U.K. Is Blueprint for How Bank 'Culture' Backlash Will Play Out

By Todd H. Baker

Testifying before Congress last week, Wells Fargo chief executive John Stumpf tried to claim that the bank's culture was not to blame for what happened in its retail branches. Bad people violated a good culture, he said.

Not surprisingly, lawmakers at the hearing and regulators who testified didn't agree with him. "[T]here's something wrong with the culture and there's something wrong with the bank," said Senate Banking Committee Chairman Richard Shelby. Indeed, several articles have pointed to the bank's scandal reflecting a problem corporate culture.

But as much as the Wells scandal shined a light on culture at large U.S. banks, the issue has had an even more intense focus across the Atlantic. Retail banks in the United Kingdom have been battling their own "culture problems" for years and – thanks to the aggressive interest of regulators – likely will be working on them for the rest of the decade at enormous costs.

At the same time, banks' work to improve culture has sparked fundamental and positive changes in the way that U.K. front-line bank employees interact with customers and may have ensured the future of the U.K. retail banking system.

Between 2000 and late 2014, British retail banks such as RBS, Lloyds, Barclays, Santander UK and HSBC paid out 38.5 billion pounds – or one pound for every four of pre-tax profits – in consumer fines, customer repayments and other costs associated with abusive front-line sales practices. By the end of 2015, the total cost to the banks had risen to 53 billion pounds, or nearly $75 billion. As New City Agenda, a prominent voice for financial reform, put it: "The profitability of UK retail banks has been imperiled by persistent misconduct and an aggressive sales based culture."

What had the British banks been doing? Mostly taking advantage of face-to-face (or telephone and online) interactions with customers to push inappropriate or over-expensive products: mis-selling payment protection insurance, interest rate hedging products, endowment mortgages, packaged bank accounts, investment products and advice, mortgages, pensions and ID theft and card protection insurance.

What did all these misdeeds have in common? A connection to poorly planned and monitored sales incentive programs, which encouraged bad behavior by front-line employees and allowed managers to tout increasing sales numbers. This is the same kind of thing that happened at Wells Fargo.

The regulatory reaction in the U.K. was driven by public outrage and an unforgiving political atmosphere. The U.K. bank regulators were not content simply to levy fines

and force consumer redress. They diagnosed a pervasive "cultural" problem in need of a broader solution. The Tyrie Commission, a parliamentary body studying the sources of the bank crisis, highlighted the role that incentive compensation programs in U.K. retail banks played in encouraging a culture of bad behavior towards customers, and pressed for change.

The Financial Services Authority, the then-regulator for all types of banking, insurance and investment firms, in 2013 released a full review of how sales incentives were being used and found that not only were incentive schemes with high-risk features common in the industry, but most firms "did not have effective systems and controls in place to adequately manage the increased risks of mis-selling arising from their incentive schemes." (That year the FSA was split into the Financial Conduct Authority and the Prudential Regulation Authority of the Bank of England.)

The FSA review uncovered a range of serious failings, including banks turning a blind eye to how incentive schemes might encourage staff to mis-sell, failing to understand their own incentive schemes because they were so complex, allowing sales managers to have clear conflicts of interest and ineffective efforts to link sales quality to sales productivity.

U.K. regulators then put in place mandatory guidance requiring financial firms to take swift action to change practices and controls so that mis-selling and other consumer abuses ended immediately, and threatened further action if changes didn't go far enough. While regulators indicated that they did not necessarily want to eliminate sales incentives entirely, they also made clear that the burden was on banks to justify any incentive program.

U.K. banks got the message that retribution would be swift if they kept using their customers as sales targets. One by one, banks like RBS, Lloyds and HSBC eliminated incentives or radically altered incentive programs to weigh customer interests more heavily than the interests of bank employees and shareholders.

So changing incentive programs got U.K. regulators and politicians off the banks' backs, right? Not by a long shot. Regulatory pressures for cultural reform only increased. In a Daily Telegraph essay in 2014, the then-head of the Financial Conduct Authority, Martin Wheatley, said that change was beginning to happen but that a lot more remained to be done.

He argued that bank culture would need to keep changing in fundamental ways to ensure that abusive customer practices wouldn't return: "Changing a culture and improving a broken reputation will not happen overnight, which is why we will not let our focus on this issue waver."

By 2106, banks had made more progress, but a study by the New City Agenda and the Cass Business School concluded that U.K. banks were far from out of the woods.

“It will take a generation to create a new culture in UK retail banks… [t]he good news is that banks have made a positive start. The ‘tone from the top’ is there. But this alone is not enough,” the study said.

What lessons can U.S. banks learn from their U.K. counterparts? First, a problem culture is a really big deal. If you don’t get ahead of it, you will be paying the price for years. While concern about retail banking culture is gaining steam in the U.S. and is about to become the next big thing in banking oversight, the public drumbeat will get worse as bank after bank is criticized for sales practices.

If stories like the Wells scandal are repeated at other banks, U.S. banks could soon experience the same reputational and regulatory fate of their U.K. cousins. They could potentially face accusations of a “broken culture.” Problematic sales incentives are one thing – minor operational matters that can be changed with the stroke of a pen. But accusatory statements have power in the social media environment.

Fixing culture could become the principal focus of regulators and management for years into the future. A bank with a problem culture can forget about doing M&A or anything else that needs regulatory approval. The board of directors and management, theoretically the custodians of corporate culture, will effectively be at the mercy of their regulators, the only ones who can decide if and when the broken culture is cured. And any bank deemed to have cultural issues will become a public punching bag for anyone in government or the press who cares to take a shot.

What kind of radical change must a bank undertake? It’s actually a rather easy answer: all of a bank’s sales efforts and practices must be based on one core principle—the bank should act in the best interests of customers at all times.

One template that may be helpful is a set of eight indicators developed by the Center for Financial Services Innovation to measure consumer financial health. CFSI’s goals, or ones like them, can be used to design a system that incents front-line employees to help customers reach important financial health milestones, like saving a percentage of income or creating a “rainy day” fund for unexpected expenses.

The positive effects of these types of incentives for bank customers, employees and shareholders will be tangible and sustained. Bank customer loyalty will grow as customers learn to look at bank employees as advocates rather than hucksters. In many respects, these “radical changes” are just a return to an older view of the relationship between banks and their customers. Bankers long believed that doing what was best for their customers was the best way for a bank to succeed.

That belief should be at the heart of any retail banking reformation. As for bankers that are skeptical about the need for cultural change? Even they will come around because the alternative—being labeled as culturally deficient—is unpalatable. Just ask a British banker.

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