Culture and purpose in financial services
The success of the financial services industry in enhancing the lives of the world’s population and furthering economic and business development is often quickly forgotten in the wake of financial crises. What went wrong during these crises – excessive lending, profit maximisation at the expense of unwitting customers, fixing benchmarks for personal gain and taking advantage of small businesses – occurred when financial services moved away from providing necessary social infrastructure and lost proximity to customers and clients.

A worldwide response to these crises has helped improve behaviour and fix aspects of the system that allowed bad behaviour to flourish. In our 2012 report *Market failures, market solutions*, we called for a radical change in culture and business practices in financial services. We concluded that finance needed to be conducted in a more responsible, sustainable and cost-effective way, reflecting its fundamental economic role. We argued that the sector needed to provide services that meet society’s needs, ensure that short-term profits and incentives did not come at the expense of ethical decision making and improve transparency, demonstrating that products are appropriately sold.

In recent years, a focus on cultural change is likely to improve the standing of many organisations in the eyes of regulators and the public. For example, the focus on community by some banks has been noted by customers (see box on page 2). However, the incentives and targets that drive individual and institutional behaviour are still not always aligned with the purpose of financial services, including how it serves society and its fundamental economic role. Until this alignment occurs there will be an innate fragility to progress made and the ability of new values and practices to withstand disruptive change to the system and further shocks.

For changes to be sustainable, there needs to be greater understanding of the importance of financial services to the operation of the economy and their significance to individuals. Even at their most complex, financial services can be reduced to a small number of essential functions: forms of money and payment systems; stores of value, like bank deposits; finance (whether through banks or capital markets); investment opportunities; and risk management (like insurance). These functions empower individuals and businesses to make decisions and have greater security.

Over and above organisational culture, corporate mission statements and values, this understanding will enable those working within the sector to see the purpose of their work and give them the resilience and context to make difficult decisions, thus cementing good conduct and culture. In this publication we suggest practical ways in which financial services can approach the issues of purpose, conduct, profit and incentives.
Introduction

Since the 2008 financial crisis, an enormous amount of work has taken place in financial services firms. This has been sponsored by a variety of national and international bodies, and is applicable on a mixture of mandatory and voluntary bases. The collective aim is to fix various aspects of the financial services industry that were found to be deficient and allowed financial crises to occur. Much of this work has centred on the three areas that this report considers in more detail: conduct, incentives and profits.

Some of the changes and regulatory initiatives now in place include:
• further use of deferred pay for bankers;
• tighter prudential standards across a greater variety of metrics (eg, capital, liquidity and leverage);
• more intense stress tests with higher hurdles to be met;
• regulation of new areas such as benchmarks;
• a new personal accountability regime;
• industry codes and guidelines;
• the creation of the UK Banking Standards Board; and
• the Parliamentary Commission on Banking Standards.

These changes have led to a safer and more tightly regulated industry. Continued pressure from the authorities on these areas helps ensure that the industry does not become complacent when successes are achieved but seeks continuous improvement.

Conduct, incentives and the way we judge and understand performance are key constituents of culture. While regulation and policy changes might help facilitate cultural change, this must be driven by the institutions themselves, across the entire industry. Banks, insurance companies and investment managers are increasingly reflecting on how they do business, and how to move beyond simply meeting regulation. This includes:
• increasing focus on culture and providing information to help boards understand their organisation’s culture;
• accepting that society expects good behaviour, without there always being a rule to require it; and
• a greater focus on diversity in all its forms, as observed in many institutions (firms that pursue diversity are more likely to be open-minded, tolerant, considerate and aspiring to improve). This helps to avoid group think and improve understanding of customers and their different circumstances.

The public is keenly aware of the cultural issues facing business across many different industries. Financial services is often the first to experience these issues, as well as the resulting fall-out. Consequently, the industry provides acute examples of the need for change. Financial services firms are at various stages of progress in reforming toxic cultures and embedding good behaviour. The banking sector has taken a number of steps, including implementing a new personal accountability framework for senior staff and risk takers. Some banks have also taken steps to separate their customer lending from their ‘casino’ banking operations to ring-fence and insulate risks and culture.

The first section of this report looks at how firms focus on ensuring good conduct. We explore the importance of ensuring that the organisation’s mission reflects the right culture, informs ways of working and is embedded across all levels, as well as the need to model and support consistent behaviours that underpin the mission. We also consider the importance of dealing with misconduct effectively and consistently.

A focus on good conduct and cultural change must be supported by how businesses operate. We look in detail at two key practical issues that can reinforce or undermine success: incentives and the use of financial targets – an area where our members may have a particularly important role to play.
Firms are increasingly willing to acknowledge that people are motivated and take action for reasons other than monetary rewards. Incentives to act come in all shapes and sizes. The organisation and those who lead it must foster a culture which does not allow misplaced incentives to take root.

To avoid such poorly aligned incentives, firms must understand and be clear about where profits are generated. Focusing on return on equity (ROE) and financial targets as ends in themselves has time and again led to suboptimal behaviour and decision-making.

Such thinking has been widely accepted across the industry, if not yet achieved. However, simply adopting this new perspective and mind-set will not be sufficient to differentiate a financial services firm. They must be underpinned by purpose to build resilient businesses and a trusted financial services industry. A change in culture and attitude is needed, with a focus on long-term sustainability. Providing services that meet the economic needs of society should be placed above short-term profits and bonuses.

The essential functions of financial services – payments, storing value, provision of finance, investment opportunities and risk management like insurance – empower individuals and businesses and give them security. This gives purpose to the industry as a whole, beyond bankers’ bonuses, firms, business models and regulatory regimes. These functions remain surprisingly consistent over time, meaning that new initiatives and developments, whether new products, financial technology (fintech) disruptors or other new entrants, should be rooted in the same purpose. This will prevent new businesses from seeking to exist simply to extract value from customers or take advantage of information asymmetry.

EVIDENCE OF CHANGE – THE PERSPECTIVE ON COMMUNITY BANKS

Instead of concentrating on individual initiatives or strategies, Handelsbanken, the community-focused Swedish bank, views wellbeing as an inherent part of the organisation that permeates every area of policy and behaviour. They have a number of interesting characteristics which have been making waves in the UK. Decision-making processes are devolved to branch managers, who are best placed to decide what type of service their community needs at the local level. In keeping with the bank’s values, bonuses are a low motivator, and are only granted to workers who have been with the bank for 30 years or more. This model fosters a sustainable culture that focuses on the long term, and encourages employees and customers alike to stay with Handelsbanken for life.
**Conduct**

Organisational culture is an important driver of behaviour, and cultural values can help people and businesses do their best by encouraging conscious and mindful good behaviour.

**FOCUSING ON GOOD CONDUCT**

In creating a culture, many well-known consumer businesses do not inspire their employees to increase shareholder value, but instead encourage and support them to be passionate about their products and the way in which real customers use them to enhance their lives. From technology to high-end brands, this provides direction as well as a sense of belonging and relationship with the customer.

Unnecessary or misunderstood distance from the customer (whether in retail, wholesale or intermediated financial services) can make it harder for employees to understand how the outcome of their actions and activities affects people. Within this void, ROE and other objective metrics can be prioritised easily.

To ensure that other equally important outcomes are also considered, the business must foster a culture that promotes customer-centric thinking as a long-term strategy and everyday consideration. To ensure that staff can easily understand the business’s mission and set of cultural values, these must be clearly communicated and effectively demonstrated by role models throughout the organisation.

This provides the ‘glue’ which helps the organisation work together in pursuit of coherent objectives while abiding by common values. However, this can be challenging to achieve. While it is easy to agree with customer-centricity and understand what it looks like, the business decisions that follow may cause short-term pain, albeit in hope of making gains in the longer term.

**SHORT-TERM PAIN FOR LONG-TERM GAIN?**

Banks receive fees when customers go overdrawn. However, one bank began to text customers as they approached their limit, helping customers avoid bank fees by making alternative borrowing or scheduling arrangements. As a consequence of these customer-friendly alerts they lost £120m. On the face of it, this is not a good message for shareholders; however, seen through a long-term lens the bank is clearly taking steps to make sustainable profits by prioritising customer needs. Hence, this step enhances its competitive positioning.

**ACCEPT IMPERFECTION**

Even when a culture provides clear support and direction, human behaviour is unpredictable and imperfect. Accepting this and understanding why bad behaviour has previously occurred can help organisations address aspects of their culture that may enable misconduct or the ability to overlook the misconduct of others. Organisations can frame this understanding by adopting effective approaches to combatting financial crime. One useful model to consider in these efforts is the ‘Fraud Triangle’, which explains the three elements that in combination can lead a person to embezzle (for more information see Donald R. Cressey’s 1973 study into the psychology of embezzlement: ‘Other People’s Money’).
<table>
<thead>
<tr>
<th>WHY DO PEOPLE COMMIT FRAUD?</th>
<th>HOW DOES THIS RELATE TO FINANCIAL SERVICES?</th>
<th>WHAT NEXT?</th>
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<tr>
<td><strong>Pressure or incentive</strong></td>
<td>Bankers’ bonuses and incentives are widely acknowledged as having contributed to past misconduct on the part of individuals, as well as creating environments where bad behaviour was allowed to occur. Incentive structures have changed. Product incentives have been banned, and regulators have introduced new remuneration rules to try to change the role of incentives.</td>
<td>A good, strong culture is needed to combat this type of pressure and influence.</td>
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<td><strong>Rationalisation</strong></td>
<td>After misdeeds occur, many justifications are volunteered, including: ‘everyone else is doing it’, ‘it’s not illegal’ and ‘I’m helping to meet targets’. This thinking can allow ordinarily moral individuals to rationalise poor behaviour.</td>
<td>Meaningful consequences for employees make transgressions harder to rationalise and should be attached to misconduct. Similar problems can be observed in relation to individual attitudes to speeding. Excuses for exceeding 30mph are plentiful, despite the potential impact being literally fatal for other road users, suggesting that until consequences are personal, it can be hard to change behaviour.</td>
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<td><strong>Opportunity</strong></td>
<td>The banking sector has historically attracted intelligent problem-solvers and quick thinkers. Such individuals may create their own opportunities for misconduct by being able to spot inconsistencies in the market and act swiftly to profit or find their way around regulations.</td>
<td>To use this quick thinking and initiative ‘for good’, behaviour should be modelled from the top of the organisation and values (alongside qualifications) should be built into recruitment processes.</td>
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The UK has codified individuals’ responsibility for their actions within financial services firms through the Senior Managers, Senior Insurance Managers and Certification Regimes. These regimes aim to counteract the influence of opportunity, rationalisation and incentives on individual behaviour through clear accountability and tangible, meaningful consequences.

THE SENIOR MANAGERS REGIME

The 2008 financial crisis exposed weaknesses in bank governance, culture and behaviours. Parliament recommended a new accountability system that focused primarily on senior management and individual responsibility. Regulators can now take enforcement action against individuals who have not taken ‘reasonable steps’ to prevent problems or deal with ones that have occurred already. The regime captures the most senior individuals directly, seeks to identify those who could cause significant harm and asks both groups to observe the conduct rules.

CONSISTENCY

Consistency is vital to cement good behaviour. The importance of ‘tone at the top’ and shared values is well accepted. However, demonstrating consistency remains challenging, even though this is what creates and sustains a culture.

For example, the perception of how a chief executive officer acts, picks their team and makes decisions in difficult times can send a more powerful message than the fact that something was discussed at a board meeting or is written on the walls. Similarly, tacit messaging about how bad behaviour is dealt with will override official lines that remain undelivered in reality. It cannot be overemphasised that everyone is a role model, and trust is undermined when junior staff see inconsistencies in behaviour and messaging.

Humans instinctively consider the behaviour of others, and determine whether it matches their words. This can be most acute when people observe the behaviour of those who determine their rewards, that is, their managers. Thus, the board, executive team and all managers must model expected behaviours consistently, and incorporate the firm’s values into day-to-day decision-making. Firms seeking to change behaviour and deliver consistency often find that the biggest challenge is presented by peers and direct supervisors, who hold the greatest influence. The Financial Conduct Authority has encapsulated this problem by referring to middle management as the ‘permafrost’.

THE PERMAFROST

Middle management are caught between more customer-facing staff who are close to the people they genuinely wish to help and the outcomes they want to deliver, and the C-suite, who say (at least publicly) that the customer is king but who may respond very differently to falling sales. This leads many in middle-management roles to believe - either implicitly or explicitly - that they and their staff still need to meet targets, even at the expense of customers and values.

Of those who hold the view that the first rule of banking is ‘always make your numbers’, many have determined that the money target trumps the customer target, even if the desire to move away from this mindset has been communicated and may be demonstrated elsewhere.
EVERYONE’S CULTURE

Consistency is important across all parts of the organisation, not just where employees are directly regulated, in compliance or customer facing. Areas like human resources, information technology and operations should consider good behaviour and culture to be an ordinary part of business.

The role of human resources, from recruitment to appraisal, is particularly important. For example, it can often be assumed that it is more expedient to recruit staff who have previously worked at another bank, or who understand financial product complexity and the regulatory environment. However, individuals with significant financial services experience may find it challenging to adapt behaviours learned in previous roles to more customer-focused outcomes. In fact some have realised that it is easier to recruit people from outside financial services and train them, than it is to get financial services staff to care about the customer.

To deal with this, human resources need to ensure that conduct and treatment of customers form a significant part of objectives, performance ratings, training and remuneration. Conduct and a balanced scorecard of goals should feature highly in everyone’s objectives and promotion considerations. Ignoring such steps creates an environment in which staff are less likely to care about non-financial risks and issues.

BONUS SEQUENCES

A certain firm used to hold their annual appraisal shortly after bonus payments were made. However, this led staff to focus less on the issues and behaviours commented on during the appraisal. Carrying out the appraisal process prior to bonus payments improved staff engagement.

The board needs to clearly articulate what culture they want to have, and compare that with the existing culture. There are a number of ways to assess culture (see icaew.com/auditculture). They can then see if the right values are embedded, assess whether the culture that exists is the one that they want and proclaim to have and consider whether their culture meets society’s expectations. The board then needs to clearly articulate what culture they want to have, and compare that with the existing culture.
Where change is required the following practical suggestions may help boards consider what could be helpful at their firms.

### MEASURING CULTURE - PRACTICAL SUGGESTIONS

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<tr>
<th><strong>Metrics</strong></th>
<th>Take a broad view of what may turn out to be a useful metric. This could include factors like:</th>
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<td>• staff turnover,</td>
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<td>• absences,</td>
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<td>• net promoter scores,</td>
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<td>• risk breaches,</td>
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<td>• social network analysis,</td>
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<td>• themes from whistleblowing (ie, bullying), or</td>
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<td>• customer metrics like complaints, cancellations and overrides.</td>
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<th><strong>Qualitative data</strong></th>
<th>This could include:</th>
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<td>• 360° staff feedback,</td>
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<td>• leaver exit interview information, or</td>
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<td>• verbal customer feedback (what do they say and feel).</td>
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| **Case studies** | This is the approach taken by the Financial Conduct Authority and Prudential Regulation Authority, making it merit-worthy by implication given their wide-ranging access to individuals and information. A case study could be a large transaction or a key process (eg, managing director appointments). |

| **External review** | This will allow a more objective perspective and expert analysis. It can be flexible and scaled to the needs of the firm at a particular time. It may also be more expensive. |

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<th><strong>External data</strong></th>
<th>This can be particularly rich and informative, and can be gained through:</th>
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<td>• surveys,</td>
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<td>• social media,</td>
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<td>• focus groups,</td>
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<td>• customer protection groups, and</td>
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<td>• independent organisations (eg, the Banking Standards Board, Glassdoor).</td>
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Consider the views of external auditors, customers, contractors and suppliers.

| **Internal audit** | Internal audit staff are well placed to consider thematic issues relating to culture that arise during other business reviews. The Chartered Institute of Internal Auditors considers this in their financial services code, and the Financial Reporting Council has additional resources on assessing culture. |
### MEASURING CULTURE - PRACTICAL SUGGESTIONS

<table>
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<tr>
<th>Method</th>
<th>Description</th>
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<tr>
<td>Whistleblowing</td>
<td>Look for locations, parties or issues that recur.</td>
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<td>Surveys</td>
<td>Surveys can be useful but should be used sparingly as they can be inaccurate (watch for survey fatigue) and/or gamed. In the UK, benchmark data from the Banking Standard Board can be helpful for member banks.</td>
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<td>Skip level meetings</td>
<td>This where, for example, staff at Level 3 meet staff at Level 1 without the line managers from Level 2. This means that staff at Level 2 are ‘skipped’. These meetings may provide new and relevant insights and empower individuals to speak up when they may otherwise be less willing to do so.</td>
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Incentives

A variety of financial and non-financial incentives influence the actions we take in our working lives on a daily basis. For those working in financial services, the financial rewards are often high, and can come with the need to take risks on behalf of the organisation. The nature of the activities undertaken and long lifespan of products sold can mean that problems with inappropriate risk-taking or bad behaviour are not always immediately visible.

To keep individuals from focusing on the here and now at the expense of the future, pay for bankers is deferred. This encourages them to take a longer term view of risk and allows scandals to emerge before large payouts are awarded. For example, the LIBOR-fixing scandal took six years to come to light.

Regulators have also introduced measures allowing them to reduce unvested bonuses, claw back vested bonuses and curtail the ability of individuals to lose a bad conduct record when they move between firms. However, the effectiveness of these rules on curtailing bad behaviour and promoting the right behaviour is subject to debate.

### DO REGULATIONS INCENTIVISE GOOD BEHAVIOUR?

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<tr>
<th>Yes</th>
<th>No</th>
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<tr>
<td>The Senior Managers Regime has focused on allocating responsibilities and individual accountability. It has helped people address important questions, helped clean up clunky governance structures, brought greater simplicity and led to the development of better delegation and monitoring. It shifts the focus from organisations to individuals. This emphasis is arguably why certain professions usually have a better conduct track record, as there is a personal relationship between the individual and the member body.</td>
<td>New rules can actually be counter-productive. The more rules there are, the more people stop using their own judgement. Individuals can effectively turn off the ‘ethical chip’ in their brains, a phenomenon referred to as ‘ethical drift’.</td>
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Those outside of financial services often believe that the financial incentives offered are the main drivers of behaviour and decision-making. Despite very high performance-related pay for many in the industry, the following soft factors have been found to be equally if not more important influences on behaviour at work:

- peer recognition,
- senior recognition,
- promotion, and
- doing ‘what makes life easy’ in that particular organisation.

Financial services staff are not the only ones who face what are ultimately ethical dilemmas in their daily jobs. Examples from the health care industry illustrate how the technical framework in which people operate, combined with a high-pressure environment, can influence the way they behave. These tacit incentives to take a certain course of action, such as a pressured environment or rigid operating framework, can also create disincentives to speak up about misconduct and unethical behaviours, even when individuals know it is the right thing to do.
ETHICAL DRIFT: WHAT CAN WE LEARN FROM HEALTH CARE?

Nurses often face dilemmas similar to those faced by financial services staff, albeit in a very different environment. New technology is changing the way people work day to day, and the pace and extent of this change make it difficult to anticipate the ethical implications of utilising new technology.

Furthermore, different hospitals use different technology in different ways. For example, the way that machines are used to monitor different signs can prompt different courses of action, including when medications should be administered or other treatments commenced. Changing the parameters or signs from the machine influences outcomes. This may mean that when individuals move between hospitals and machines are used differently it is harder to identify potential ethical concerns, as people may defer to technology instead of using their own judgement.

If the technology being used is otherwise meeting goals, people may be reluctant to voice the dilemmas presented by technology. This can lead to situations in which professional and ethical values conflict with management and administrative goals, and subsequently lead to moral drift and distress.

Moral drift: if an option is the lesser of two evils, that makes it right.

Moral distress: even if an individual knows the right thing to do, institutional constraints make it nearly impossible to pursue the right course.

To balance the role of financial and other cultural incentives to foster desired behavioural outcomes, firms should:

• reward good behaviour, not simply financial performance;
• deal with staff who do not behave well, even if they meet financial targets; and
• be clear and consistent in doing so.

This will help align incentives and deterrents with good customer outcomes. Otherwise the system can be gamed and further misconduct is likely to occur. It is also important to deter bad behaviour in real and relatable ways. Making an example of bad behaviour (referred to anecdotally as ‘a public hanging’) can effectively deter similar behaviour in the future. For example, removing individuals on the same day and making it known that, although they met their targets and delivered their business objectives, they are being removed for bad behaviour that did not meet the firm’s standards sends a clear message.

Financial services firms looking to embed ethical behaviour must also be cognisant of technology’s increasing role in developing products and services and meeting customer needs. As technology changes and humans increasingly work alongside robots and artificial intelligence, opportunities for taking advantage of the system, or misplaced incentives, may decrease. At the same time the machines themselves may display suboptimal behaviour.
REGULATING ROBOTS

Artificial intelligence, fintech and machine learning are playing an ever-increasing role in financial services. While technology can provide control and risk solutions, human advisors and robo-advisors working side by side is new territory. For example, the current framework of risk management and regulation was not designed for a learning algorithm. If an algorithm learns and optimises its advice to each customer, who is responsible if subsequent issues emerge?

To adapt to the changing world, firms and regulators should:

• understand how a range of customers might interact with technology and develop a full picture of a customer’s online journey;

• investigate how to use technology to deploy better controls and the new risks presented by changing operating models using technology; and

• consider how to build compliance and risk systems around an algorithm that is designed to learn and adapt.
Despite clear financial incentives for ethical behaviour at the corporate level in financial services firms (i.e., the deterrent effect of very large fines), there is evidence that banks remain strongly focused on short-term ROE metrics. Meeting these targets can often be at odds with good customer outcomes and distract from the way products and services work for customers.

Even when executives are aware that a particular way of doing business may leave the organisation more open to misconduct issues, they can still find it challenging to change things and ensure that people are acting in accordance with the organisation’s mission when there are economic consequences. For example, the buy-to-let mortgage market could be a potential area of focus due to the dominance of brokered sales. Given the role in past scandals played by incentives paid to brokers, this could be a riskier area in which it would make sense to curtail activity. However, it is likely that this would significantly impact sales and therefore profits.

Higher ROE targets encourage lower costs, which could manifest in lower investment in controls and training. Prioritising these financial targets may mean that staff feel they must pursue sales and profits at all costs. This creates an environment which is perceived as having led to a systemic cultural crisis rather than issues being solely traceable to a few rogue individuals.

It would be wrong to think that financial services is alone in this problem. Pursuit of shareholder value above all else has created difficulties and negative consequences at many household names including BHS, United Airlines, Volkswagen and Toshiba, among others.

Chartered accountants can play a critical role in resetting the balance between profit and customer outcomes by pursuing appropriate ROE alongside good customer outcomes. This does not mean there will be a one-size-fits-all ‘good’ level of ROE, and it will not necessarily mean that companies have to reduce their targets. It does mean that targets should be set more consciously with conduct considerations in mind, not as an afterthought. To ensure that individuals, teams and departments are suitably aligned within the organisation there must be a coherent framework for setting ROE targets which also properly aligns risk and reward.

There are actions that can be undertaken by finance professionals and board members to facilitate this:

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<tr>
<th>CHARTERED ACCOUNTANTS AND OTHER FINANCE PROFESSIONALS</th>
<th>BOARD MEMBERS AND CHIEF FINANCIAL OFFICERS</th>
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<td>Identify highly profitable products (such as payment protection insurance [PPI]), where high profits may presage future conduct issues.</td>
<td>Be realistic about the impact of ROE targets and how they affect staff behaviour.</td>
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<tr>
<td>Help to provide a sense check on profits as part of new product governance and evaluation.</td>
<td>Ensure a suitably robust control framework.</td>
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<td>Lead the debate on whether the economics of a product are being shared fairly between the customer and the firm to ensure sustainable profits.</td>
<td>Communicate the rationale for targets and customer outcomes clearly to shareholders.</td>
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**PRODUCT PROFITS**

While a top-down approach is clearly essential in terms of setting and managing ROE targets and expectations, a bottom-up approach is also needed. This is where finance has a more proactive role to play in bringing more transparency, information and analysis to the process.
It can be challenging for financial services firms to understand how and where they make money at a product and customer level, due in part to the volume of data, age of products and way in which data are collected and presented. A greater depth of understanding with regard to product income, costs and profitability will help deliver better conduct outcomes. Financial teams must be more involved in sourcing and interpreting these data, and should use their expertise and insight to challenge the figures robustly, and bring potential issues to light.

Issues may currently exist in many areas – including ‘free’ banking, back-book savings products, standard variable rate mortgages, 0% credit card balance transfers and caravan insurance – all present profits of which may not appear to fit with the purpose or desired customer outcomes of the product. Financial services regulators may wish to consider these areas in due course.

In addition, product profitability needs to be discussed in more detail, including the evaluation of customer outcomes and the sales processes used. To avoid additional future issues, firms should make product profitability part of their new product assessment and evaluation processes.

### UNDERSTANDING PROFITABILITY AT THE PRODUCT LEVEL

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<thead>
<tr>
<th>Look at the profitability of each product as part of its product governance sign-off, and evaluate it again after product implementation. This could help identify future problem products and products that risk being mis-sold (such as interest rate swaps to SMEs).</th>
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<tr>
<td>Customers often mistakenly assume that all products have the same profit profile for the firm on the other side of the transaction. This is not always true and could be more clearly communicated to customers.</td>
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<td>Develop customer value metrics to understand the benefit of the product or service. Consider and analyse profitability from a customer perspective in a range of circumstances. To help identify high-risk products, assess whether the customer derives a fair value from the product.</td>
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<td>Consider the customers’ perspective and outcomes in a range of circumstances taking into account potential stresses. For example, a mortgage key-features document should show the cost of the mortgage under different rates. As part of the product approval process it would be useful to look at customer fair value in a range of scenarios.</td>
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<td>Regulators should look at product pricing as it is a key determinant of the customer outcome.</td>
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### UNDERSTANDING PROFITABILITY AT THE FIRM LEVEL

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<th>Undertake a strategic review and evaluate the impact of ROE on the control environment and business model. Identify what might change if ROE was set at various different levels.</th>
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<tr>
<td>Acknowledge that the business model for banks is changing. Regulations (capital and liquidity rules) and the threat from fintech or other disruptors are changing how and where banks make money. The ROE for banking as a mature industry needs to be set at a sustainable level and one that considers conduct risks.</td>
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**Purpose**

**THE ABILITY TO ENHANCE LIVES**

The financial services industry has enhanced the lives of much of the world’s population. Prior to the financial crisis it enabled the internationalisation of the flow of money and the allocation of capital, bringing growth to developing economies. It created deep specialisations and expert centres which have helped further economic and business development as well as increasing individual wealth. Banks, insurance companies and investment managers allow people to get things done by creating money and enabling payments, storing value, providing finance and investment opportunities and allowing us to help manage the risks to which we are exposed. These functions empower businesses and individuals, and provide them with security.

**THE NEED FOR CHANGE**

The 2008 financial crisis marked the end of an era in growth and innovation. Banks, insurance companies and investment managers lost the ability to connect with people. Within this void, crises and conduct issues took root, the consequences of which have presented on a massive scale. This included excessive lending, profit maximisation at the expense of unwitting customers, fixing benchmarks for personal gain and taking advantage of small businesses. A lack of understanding of their proximity to the customer and the essential role of financial services allowed misconduct to flourish.

As outlined in this report, an immense amount of progress has been made since then, both in regulation and within financial services organisations themselves. Regulation has helped to correct where things have previously gone wrong or been deficient, creating stronger capital bases and an ability to withstand shocks. Bad behaviour has been made public and dealt with. The industry has accepted that things must change and is working to meet regulatory and societal expectations in terms of behaviour, incentives and culture. Although progress is being made, financial services continues to change rapidly. Amid dynamic change and innovation it may help to preserve good behaviours and values if there is something beyond the individual and beyond the organisation which gives bearing to activities and actions, outside of working within regulations and the firm’s existing culture. While culture comes from the inside, purpose imparts an outside perspective and provides a link to the customer and the real outcomes of one’s actions.

**THE NEED FOR PURPOSE**

Much of the current dynamism in the industry is being led by fintech, which presents incumbents with both a challenge and an opportunity. While customer-centricity often features at the core of these new ideas and propositions, developments must be evaluated against their purpose. Access to new platforms, exotic products and unusual investments may represent the democratisation of financial services, but the question remains whether these are truly meeting the customers’ needs, or are simply a distraction which will not be viewed favourably in the future.

With this grounding should come the ability to translate all activities to the customer in a way that can be easily understood and conveys clear benefits. Purpose can provide an anchor to any new activities and products during change and innovation, thus preventing them from straying into dangerous territory. For example, collateralised debt obligations, bitcoin futures and contracts for difference all lack a straightforwardness to the end user or consumer, making it difficult to understand whether or not they are meeting a need.

Purpose differs from culture in that it extends beyond a single company or industry sector and can inspire change outside the core business. Financial institutions are also considering the environmental and societal consequences of their actions; for example, many are no longer funding Arctic drilling and are instead investing in sustainable finance. This shows a commitment to look beyond simple profit and loss to wider outcomes. Once this is understood, banks can also use their purpose to influence external
behaviour and drive change – for example in response to mass shootings, some US banks have curtailed the ability of customers to use their accounts and credit cards to buy guns. This is an acknowledgement that banks have the ability to drive responsible social behaviour as an outcome of how they do business, even when it may negatively impact their bottom line.

CONSISTENCY AND UTILITY

Remaining connected to purpose provides the necessary grounding and direction to work in an ethical way, regardless of timing, circumstance or other pressures. It can also help us judge the value of products and services in simple terms. For example, selling an insurance policy to a customer who will never be able to make a claim against it is stealing their money. If such a sale had to meet a test of true social utility, it would never occur. A good culture will reinforce individuals’ ability to act with purpose and create accountability for doing so.

There are disincentives to making changes proactively, as the ‘pain’ or cost is felt now, and the benefits may be less tangible or not felt until later (eg, overdraft fee alerts [see page 3]). Belief in purpose can help individuals and businesses to choose the right but difficult option, whether structuring a product that appears to be less profitable or resisting the urge to move a number or manipulate data causing customer and stakeholder harm.

UNDERSTANDING THE NECESSITY OF FINANCIAL SERVICES

A clear understanding of purpose gives individuals the context and resilience to make difficult decisions, and is necessary to cement good culture and conduct. Purpose serves simultaneously as a lowest and highest common denominator for business. It can be easily understood by all employees and customers, and used to explain activities and products. Purpose also provides a framework to ensure that new initiatives, developments and practices have coherence. This provides a more holistic perspective when considering the need for change, as well as the ultimate success or failure of that change.

Due to the essential nature of the industry, customers cannot simply walk away from financial services. When information and risk asymmetries exist and goals are not shared, the system allows these companies to easily take advantage of their customers. This becomes highly visible when the industry is reduced to firms seeking to differentiate themselves on the basis of integrity, implying that the wider culture is so problematic that simply not ripping off or confusing customers makes you a preferred choice for doing business. Without purpose, institutions will be unable to prepare for the future in a coherent and sustainable way, and may lack the necessary clarity about what drives innovation and profit to ensure that it is not simply at the customer’s expense or exploiting a position of advantage.
WORKING WITH SOCIAL PURPOSE – PRACTICAL APPLICATION

To reconnect with customers and achieve a recognisable social purpose, financial services must consider measures and outcomes that support these objectives. ROE continues to rule banks and is often at odds with best customer outcomes (which can be taken as a proxy for social purpose).

Such proxies include the following:

• Best customer outcomes mean that with all products and services customers take their fair and appropriate share of risk and reward.
• Good customer outcomes often simply mean the absence of a formal complaint, which is not sufficient.
• Product design is led by customer need, desired outcomes, fair pricing and what is sensibly attainable.
• Sustainable products and services should be targeted, and loss leaders and products where form and substance do not match up – such as 0% credit cards, caravan insurance and vehicle finance – should be avoided.
• Efficient and necessary risks are taken as a matter of course.
• Only necessary value extraction should occur during intermediation, and costs of intermediation should be directly related to value added for the customer.
• Ask what customers need, and what it costs. This will help companies design the right products for the right customers.

PURPOSE AND OUTCOMES

Building societies have their purpose codified in statute: ‘...its purpose or principal purpose is that of making loans which are secured on residential property and are funded substantially by its members...’ (Building Societies Act 1997)

Nonetheless, the 2008 financial crisis saw some societies fall victim to issues similar to those that befell banks. For example, some building societies mis-sold PPI. We see that building societies face many of the same commercial pressures as banks. They too will seek to generate profits and grow their capital to ensure their long-term survival, and they may benchmark their behaviour against what their competitors are doing. Purpose is an important and necessary condition for making a firm successful, but it alone is not sufficient. Outcomes must also be considered.
COPING WITH INCREASING COMPLEXITY

Many businesses have onerous and complex legacy IT environments with fragmented and non-standardised systems. These present challenges and make good cyber security much harder. What can businesses do to cope with this complexity and be safe?

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