ACCA

Culture vs regulation: what is needed to improve ethics in finance?

About ACCA

ACCA (the Association of Chartered Certified Accountants) is the global body for professional accountants. We aim to offer business-relevant, first-choice qualifications to people of application, ability and ambition around the world who seek a rewarding career in accountancy, finance and management.

Founded in 1904, ACCA has consistently held unique core values: opportunity, diversity, innovation, integrity and accountability. We believe that accountants bring value to economies in all stages of development. We aim to develop capacity in the profession and encourage the adoption of consistent global standards. Our values are aligned to the needs of employers in all sectors and we ensure that, through our qualifications, we prepare accountants for business. We work to open up the profession to people of all backgrounds and remove artificial barriers to entry, ensuring that our qualifications and their delivery meet the diverse needs of trainee professionals and their employers.

We support our 162,000 members and 428,000 students in 173 countries, helping them to develop successful careers in accounting and business, with the skills needed by employers. We work through a network of over 91 offices and centres and more than 8,500 Approved Employers worldwide, who provide high standards of employee learning and development.

This paper examines the respective roles of the regulator and of culture in increasing ethical behaviour in finance, and the need to address dysfunctional finance market and behaviour since the financial crisis.

It summarises discussions that took place at an ACCA roundtable in London in October 2014, which brought together regulators, economists, academics and representatives from think tanks, banks and accountancy firms.

THE STATE OF PLAY

As the consequences of the financial crisis continue to reverberate, there has been a pronounced trend among government and regulators to design policy that will prevent certain behaviours in financial institutions. Nonetheless, regulation and policy cannot be the sole solution; there is growing recognition of the need for a culture change: a need for ethics to have an increasing role in finance.

Numerous interventions have been launched aimed at the banks, most notably the Lambert Review, which recommended setting up the Banking Standards Review Council. The Council has been tasked with raising standards, and improving behaviour and competence in the UK banking sector. Criticism has been levelled at the funding model; the banks will fund the Council, which has raised concerns about its independence. Though the Council was not directly discussed at the roundtable event, participants pointed out that because of the global nature of banking, the Councils success may be limited because its remit covers only UK operations.

To establish greater ethics in finance it must be recognised that this is critical to those employed in finance functions and it must be understood that growth in economies must be sustainable and long term. Now that the International Monetary Fund has stated that Britain's economy is recovering faster than that of any other developed country, unemployment is at its lowest level since 2008 and with small businesses set to create nearly two million jobs by the end of the year, has the issue of ethics been forgotten as growth returns? What has been learnt from the crash?

WHY DO ETHICS IN FINANCE MATTER?

The financial crisis demonstrated the interconnectivity of global economies; globalisation has brought with it the interdependence of many countries' financial institutions. Financial transactions rely on trust and ethics create trust: without trust the system collapses.

The crisis has shattered the public's trust in the banking system and as the examination of financial institutions continues the relationship between bankers and public continues to deteriorate as ever more scandals are announced. Those at the London roundtable agreed that rebuilding the relationship will take time, and ethics must be at the core. Regulation can have only limited impact but by embedding an ethical culture, behaviours and ultimately the way business is done can change.

THE ROLE OF THE REGULATOR

Regulation can have only limited success when working in isolation. Technological developments and complex products can be created rapidly, which means that the regulator will always be playing 'catch up'. There are often significant time lags between introducing a financial product and being able to assess its outcomes and performance. In such cases there is a need for an ethical underpinning of these products. There has to be a stronger focus on the customer. As one participant noted, 'you're more likely to change your partner than your bank' so banks need to work on behalf of the customer.

The crash has raised questions about how businesses should operate; where ethics and corporate social responsibility were once seen as distinct from a company's aim of profit maximisation, they are now viewed as a requirement for a proper decision-making process.

Regulation failed to prevent the 2008 crisis; risk was constantly discounted. In some instances it was considered non-existent, most notably in Jamie Dimon's statement to the US Financial Crisis Inquiry Commission: 'the biggest mistake we made [at JP Morgan], somehow, in mortgage underwriting we just missed that home prices don't go up forever'. Participants in under-regulated markets acted in self-interest. The recent £1.1 billion fine that the Financial Conduct Authority levied on UK banks for the LIBOR scandal is testament to this and illustrates regulatory failure in preventing problems. The need for whistle-blowers and the manner in which some have been treated further indicate endemic cultural problems and failures of corporate governance. These events have also demonstrated that the role so far played by the regulator might be insufficient. Participants agreed that although regulation has been part of the problem it will nonetheless be an integral part of the solution.

All participants agreed that renewing trust in the system is vital. There was an acceptance that there is a need to address asymmetry of understanding, not just asymmetry of information, because of the nature of financial products. These are often based on long-term agreements and so the repercussions of poorly designed and mis-sold products have widespread impact but are often not recognised for many years. There was agreement that financial education, which came into the UK school curriculum this year, could help with this. Yet participants noted that because consumers have a 'rare touch' relationship with their bank and evidence shows that they are apathetic towards banks, the regulator needs to have a stronger role in protecting consumers and ensuring that the end product works in their favour.

CREATING GREATER DEMAND FOR ETHICAL FINANCIAL PRODUCTS

There was a suggestion that regulators need to create greater levels of demand for ethical finance products; because financial products can appear homogeneous and consumers are apathetic, competition does not necessarily encourage best practice. Participants were keen to highlight that in the retail sector if a consumer does not like a product or company they switch; in the finance sector this has not been the case. Involvement in this area is a distinct move away from the former role of the regulator and indeed efforts have been made through the introduction of a 'current account switch service', making it easier for consumers to move their current account. All participants believed that more could be done, however, if a regulator were to encourage and create demand for ethical products through nudge policies and regulation so that consumers could begin to see a real difference in the way that products are designed and sold.

Conversation about stimulating demand led to a look at the cultural behaviours of reward and risk; it was argued that regulators and policymakers should look at how to reward long-term decision making, encourage greater transparency and promote sustainable growth over short-term profit. Practical steps such as integrated reporting offer one tool, as this could encourage investors to look at the total health of a company by reporting on financial, manufactured, human, intellectual, natural and social capital to the extent that each contributes materially to the organisation's ability to create and sustain value. This type of report can also help mitigate risk, as it incorporates the external factors on which the organisation's performance relies.

The effects of new finance models were also considered; participants talked about whether crowdfunding could help increase transparency. There were mixed views as to whether new models would increase transparency and whether in principle thismatters if there is still no symmetry of understanding. The prominent view was that crowdfunding and other new entrants to the financing market would drive innovation and change but, as with the banks, dissemination of information, transparency and even ethics may well be ignored while consumer apathy and asymmetry of understanding remain.

A CHANGING ROLE FOR THE REGULATOR

Underpinning the discussion was the issue of pre-crisis regulation being inadquate, which has frequently been raised in the aftermath, resultingly participants argued that there is now a greater appetite for the role of the regulator to evolve. Some in attendance argued that before the crash regulation was perceived only as a punitive measure that would prevent bad behaviour, but clearly this did not work. It was suggested that competition had not been allowed to flourish because there was no symmetry of understanding between consumers and financial services providers so that the former were not able to 'choose with their feet'. As a result, participants opined that the regulators' role should be developed to protect consumers, and even to assist in creating innovative new products that would benefit them.

Earlier intervention by regulators implies that they will need to look at why decisions are being made, and to assess culture, behaviour and what is rewarded. The medical profession was discussed as an example as it was believed that doctors (in the UK) do not have the same conflict of interests as there is no profit motive. Participants considered litigation and duty of care; considering the nature of financial products, some wondered whether there should there be a level of professionalism introduced to ensure that those selling the services are acting in the interests of the consumer. For instance, accountants must complete an ethics paper as part of their qualification. There was complete agreement with a suggestion that a cultural change might be helped if those in financial industries were encouraged to consider the consumer first.

CASE STUDY: PROJECT INNOVATE

In the UK the changing role of the regulator has been clearly reflected in the work and approach of the Financial Conduct Authority, most notably through 'Project Innovate', which offers direct support to innovators and considers how we adapt the regulatory regime to foster innovation. The scheme fosters open relations between those looking for informal guidance or those seeking authorisation or a variation of permission. The hub works with firms to test innovative tools and will identify policies and processes that need to change to support innovation.

It is also intended to add more flexibility to the regulatory framework and remove barriers to entry through open dialogue, to encourage and support innovation where it will not erode consumer protection or the integrity of the financial system.

The hub is future focused, anticipating trends and reacting accordingly. The model of openness with the regulator demonstrates a move forward in which the regulator and the finance industry work together to foster innovation, arguably a more ethical approach to finance.

THE NEED FOR A CULTURAL CHANGE

The importance of culture, both good and bad, was overlooked in the years preceding the crisis. Across all institutions whether financial or non-financial, there is now a greater understanding of how the prevailing culture of an organisation shapes behaviours, judgements and, indeed, ethics. As the Saltz Review concluded, without proper control culture shapes itself, with the inherent risk that the behaviours that are manifested will not be those desired. Evidently in the run up to the 2008 financial crisis there was an inherent 'bad' culture within the banks and this encouraged pursuit of excessive profits and high-risk behaviour. Excessive profit was valued more than the interests of the consumer purchasing the product.

The participants recognised the limits of regulation and the need for an ethical response to be part of compliance with regulations. One suggested that when the culture of an organisation is at odds with the type of behaviour the regulator or government is trying to encourage it will fail because organisational culture can be so dominant in setting tone and therefore outcomes. It was agreed that the very fact that a conversation was taking place shows that change is occurring but there was a clear recognition that it would take time. All agreed that cultural change will be the hardest part, particularly in organisations that span continents, come under the jurisdiction of a number of regulators and include hundreds of people. It was argued that an ethical culture is not achieved merely through transparency but also by openness, until a stage is reached when whistle-blowers are not needed because people at any level are able to raise issues without believing that they are going to jeopardise their careers for questioning what is going on. It was suggested that once such an open culture is achieved, advances can be made, but many pointed to the evidence that it is very, very slow to embed such a culture at the heart of an organisation. The middle management problem, so often called 'the muddle in the middle', was raised – that is, the challenge that when trying to change the culture it is not enough to convince those at the top: it must be embedded throughout. This brought the conversation back to why ethical behaviour must be central; the banker is in the room and is the one who has to make decisions about what their interaction with the customer will mean for their future and at that point only they are able to make decisions in the interests of the customer. That question is ethical, not regulatory. It was therefore argued that regulation can ultimately only be a backstop. It can make rules for behaviour up to a point but the regulator is not in the room with the customer, the banker is and hence, it was argued, must have ethical underpinnings.

THE NEXT GENERATION

The conversation took on an interesting dimension when considering the next generation. A recent international study, *Gen Y and Gen Z Workplace Expectations*, looked at the global change in workplace preferences between Generation Y (those aged 21–32) and Generation Z (16–20) and found that even between these fairly similar age groups there are different expectations and drivers.

28% of Generation Z said money would motivate them to work harder and stay with their employer longer as opposed to 42% of Generation Y.

Generation Z has more of an entrepreneurial spirit than their older counterparts, with 17% of Generation Z wanting to start a business and hire others compared to 11% of Generation Y.

Similarly Deloitte's annual Generation Y survey found that 75% of the workforce want to work for organisations that foster innovative thinking, develop their skills and a make a positive contribution to society, and see themselves doing this by 2025. At the roundtable several participants commented that the banks are struggling to recruit the best talent; this may signify a market-driven change, with companies being compelled to act more ethically to ensure they are able to recruit the best and brightest.

This change is also reflected in the rise of alternative finance models and how people choose to invest. In a recent report, *Understanding Alternative Finance: The UK Alternative Finance Industry Report 2014*, the growth in community shares supports the above argument. The report highlights that 24% of investors said that the prospect of a financial return was important or very important to them and 32% of investors have offered to volunteer directly with the project they supported.

The report notes that the alternative finance market in the UK is growing rapidly, having more than doubled in size, year on year, from £267m in 2012 to £666m in 2013 to £1.74 billionn in 2014. Proportionately, the sector remains small but it is already changing the dynamics of the finance industry, fostering innovation. As mentioned above, embedding ethics in the culture of SMEs will become integral as this sector evolves.

WHERE NEXT

Participants noted that the issue of ethics in finance has become more dominant within both banks and large firms but they supported the need for all businesses to embed ethics in their decision making as every business operates within an 'ecosystem'. Several participants noted that ethical situations need to be tested out, placing people in scenarios so that they truly consider the opportunity cost of acting unethically, noting that embedding ethics cannot be achieved merely by passing a test but must involve understanding what it means to act and behave ethically.

There was an understanding that in a post-crash world, the financial sector regulators should have a greater duty to the consumer because of the lack of understanding and the mistrust that has created apathy, but should also recognise that, by working together with the financial services sector, regulators can help foster innovation. The banks must sit alongside the regulator and change their culture from within, both encouraging and rewarding ethical behaviour. The rise of technology and alternative finance will create new challenges but also has the potential to bring positive results.

ACCA AND THE ROBIN COSGROVE PRIZE

Robin Jarvis, Special Adviser to ACCA, has been a member of the Prize Jury since 2012. ACCA has partnered with the prize as part of its global commitment to increasing ethics in finance. ACCA was the first accountancy body to introduce an ethics paper; since its founding in 1904 ACCA has strived to promote integrity, opportunity, diversity, innovation, and accountability. ACCA believes that good business relies on good ethics.

Over the past few years ACCA has been conducting research into corporate governance, organisational culture, and behaviour in the boardroom. ACCA supports this global prize as part of its aim to ensure that the conversation around ethics in finance is not limited to anyone region or group of stakeholders. ACCA also believes that embedding ethical behaviour at every level improves corporate governance and encourages a positive culture within finance.

ACCA will be hosting a further event in Brussels on 28 January 2015 in support of the Robin Cosgrove Essay Prize for Ethics in Finance.

For further information about the event or ACCA's involvement with the Prize please contact **rosalind.goates@accaglobal.com**

ABOUT THE ROBIN COSGROVE PRIZE

The Robin Cosgrove Prize is awarded in an essay competition designed to promote ideas on trust and ethical behaviour in all aspects within the finance sector. The Prize is biennial and is awarded to the best Innovative Ideas for Ethics in Finance.

The award honors the vision of Robin Cosgrove, a bright investment banker, who died at the age of 31. He believed passionately that the lack of integrity and ethical practice in banking and finance could be a major barrier to sustainable economic development. The prize is managed by the Observatoire de la Finance, a Swiss not-for-profit foundation in Geneva, and Dr Carol Cosgrove-Sacks, Robin's mother, in partnership with ACCA.

THE ETHICS IN FINANCE ROBIN COSGROVE PRIZE 2014–15

The theme for the 2014–15 Prize is 'Innovative Ideas for Ethics in Finance'. The competition is open from 1 October 2014 to 15 April 2015. The Jury will decide on the allocation of $20,000 between the authors of the best papers. Applicants are asked to submit a paper, consisting of a maximum of 5,000 words (including notes and annexes, but excluding bibliography), which meets the following criteria:

- intellectual rigour
- innovative ideas
- clear conclusions.

The award is available internationally, and entries may be written in English or French. For more information about the prize or how to submit proposals, visit **http://www.robincosgroveprize.org**

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