through the process of turning a blind eye'.<sup>36</sup> It produces a 'corrupted herd', as all the individuals in the group may display the same 'illusory, self-deceptive ... and exploitative' attitudes and the 'development and reward of narcissistic characteristics leads eventually to the creation of a perverse system'.<sup>37</sup> The extent of the self-deception is best summed up by the answer of one of the failed bank CEOs: 'we thought that ... we were on the side of the angels'.<sup>38</sup>

## CONCLUSION

The call for the regulators to impose a higher duty of care is evidence of a continuing mistrust of the financial services industry. The remedy largely rests in the hands of the latter to demonstrate that it is worthy of trust. This requires a number of actions, including some not addressed here, such as greater positive engagement of shareholders, greater senior executive and board diversity, and much more professionalism in the industry. We do not see yet another layer of a general legal obligation, such as the duty of care, as a silver bullet. Rather, whether or not the reform materialises, firms need to overhaul poor cultures and engage in active compliance and self-reflection. In addition, the industry needs to take the steps outlined above and to show its determination to demonstrate that it is trustworthy.

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