TC NOTES

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SUPERVISORY RESPONSES TO RETAIL MISCONDUCT

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SUPERVISORY RESPONSES TO RETAIL MISCONDUCT

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SUPERVISORY RESPONSES TO RETAIL MISCONDUCT

Introduction[1]

Recurring retail misconduct across all sectors of financial intermediation globally has cost billions in compensating consumers and enforcement penalties, eroding confidence in financial institutions and even threatening financial stability. The efficacy of national and international attempts at prevention, extending supervisory intervention to non-financial risks and governance and imposing stronger enforcement penalties, remains to be proven. This Toronto Centre Note suggests that the relevant authorities should re-think their priorities, institutional structures, regulatory requirements and supervisory interventions, tailoring them to local markets, culture and resourcing.

Following widespread events, authorities and financial markets have found themselves in unchartered areas as a result of the frequency, size and cost of retail misconduct. Short-term responses have taken precedence over longer-term structural, policy and supervisory reform. The use of quantifiable financial metrics in on- and off-site supervision has been expanded to the qualitative assessment of governance, culture and accountability. This has required institutional responses and related supervisory training and assessment, while authorities traditionally more used to moral suasion and negotiated outcomes with errant financial institutions have had to tighten enforcement as a deterrent and to meet public expectations.

This Note:

- Reiterates, by way of continuity, the existing Toronto Centre (2016) guidance on conduct supervision;
- Alerts supervisors to the structural and behavioural triggers of retail misconduct, considering the context of their own economies, industries and portfolios of supervised institutions;
- Explores the institutional causes that contribute to retail misconduct and the need to identify and respond to these as early as possible;
- Considers the role of whistle-blowers and how they might be enlisted in preventing and addressing retail misconduct;
- Explains the responses to date and their limited usefulness;
- Lists possible supervisory actions; and
- Discusses the likely emerging future scenario.

[1] This Note was prepared by Senthamangalam Ganesan Venkatramani.

Previous Toronto Centre guidance

This Note is a sequel to, and should be read in conjunction with, the earlier Toronto Centre (2016) guidance. That earlier Note observed:

- Some of the steps that supervisors can take to address retail misconduct issues and the differences in how prudential, conduct and system stability supervisory authorities deal with them.
- The inclusion of retail misconduct risk and the effectiveness of controls in supervisory risk assessments of regulated firms, although an agreed optimal approach is yet to emerge, partly due to differing regulatory mandates, legal obligations and priorities.
- Supervisors have been enhancing their approaches to retail conduct, including supervisory product approvals.
- A lack of transparency in banking, insurance and investment products has contributed to abuses in the selling, trading and advising on these products.
- A trend towards vertical integration and commission-based cross-selling of others' products has increased the scope for potential misconduct and the need for supervisory awareness.
- Where financial institutions are allowed to self-regulate, often through industry codes with or without the imprimatur of the authorities, oversight has been increased by focusing on the evaluation of the effectiveness of self-regulation.
- Stronger regulatory enforcement has helped aggrieved parties to litigate for their rights, in addition to the existing protection from the basic obligations of financial institutions and normal supervision.
- Principles-based regulation has been increasingly supplemented with prescriptive and detailed requirements in regard to product design, sales, servicing and complaints-handling.
- The preference of prudential supervision to remedy underlying concerns in regulated firms away from the glare of publicity, along with its implications for deterring misconduct.
- The core elements of a conduct regime (including legal rules, operational approaches, tools, self-assessment, mystery shopping, whistle-blowing and fraud alerts). Traditional risk-based prioritization has been used to allocate resources.
- The need for greater sharing of information among different supervisory authorities.
- The global financial crisis and the inadequacies since publicized in the setting of interest rate and exchange rate benchmarks showed that wholesale market misconduct may flow through to retail consumers. Accordingly, commensurate attention is required to governance, risk, compliance, fostering the right culture and criminalizing manipulation and insider-trading in wholesale markets.

Financial regulators and supervisors face significant challenges in pre-empting and rectifying misconduct, when product-manufacturers, distributors and related professional experts cause actual and potential detriment to consumers of banking, insurance and wealth management products. Recent examples of the exploitation of vulnerable consumers across the entire chain of product design, marketing, servicing and payment have prompted calls for exemplary enforcement. The solutions adopted need to take account of local economic structures, laws, market development, access to professional services and culture.

Recent developments

Misconduct has no national, industry or professional boundaries. 'Copy-cat' misconduct across jurisdictions is therefore quite common. Recent developments, as for example outlined in the Justice Hayne Royal Commission report into the Australian banking, superannuation (pension) and insurance industries (Hayne 2019), demonstrate continuing instances of serious misconduct. Meanwhile, supervisors in many regimes have faced practical difficulties in pressing ahead with revised approaches to preventing retail misconduct.

Recent findings of retail misconduct have included:

- In 2013, Wells Fargo in the US was caught up in a cross-selling scandal when staff were incentivized to boost sales and falsify customer records. By 2018, the cost in fines, consumer and investor compensation had reached USD 3 billion (Tyan 2019);

- Commonwealth Bank of Australia's life insurance arm had illegally sold its products through telemarketing between October and December 2014, resulting in criminal prosecution for 87 separate offences;

- More than half of Australians (54 per cent) have been negatively affected by misconduct, losing an estimated AUD 201 billion during the last five years (Godwin and Murawski 2019);

- Australian consumers were refunded more than AUD 100 million for having been sold worthless consumer credit insurance, including global insurer Allianz's share of AUD 45.6 million;

- The UK Financial Conduct Authority's (2018) thematic review of UK household insurance sales in 2017/18 exposed a number of anti-consumer practices harming purchasers;

- The Financial Consumer Agency of Canada (2018) has called on Canadian banks to strengthen their governance and control frameworks over sales practices and market conduct, to reduce a growing misconduct risk from putting profits ahead of consumer protection;

- Analysis of financial advisors in the United States from 2005 to 2015 found that seven per cent of advisors have misconduct records, and this share reaches more than 15 per cent at some of the largest advisory firms (Egan, Matvos and Seru 2017). This is consistent with some firms "specializing" in misconduct and catering to unsophisticated consumers.

Structural weaknesses

A number of factors contribute to retail misconduct. Awareness of these weaknesses could alert supervisors and consumer organizations to potential problems.

Across the world, consumers are disadvantaged by varying degrees of financial illiteracy, often compounded by disengagement, when dealing with much better-informed product providers and distributors. Even where financial literacy is stronger, imbalances continue in practice as consumers may disadvantage themselves by disengaging from sales and advice processes.

Disclosure and plain language requirements aimed at improving consumer understanding have been widely mandated but may not be sufficient to enable supervisory authorities to rely on a ‘caveat emptor’ approach. For example, a joint report by the Australian and Dutch conduct regulators has warned of the risks of relying on disclosures as the default supervisory response.[2]

The traditional presumption in insurance of policy holders having better knowledge than insurers, enjoining on them the duty of ‘utmost good faith’, is reversed here. The conventional ‘caveat emptor’ (buyer beware) requirement can no longer serve consumer interests, given the imbalance. Instead, there is a justifiable move towards making ‘seller responsibility’ the new paradigm.

Embedded conflicts of interest and duty in product sales have also caused and worsened consumer detriment. It is often unclear who the financial advisors recommending products and services to the consumer act for. Even where the laws require them to act in consumers’ interests – and this is by no means universal – their remuneration structures predispose them to act primarily in their own interests and in the interests of product providers rather than in the interests of the consumers they advise. This is often reinforced by the practice of allowing financial advisors to be remunerated through commissions paid to them by product providers rather than through fees paid by consumers – thereby giving advisors a strong incentive to recommend products that carry the highest rates of commission, rather than those that might be most suitable for consumers.

Trail commissions (paid long after a product or service has been purchased) cement the provider–distributor nexus still further, being literally a form of deferred compensation even when no further service is being rendered by a financial advisor. It is therefore not surprising that some product providers have been emboldened to charge fees for no service.[3]

Resolving historical practices through amending laws has encountered legal difficulties for two reasons:

- Abolition of historic property rights (for example accrued entitlement to trail commissions) may be open to challenge as being unconstitutional (for example acquisition of property without adequate compensation); and
- Retrospective legislation is perceived with distaste as people expect to have certainty in arranging their affairs based on the rules at a given time.

[2] Australian Securities and Investments Commission and Dutch Authority for the Financial Markets (2019).
[3] This caused a furore during the public hearings of the Hayne Royal Commission.

Over many years, supervisors transitioning from compliance-based to risk-based supervision have generally found, subject to the availability of technical skills and legal framework, a principles-based approach to be more effective than prescriptive requirements. During normal supervision this has worked well, optimizing institutional and supervisory resources, and preventing the gaming of overly detailed rules by regulated financial institutions. However, identifying and resolving misconduct does require a measure of black-letter prescription without which enforcement may not meet the legal rigour of proving the breach of a high-level principle.

Traditionally, prudential supervisors have tended to work more closely than conduct supervisors with regulated firms to keep abreast of emerging risks and address them collaboratively before they become overwhelming. In recent instances of misconduct, the question has been asked whether this might prevent robust enforcement against wrongdoing.[4] Tools such as Enforceable Undertakings[5] have been described as too soft an alternative to deterrent public action. 'Why not litigate?' has accordingly become the immediate recourse of some supervisors criticized for being asleep at the wheel.

Other underlying causes of retail misconduct

In addition to structural weaknesses, four other underlying causes of misconduct can be identified.

First, people may behave in ways that differ from the 'rational' behaviour that underlies the theories of classical economics. Principles and rules on corporate conduct, emphasizing the primacy of protecting consumers and the avoidance of conflicts of interest, have had to recognize that it is unrealistic to expect boards, managers and professional advisors not to act in their own self-interest. Over time, undetected misconduct tends to breed complacency, and perhaps even a sense of invincibility.

There have been many instances of greed on the part of providers and distributors trumping the law (where it requires them to place consumers' best interests before their own), disadvantaging consumers already suffering from inadequate understanding. Often this has been hidden – unwittingly or arguably deliberately – under elaborate corporate structures permitting the rationalization of misconduct as being attributable to 'rogue' operators or as a system failure rather than as a fundamental design fault or conduct failure. Misaligned incentives have reduced the effectiveness of necessary checks and hindered the detection of misconduct.

Second, complex institutional structures and the use of the outsourcing of services such as data management make board and management oversight more difficult.[6] In addition, outsourcing may be an example of a conflict between maximizing profits and treating customers properly. Over time, such conflicts tend to be accepted as part of the business. Outsourcing has been addressed

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[4] Venkatramani (2014) explores this in more detail.

[5] An agreement between an institution and the supervisory agency whereby the former agrees to do, or not do, certain things to avoid legal action, without admitting liability. If breached, the supervisor can take the institution to court. In the light of serial misconduct by institutions afforded enforceable undertakings, their use has been criticized.

[6] Despite regulatory standards governing outsourcing, and the use in many jurisdictions of special reports from auditors of control procedures in outsourced services.

in many jurisdictions through enforceable standards but managing the inherent conflicts of interest continues to present problems in practice.

Third, while there are always likely to be at least some regulated firms that breach the rules, the attitude towards compliance by other firms may be shaped by how much the offenders can get away with. Lax or tokenistic enforcement does not help, because it may lead to regulated firms dismissing the fines imposed for infringements as being no more than ‘the cost of doing business’.

In all jurisdictions, supervisors (conduct as well as others such as prudential, competition and anti-money laundering) have a variety of tools at their disposal. Their repertoire ranges from the informal to the formal: negotiation, agreeing and monitoring improvements, up-skilling and resourcing, improved consumer interaction including continuous disclosure, administrative penalties (for example for late or inaccurate reporting and certain breaches), license conditions, capital charges and court-sanctioned enforcement against individuals and institutions.

Given the focus on outcomes, it is practical and sensible for supervisors to avoid costly and uncertain litigation through informal methods, without the benefit of legal adjudication in terms of binding precedents. However, it is debatable whether, in the light of serial misconduct, recourse to informal approaches might engender institutional indifference, or even the presumption of supervisory tolerance for misconduct.

Fourth, regulated firms may feel themselves under pressure from shareholders and market analysts to generate and report high short-term profitability, which may incentivize misconduct, as opposed to the longer-term potential benefits arising from the good treatment of consumers. This is similar to the conflicts that may arise in the short term between a firm’s immediate profitability and its sustainable performance in meeting environmental, social and governance objectives.

Examples of misconduct across sectors

The mis-selling of financial products and services has assumed many forms.

In banking:

- Irresponsible lending to consumers who could not service their obligations. Borrowers may overstate their income and understate their expenses, sometimes with the encouragement of brokers and lenders, or lenders may rely too much on collateral rather than on a borrower’s ability to repay. Use of formulaic expense assumptions understating realistic experience affects the integrity of credit evaluation contributing to the growth of non-performing assets. Brokers may be conflicted by sales commissions and seek to maximize their sales revenues, while bank managers may be incentivized to meet short-term targets imposed from above. In addition, incentives may lead to banks causing distress through unacceptable recovery methods when borrowers face repayment difficulties.
- With vertical integration into insurance and wealth management, the attraction of the ‘one-stop’ shop has contributed to pressured sales from agents not well-versed in the risks of the products they sell.

- In times of rapid growth, the required attention to checking transactions for accuracy, completeness and reasonableness has been insufficient, contributing to consumer losses. In some cases, IT and other systems do not keep pace with product innovation or legislative requirements (for example the strengthening of anti-money laundering and terrorism-related finance requirements). Rectification delays and faults even after complaints have been made have compounded the problem.

In insurance:

- The information asymmetry between provider and purchaser has made it difficult for consumers to understand the value of the product. Indeed, some products have simply had no value, for example add-on warranty insurance for household appliances where existing consumer laws already cover the risks. Sales pressures have worsened this situation.
- In some cases, insurance products have been sold to consumers who would never be able to claim under them. And even where valid claims are made, claims settlement may be slow and difficult. The dividing line between the robust claims processes insurers must follow to ensure solvency on the one hand and deliberate delays and difficulties on the other has been exploited against claimants already suffering from insured losses.
- Pressured selling of products to vulnerable consumers has continued despite existing legal prohibition.

In wealth management and pensions:

- Aggressive product selling has continued even where the product is compulsory, with sales incentives to distributors skewing consumer outcomes. For example, with the shift in pensions design from defined benefit to defined contributions, ageing population and the inability of state pensions to meet minimum retirement needs, many regimes require compulsory contributions, which providers try to capture through sales pressure. Workers Compensation, Public Liability and Third Party cover for vehicles are also compulsory in many places.
- The prevalence of ‘trail commissions’ where little or no service is provided has been made worse by grandfathering existing arrangements even when new arrangements are prohibited. Investor inertia has been exploited by charging ‘fees for no service’, compounded by the long time periods over which these fees have been imposed.
- Occasional whistle-blowing, when encountered, has been promptly muffled. Whistle-blowers have been victimized and traumatized.

In all sectors of financial services there has been a wide divergence between what the reasonable consumer would think was being acquired and what was actually provided, lasting over time and harming those who are unable to know they have been mistreated, let alone fend for themselves by seeking redress.

Advisors whom consumers thought were acting in their interests were not. The names of well-regarded financial institutions have induced blind trust which in hindsight has been misplaced.

Alternative dispute resolution mechanisms (consumer tribunals) are designed to help aggrieved consumers to resolve disputes quickly, without the formality, cost and intimidating image of the courts. Where they exist, these mechanisms have sometimes lacked real teeth, in particular the power to enforce compensation.

Regulatory and supervisory responses

It is fair to say that the recent avalanche of misconduct cases has caught many authorities off their guard.

Responses have included:

- Governments announcing in-principle responses to revealed patterns of retail misconduct and any recommendations put before them. For example, the Government of Australia (2019) responded promptly in accepting the Hayne Royal Commission recommendations, although the actual reform process will take many years;
- The slow, often painful process of implementing agreed reforms, often affected by changes of those in power, parliamentary legislative agenda and priorities, the need to consult with stakeholders and avoid unintended consequences, the need to balance competing pressures from lobby groups and the tendency to compromise / water down initial proposals. For example, Australia abandoned the idea of requiring mortgage brokers to be paid directly by borrowers instead of by lenders, as recommended by the Hayne Commission, after initially accepting this recommendation;
- The publicized cases of misconduct have provoked debate as to whether regulatory structures facilitate addressing misconduct, in particular where a relatively well-resourced and powerful prudential regulatory authority is separate from a poorly resourced conduct authority that has inadequate powers. Some countries have responded to this by proposing that conduct supervision should be strengthened through shared use of resources and skills (such as joint investigations). Conduct supervisors may benefit from adopting statistical and risk analyses that are normal in prudential supervision to pinpoint weaknesses. Moreover, the separation of prudential and conduct supervision might induce an industry mindset of adopting a compartmentalized view, and might allow issues such as poor governance, culture and controls to fall between regulatory stools. There is also scope to extend and clarify the mandates of conduct authorities, to improve collaboration with other authorities, and to mandate periodical capability reviews of supervisory agencies in addition to the international Financial Sector Assessment Programs conducted by IMF / World Bank.;
- Changes to legal rights, obligations and penalties, for example making some offences criminal instead of civil, to increase deterrence;
- Changes to supervisory approaches to monitoring and enforcing proper conduct,[7] although the default use of litigation post global financial crisis in preference to a multi-faceted approach has been criticized in the UK and the US[8];
- Many authorities have introduced additional disclosure requirements, reiterated the duty to act in consumers' interest and to report breaches promptly, refined remuneration guidance to include non-financial risks, and increased compliance checks. Ever since the global financial crisis, there has been an increasing emphasis on governance, culture and individual accountability in regulated firms, but the supervisory skills and tools to meaningfully measure these and incorporate them into risk assessments are still being developed;

[7] In the aftermath of serious cases of misconduct, regulators are being asked 'Why not litigate?' See Recommendation 6.2 in Hayne (2019).

[8] See L'Estrange and Moloney (2019).

- Given the increased focus on improving institutional culture to pre-empt misconduct, attention has naturally turned to supervisory culture as its obverse. Globally, the importance of supervisory authorities adopting a more customer-facing mindset has gained traction with many international standard setters, including the Financial Stability Board, OECD, IAIS, Basel Committee, the European Insurance and Occupational Pensions Authority, and the Global Partnership for Financial Inclusion[9];
- A development in customer-facing conduct is the emergence of shadow regulatory committees consisting of experts and academics in the USA, Europe, Japan and Latin America. In Brazil, for example, consumer groups have the power to issue fines;
- Strengthening advisory obligations, in particular by legislating for advisors to put customers' interests first, ahead of their own interests or those of product providers. That this fundamental responsibility has taken so much time to introduce following serial misconduct is shocking. In addition, fees for services are being subjected to stringent tests including customer opt-in, annual renewal, actual delivery of service and regulatory attestation;
- Reviewing industry codes and their enforceability. Industry codes, premised on self-regulation, have often been a well-intentioned yet non-enforceable guide to ward off prescriptive supervisory intervention. While their informality and industry commitment can be an advantage, aggrieved consumers have had to take formal or informal action to resolve disputes. Making codes enforceable is gaining increasing support;
- Improving compensation mechanisms to make them swifter and more equitable. Many financial institutions have appointed internal Customer Advocates to redress grievances and award compensation;
- Weeding out 'bad apples' from the industry. In some cases, existing 'fit and proper' standards of responsible persons, if rigorously implemented, should suffice. Unfortunately, this has not always been the case. In Australia the 'Banking Executive Accountability Regime' (BEAR) would give more power to the supervisory authorities;
- Enhancing education and engagement. This remains a long-term work-in-progress even in developed regimes, with several agencies providing education and engagement guidance, and working with consumer bodies. A more lasting solution would be to include it in school curricula, as part of basic life skills;
- Reviewing the performance of the supervisor and avoiding turf battles among different supervisory authorities. In most regimes, regulators are required to report to their responsible minister, and often to the Parliament / nation at large through annual reports. Parliamentary Committees may periodically call senior supervisors to explain their work and raise concerns. Increasing awareness of the need for various regulators to collaborate within and across national regimes has led to more interaction, with any legal impediments to information-sharing needing to be addressed;
- Whistle-blower protection. Both supervisory authorities and the boards and senior management of financial institutions require timely, accurate and relevant information to assess risks and determine suitable action. Formal reporting mechanisms are designed to facilitate information flow, but in practice their effectiveness can be affected by emerging risks, human weaknesses, lack of skills, legacy systems, controls no longer commensurate with risks, and dominant managers. This is where whistle-blowers can help to restore effectiveness. Their role is invariably hard, and in many cases against their own immediate short-term career and self-interests. That is why many regimes impose an

[9] See for example Bank for International Settlements (2017), International Association of Insurance Supervisors (2017), European Insurance and Occupational Pensions Authority (2019) and Global Partnership for Financial Inclusion (2019).

obligation on responsible officeholders to report failings to the supervisory authority and to protect whistle-blowers from victimization, with varying degrees of success. An effective whistle-blower regime can offer protection against the proliferation of misconduct.

Practical difficulties in implementation

Reform steps have been hampered by lower prioritization by resource-constrained supervisors, who have to play catch-up with emerged and emerging risks, enhance their systems and staff training to meet legislative changes, and compete with better-paying industry for similar skills. Funding mechanisms for supervisory authorities differ: from tax revenues, industry levies and fines imposed on regulated entities. Misconduct management calls for a significant increase in resources and funding but faces resistance from stakeholders. Regimes facing these challenges have prioritized staff training and upskilling, top-level support for additional activities and support when challenged by regulated institutions.

Adapting to the new paradigm of assessing and acting on non-financial risks has been a formidable challenge. Unsurprisingly, the charge of regulatory capture of supervisors by the industry is not uncommon after serious misconduct is exposed. Periodical rotation of responsible staff, enforcement of conflict policies and regular peer reviews within a supervisory authority can mitigate the likelihood and impact of regulatory capture.

What supervisors can do: an indicative list

As national authorities consider and progress policy and legislative reform, frontline supervisors must continue to focus on day-to-day supervision. Their task has been expanded to include the identification, control and remediation of retail misconduct, and the continuing updating of supervisory risk assessment at institutional, line of business, industry and economy levels.

Historically much less progress has been made on establishing international standards on retail conduct than on establishing prudential standards. Following the global financial crisis, the OECD was asked by the FSB to develop some principles for consumer protection, but this has remained a high-level exercise that has only had limited impact at national level.

While the development of international standards would help to harmonize approaches in the future, for the immediate future, pro-active risk-based supervisors should consider:

- Assessing the likelihood and impact of retail misconduct through a stronger customer-facing lens, based on on- and off-site analysis, periodical meetings, industry landscape, internal peer reviews and external ‘supervisory college’ discussions; and signalling a heightened and more intrusive supervisory presence to regulated firms;
- Updating existing internal supervision and quality control processes of the supervisory authority for oversight of misconduct;
- Focusing more on the potential impact of retail misconduct on prudential supervision, for example on solvency and reputational damage;

- Analyzing the exposure of local consumers to misconduct in terms of their financial literacy and engagement, distribution channels, the track record of regulated firms in prioritizing consumer interests ahead of others, conflicts of interest and duty, and access to and ease of dispute resolution (including informal alternatives to courts) and compensation mechanisms. Supervisors must be alert to likely gaps between the intent of the rules and the actual practice of stakeholders;
- Similar to the heat-maps used to measure and signal financial crises, analyzing the incidence and impact of misconduct using national economic parameters, consumer, industry and distributor behaviour and the complexity of products and services on offer;
- Recognizing that misconduct in one part of financial services can quickly spread to others, given the interconnected nature of intermediation, common ownership structures and conflicted agency arrangements. Such cases should be reviewed for the risk of contagion;
- Where the regulatory structure does not allow free exchange of useful information, taking steps at senior levels of supervisory authorities to facilitate information exchange, including removal of legal, territorial or turf barriers, if necessary, by appealing to political leadership;
- Reviewing existing complaints-handling procedures periodically to check they remain fit for purpose. Consider if institutions are bound by industry-wide arrangements and how current complaint-handling compares with best practice. A low level of complaints might not necessarily mean that there is no dissatisfaction, but simply that the process is too onerous and off-putting;
- Making whistle-blowing an integral part of the robust pre-emption of retail misconduct. Whilst supervisory action should be based on verifiable information, whistle-blowing can help to identify the lines of inquiry to pursue during the risk assessment of regulated firms;
- Questioning extraordinary growth in revenues and profits, relative to industry data, as much as questioning poor performance. The skeptical mindsight of the supervisor should extend to misconduct events;
- Reviewing breaches of standards that are reported to the supervisor and investigating more serious instances. Supervisory authorities would be rightly blamed if information available to them is not analyzed and acted upon in time.
- Questioning remuneration practices that are out of line with prudent and pro-consumer practices;
- Checking and enforcing compliance with ‘fit and proper’ standards;
- Updating the crisis binder for each industry / institution to include misconduct risk, allowing for the possibility of systemic contagion from serious consumer damage.

A caution

This Note is primarily concerned with retail misconduct, including preventing and remedying consumer detriment. However, supervisors should also be careful to ensure that the legitimate activities of banks, insurers, wealth managers and pension funds aimed at protecting their solvency and enforcing contractual obligations continue unhindered. Supervisors should take care to ensure that actions to protect consumers against misconduct do not compromise counterparty obligations.

For example, consumer lobbies may try to use the public resentment against industry misconduct to dilute the contractual obligations of customers (such as the payment of interest, agreed fees and charges, compliance with loan covenants, and the disclosure of relevant information).

Equally, a customer may fall on hard times due to no fault of the supervised institution (such as poor health, death, loss of employment, uninsured or under-insured risks, natural calamities). There are sound reasons for such people to be treated sensitively and without harassment. However, if they should be afforded some concession, the burden should not fall on commercial banks, insurers, or wealth managers, but on the state.

The future

The primary responsibility for controlling misconduct remains with the supervised institution and this responsibility should be reiterated and discharged through robust risk management and must be highlighted.

Enhanced cooperation, a focus on governance, risk management and culture, and calibrating incentives with prudent risk-taking have been attempted across regimes with varying success. Measuring and mitigating retail conduct risks has not been easy, and recurring misconduct evidences it.

A potential and powerful change could be to require offending institutions to disclose for a given period (for example five years) proven instances of misconduct when marketing and contracting for financial products and services. Similar to disclosures mandated on undischarged bankrupts to alert innocent counterparties who might deal with them, this should put consumers on notice and might deter future misconduct.

Traditionally, white collar crimes have not received comparable penalties as blue collar offences (in finance as well as other industries). In particular, perpetrators of misconduct have been able to get away with civil penalties, loss of bonuses, and deferred incentives and jobs. Criminal penalties and jail terms have been rare (except in the case of traders who were found to abuse sensitive information). There is growing pressure to treat white collar criminals like blue collar offenders.

The lack of international guidance on retail misconduct to date has not been for want of realizing its importance but the challenges of formulating common approaches across different industries, regimes, needs and development.

A further complication is the proliferation of fintech and the disruption to intermediated financial institutions: this has called for supervisors to focus on related risk identification and controls and the task of staff upskilling. Fintech applications can and should be harnessed in future to achieve better conduct outcomes. But supervisors should remain alert to the possibility that in some cases fintech may result in new forms of misconduct.

For authorities (including policymakers), the urgency is to recognize the importance of retail misconduct and to devote sufficient resources to this problem, including adequate powers and effective enforcement. As initiatives are being tried out, continued efforts on the part of global bodies (guidance) and national regulators (standard-setting and cooperation) are critical.

Conclusions

Given the impact of uncontrolled misconduct on consumers as well as on confidence in the system, supervisors and other authorities have begun addressing it by modifying traditional approaches. Since the global financial crisis, regulators and supervisors of retail conduct have turned to executive and other remuneration to align it with risk management for enhancing consumer protection; regulatory reach has been expanded; whistle-blowing has been co-opted as a pre-emotive tool; more prescriptive requirements have been added even in regimes used to principle-based regulation; more use has been made of little-used existing powers; and more intrusive scrutiny has followed.

The traditional compartmentalization between prudential (holistic, solvency and risk-focused) and conduct (consumer-centric and legal and compliance-oriented) supervision has not been conducive to deterring, identifying and remedying misconduct. In addition to the obvious medium-term need for authorities to consider structural and policy changes, frontline supervisors would benefit from guidance (which is the purpose of this Note) on how they might identify emerging concerns and respond in their day-to-day tasks of risk assessment and follow-up. Financial Sector Assessment Programs conducted by the IMF and World Bank in national jurisdictions will no doubt focus more on how misconduct risks are controlled in legislative and policy design, implementation and monitoring.

Addressing misconduct involves many steps often taken in tandem. These include compensating victims by restoring them to where they should have otherwise been; punishing wrongdoers (individuals and financial institutions); reviewing laws and guidance; re-assessing supervisory practices; improving infrastructure such as education and communication; and learning from experiences in other regimes. The approaches and tools will continue to be refined through shared experience.

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The complexity of an interconnected financial system and continuing disruption from technology also demand supervisory scrutiny to safeguard solvency, consumer interests and data security.

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