Conduct Capital Buffer

Ethics & Trust in Finance
Global edition 2018-2019

Finalist

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* The views expressed herein are those of the author and do not necessarily reflect those of the Organization she is affiliated with or of the Jury.

The aim of this essay is to propose a regulatory instrument rewarding ethical behaviour in the banking sector.

It is divided into the following parts:

i) Rationale for a regulatory-driven incentive for banks to behave more ethically;
ii) Key findings in literature about conduct and ethics in finance and how I define them in relation to banking;
iii) Proposal of a measure to evaluate the conduct of banks;
iv) Discussion of how to promote conduct effectively by regulatory stimulus;
v) Proposal of a Conduct Capital Buffer;
vi) Brief discussion on credit risk related concerns of the Conduct Capital Buffer.

I mostly used the example of the Poland for illustration purposes while developing the concept of the Conduct Capital Buffer. The key findings and ideas seem to be universal in nature and should be applicable to most countries with a developed rule of law.

The unethical world we live in

The issue of ethics in banks is quite complex. As demonstrated during the last global financial crisis, the conduct of banks significantly deviated from the desired ethical standards. This was a key point of interest for a number of newspaper articles (Irwin, 2014; Wild & Glover, 2018), books (McCormick & Stears, 2018; Koslowski, 2011; Villa, 2015; Aragon, 2010; Carboni, 2011), films (Wolf of Wall Street, 2013; The Big Short, 2015; Inside

La question de l'éthique dans les banques est complexe. Comme l'a démontré la dernière crise financière mondiale et les amendes élevées que les plus grandes banques du monde doivent payer à cause des comportements contraires à l'éthique. La gestion des banques s'est considérablement écartée des normes éthiques souhaitées. Dans le même temps, il semble que l'absence actuelle de règles de conduite au sens strict n'ait pas d'impact (direct) suffisant sur les opérations réelles des banques et que les autorités de contrôle manquent d'instruments pour obliger les institutions financières à adopter un comportement plus éthique.

Job, 2010) and even Master's theses (Turner, 2010) and Ph.D. dissertations (Tischer, 2013).

The behaviour of banks in recent years significantly deviated from the desired ethical standards. The scale of financial fees imposed on financial institutions has also been growing. In Poland, the lack of research devoted to conduct makes the assessment of the level of compliance impossible, especially since it would be too superficial to link this assessment of individual banks solely to fines imposed by the Polish Financial Supervision Authority (PFSA). At the same time, it seems that the current lack of conduct regulations in the narrow sense does not have a sufficient, direct impact on the actual operations of banks and supervisors lack the competence to force financial institutions to behave more ethically.

In the United Kingdom, for several years now, an innovative study has been conducted to measure the level of conduct compliance in credit institutions. For the mechanism for awarding ethical behaviour to be effective, it must motivate the actions of the bank's shareholders rather than its employees.

A comprehensive study by the Conduct Costs Project Research Foundation (CCPRF) has revealed distortions that show how the banking sector diverged from the common standards of morality[1]. In the period 2012-2016, the 20 largest banks in the world, employing a total of 2.3 million people paid £300 billion in fines for misconduct, equivalent to about 70% of Poland's GDP. Contrary to popular belief, misconduct consisted mostly of faulty internal processes and procedures, not deliberate frauds by individuals in cases that were often covered by the media, such as that of the Credit Suisse employee, Patrice Lescaudron. The majority of fines resulted not from fraud or market abuse (which only accounted for 6% of all fines, including the LIBOR scandal), but from banks' persistence in virulent practices towards their customers, due to their focus on profit and vulnerability to moral hazard. Thus mis-selling issues, based on misleading customers, was the root cause of the majority (85%) of cases.

Pure market forces fail to promote ethics in banking

Perhaps the most significant fact is not the size of the fines related to misconduct but the impression that top management at banks do not fully appreciate the negative impact of misconduct on the financial performance of their institutions. Costs incurred to repay fines and redress or remediation of misconduct amounted to an average of 10% of all expenses incurred by banks between 2012 and 2016. If the analysed banks had not been compelled to pay fines, their profits would have been on average 21% higher, with annual Return on Equity (ROE) increased by 3 percentage points.

1 Conduct, Culture and People Research Foundation: www.ccpresearchfoundation.com/index, (accessed 14 January 2019).

Il est intéressant de noter que ce n'est pas le niveau des amendes qui est le problème, mais le fait que les dirigeants des banques ne semblent pas pleinement prendre conscience de l'impact négatif d'une telle conduite sur la performance financière de leurs institutions. Une explication possible réside dans la mentalité à court terme des actionnaires et des dirigeants de la banque : les résultats trimestriels sont beaucoup plus importants que les conséquences à long terme d'une stratégie donnée. Cette observation suggère que les forces «pures» du marché ne poussent pas les banques à adopter un comportement plus éthique. Cela m'amène donc à plaider en faveur d'une solution réglementaire.

Reputational cost, another hidden cost of misconduct, is also worth highlighting. Armour et al. (2010) estimated that this type of cost could be almost nine times the size of fines. Given this finding, one might suppose that managing a bank in an ethical way would be promoted by market forces – in particular, by shareholder pressure and pressure on bank management to minimise costs and maintain a good corporate image. A potential explanation for why this is not the case is the short-term mindset of shareholders and senior bank management, as noted by Rappaport & Bogle (2011), Dallas (2012), Milbradt & Oehmke (2015) and Repenning & Henderson (2010).

This observation, as well as the review of the literature, suggests that the market is not driving banks' behaviour in a more ethical direction, as desired by customers and regulators. This leads me to argue in favour of a new regulatory solution, aimed at rewarding the ethical behaviour of banks. It would consist of a six-month assessment of the ethics of banks in Poland, conducted on the basis of a survey and a qualitative study which would be an extended version of the cited study from the UK. Based on the results of such a study, the PFSA could reduce or increase the soft capital requirement by one percentage point.

Step 1: Defining an ethical bank

Over the years, many academics (Murdoch, 2015; Perezts, 2015; Koslowski, 2011) have attempted to produce a definition of the term conduct or ethics in banking, with reference to ethical standards devised by ancient philosophers and applied to today's financial world. However, no universal agreement has been achieved on what ethical behaviour in banking or what banking conduct really mean. Even the Banking Standards Board, the Conduct Costs Project Research Foundation (CCPRF) and Reuters in its Culture and Conduct Risk report, fail to provide a clear definition or set of benchmark requirements. Instead, they focus on policy and management guidance.

In addition, in most (if not all) jurisdictions, information on conduct and ethics in finance is significantly dispersed in the current regulatory environment, without a single point of focus in a dedicated legal act, regulation or recommendation[2]. The lack of a harmonised approach or even a basic, agreed definition makes it all the more difficult for markets to implement and value ethical standards.

However, there is a consensus that,

2 The current Polish examples of recommendations containing conduct-related provisions are: i) the Code of Banking Ethics (PBA); ii) Recommendations of the Banking Ethics Committee of the Polish Bank Association (PBA for older customer service (PBA); iii) to a certain extent, Corporate Governance rules for supervised institutions (PFSA). At a European level, conduct-related provisions can also be found in many EU secondary laws, including: i) MIFID; ii) CRR/CRDIV; iii) EMIR; iv) guidelines and standards originating from EU agencies such as EBA and ESMA).

Au fil des ans, de nombreux universitaires ont tenté de définir le terme «conduite» ou «éthique» dans le secteur bancaire, en se référant aux normes éthiques élaborées par les philosophes anciens et en appliquant leur raisonnement au monde financier actuel. Cependant, aucun accord universel n'a été trouvé sur ce que signifie réellement un comportement éthique dans le secteur ou la gestion bancaire. L'absence d'approche harmonisée et même d'une définition de base compliquent d'autant plus la tâche des marchés pour la mise en œuvre, la valorisation et l'exécution de normes éthiques. Cependant, il existe un consensus sur le fait que, en raison de leur rôle social, l'attitude des banques en matière de comportement privilégie les intérêts des clients avant leurs propres profits. Dans cet essai, je propose d'examiner le comportement dans les banques de la façon suivante: à travers le comportement éthique (compris comme faisant ce qu'il convient de faire conformément à ce que Plante (2004) a suggéré) à l'égard de trois groupes distincts de parties prenantes: i) les clients, ii) les employés et iii) les actionnaires.

due to their social role, banks' attitudes to conduct should put the customers' interest before their own profits. There is a rich literature on whether ethical behaviour has a financial impact on banks. Marlene (2015), Halamka & Teply (2017) and Herrera et al. (2016) used econometric tools to analyse differences in financial performance between ethical and standard or non-ethical banks. They came to the same two conclusions.

First, conventional banks show higher profits in the short term, which is aligned with the problem of short termism. However, in the long term this difference from ethical banks becomes smaller. Second, ethical banks tend to be less risky and more stable with ROE volatility lower than their standard peers. Similar conclusions were drawn by Mascu (2010) and Climent (2018) in their case studies on selected banks.

In this essay, I propose the following way of looking at conduct in banks. It is ethical behaviour as understood by doing the right thing towards three distinct groups of stakeholders: clients, employees and shareholders. This is in line with what Plante (2004) suggested.[3]

Step 2: Assessing if a bank is ethical

Since 2015, the UK's Banking Standards Board (BSB) has conducted an annual survey of UK banks[4] to assess awareness and compliance with corporate conduct. The BSB undertakes a general survey of bank employees, qualitative, in-depth analysis of focus groups, and interviews with management and supervisory boards. The aggregated research results are highly publicised in the UK. Many organisations refer to them, including the Financial Conduct Authority (FCA), the Bank of England (BOE) and the UK government.

While the results are not binding for banks and do not require them to take any regulatory actions, I am aware from my own professional experience that they are discussed in detail during bank management meetings. They form the basis for taking internal steps to improve banking processes. In addition, the BSB results initiate analysis, including whether current incentive models for employees are appropriate and whether the institution generally behaves in an ethical manner.

Therefore, drawing on the BSB surveys, I would suggest a wider-ranging assessment of banks' conduct based on three similar tests for the three stakeholder groups that I identified above: clients, employees and shareholders. The principles of the present proposal are universal and should be applicable to any

3 Professor Thomas G. Plante, Stanford University School of Medicine, author of *Do the right thing: Living ethically in an unethical world* (New Harbinger Publications, US, 2004. There is not space in this paper for full analysis of Plante's definition.

4 The public version of the report, containing aggregated results, is published online: https://www.bankingstandardsboard.org.uk/annual-review-2017-2018/. However, the BSB does not disclose data for individual banks participating in the survey.

En se basant sur les enquêtes du Banking Standard Board, je suggérerais de faire une évaluation plus large du comportement des banques basée sur trois tests similaires pour toutes les parties prenantes: i) les clients, ii) les employés et iii) les actionnaires. Le questionnaire évaluerait la culture interne de la banque, ses procédures et sa politique, ses priorités commerciales, l'adéquation des produits et services fournis ainsi que son service à la clientèle. Les coûts de l'enquête seraient pris en charge par les banques participant à l'étude, en respectant le principe de proportionnalité.

country or region. The assessment would take place every six months and would be carried out by the local Financial Supervision Authority (FSA). The questionnaire would grade bank's internal culture, procedures and policies, business priorities, suitability of products and services provided, and customer service[5].

The costs of the survey would be covered by banks participating in the study, subject to the principle of proportionality[6]. The results and the ranking of banks' performance in terms of conduct would be publicly available and all cases of misconduct would have regulatory implications.

In order for banks to be motivated to act ethically, all stakeholders should share a common purpose: bank employees, who respond to their managers, who in turn at the most senior levels respond to their superiors or principals, namely the shareholders. This interpretation of a corporation, where the ultimate purpose is to maximise shareholders' wealth, is known as *shareholder primacy*.

Step 3: Designing the regulatory stimulus

I therefore argue that in order for a regulatory stimulus to be effective in promoting ethical behaviours in banks, the regulations should incentivise the top management via shareholders.

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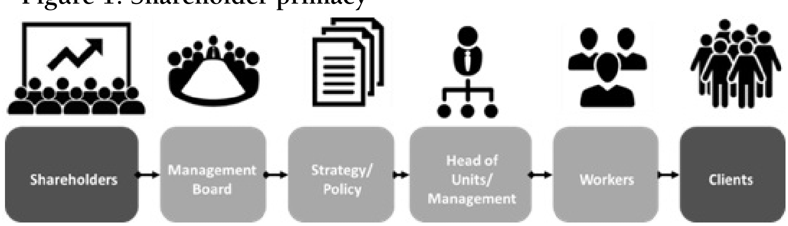
Return on Equity (ROE) is the key indicator for shareholders, as noted by Damodaran (2008), Maverick (2019) and repeatedly by the investor Warren Buffet since 1987. It is considered to be a measure of how effectively management is using the company's assets to generate profits. The ROE consists of profit (numerator) and equity (denominator). The higher the ROE, the more attractive a company is for investors. To obtain a higher ROE, institutions can increase profits or reduce the equity. The detailed breakdown of ROE is provided below.

For banks the equity part is driven by the regulator. In

5 In particular, processing complaints, fair and clear communication with customers, remediation and redress.

6 Options may include the number of customers, size of the bank or share in the market.

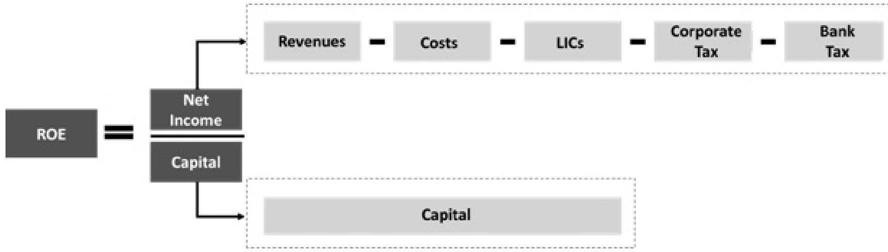
Figure 1. Shareholder primacy



Source: Author's presentation.

Pour que les mesures de stimulation réglementaires soient efficaces à promouvoir un comportement éthique des banques, elles doivent stimuler la direction à travers ses actionnaires. Je soutiens donc que la règlementation devrait d’une certaine façon avoir une incidence sur l’indicateur financier le plus important utilisé par les investisseurs, à savoir le ROE (« Return On Equity » ou rendement des fond propres). Pour obtenir un ROE plus élevé, les institutions peuvent augmenter leurs bénéfices ou réduire leurs fonds propres. Basé sur la décomposition du ROE, deux «endroit » ont été identifiés, qui méritent d’être pris en compte pour l’introduction d’une incitation réglementaire afin de stimuler les comportements éthiques souhaités: i) l’impact réglementaire sur les bénéfices (numérateur) ou ii) le capital (dénominateur du ROE). La revue de la littérature suggère que le changement le plus efficace consisterait à modifier les exigences de fonds propres (réduction), ce qui renforcerait l’incitation dans la mesure où les actionnaires auraient quelque chose à rechercher (des exigences de fonds propres plus faibles entraînent plus de bénéfices à distribuer) plutôt que quelque chose à éviter (prélèvement).

Figure 2. ROE analysis



LICs are Loan Impairment Charges. In Poland, banks also pay bank levies. Source: Author’s presentation.

simplified terms, these are assets or capital that the bank must retain in case a crisis occurs. However, the structure of indebtedness, which is reflected in banking, also includes risk-weighted assets (RWA), which allows a risk weight to be assigned to specific groups of assets. The aim of this indicator is to emphasise that not every bank loan is equally risky. The level of capital required depends on the level of RWA.

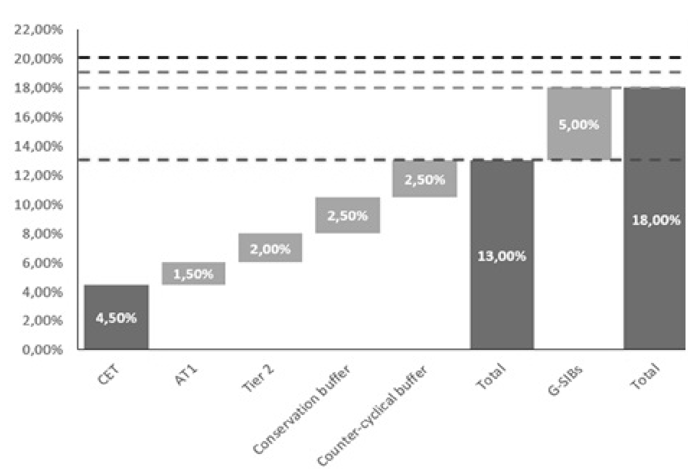
For the largest banks[7], the required capital can be up to 18%. However, for most banks globally, the requirement varies between 12-13%. Some analysts and bankers suggest that current capital requirements are already too high and render business unprofitable. However, research suggests that banks would be able to remain profitable and generate value for shareholders if their combined capital requirements were 18% (International Monetary Fund, 2013), 19% (Bank of England, 2011) or even 20% (Bank of International Settlements, 2010). This indicates that there is room for potential additional capital surcharges on banks.

Based on the ROE breakdown, two “spots” have been identified which are worth considering for the introduction of a regulatory stimulus to drive desired ethical behaviours: either the regulatory impact on profits (numerator), or capital (denominator).

First, I discuss profits. The obvious idea for a regulatory impact would be an additional levy on banks’ profits which depended on the degree to which a bank had acted unethically. However, the disadvantage of this solution is that it would be an inherently negative stimulus. In order for a regulatory impact to be effective, it should not be a punishment, but a reward for banks with a high level of good conduct. Such

7 Defined by the international Financial Stability Board as Globally Systemically Important Banks (G-SIBs).

Figure 3. Capital Requirements – an overview



Lowest line: Requirement for most banks
Third line: Requirement for largest banks at maximum level at which banks would be profitable according to the International Monetary Fund (IMF)
The two top lines: Maximum level at which banks would be profitable according to BOE and Bank of International Settlements (BIS).

Source: Author's presentation.

an approach is supported by Coglianese & Mendelson (2010), who emphasise that effectiveness and compliance with regulations are heavily dependent upon incentives and rewards.

The second area is capital. Here, the suggestion would be a change in capital requirements (reduction) which allows for a more positive stimulus. Such a measure would give shareholders a goal to pursue (lower capital requirements result in more profits for distribution to investors) rather than a penalty to avoid (bank levy).

Step 4. Putting pieces together

Based on the above considerations, I propose that a Capital Conduct Buffer (CCB) tool is introduced. It would be a regulatory solution modelled on the own funds requirements under the EU's Capital Requirements Regulation (CRR) and Capital Requirements Directive IV (CRDIV). An additional capital requirement of 1% of risk-weighted assets (RWA) would be imposed automatically on all banks in a jurisdiction. For the purpose of demonstration, I will focus on Poland as an example but the below are universal and could be applicable in most, if not all countries.

Compte tenu de ce qui précède, je propose l'introduction d'un outil Capital Conduct Buffer. Il s'agirait d'une solution réglementaire élaborée par analogie avec les exigences du fonds propre selon le Capital Requirements Regulation et Capital Requirements Directive. Sur la base d'enquêtes de la BSB (Burgundy School of Business), je suggère une évaluation plus large du comportement des banques basée sur trois tests similaires pour toutes les parties prenantes: i) les clients, ii) les employés et iii) les actionnaires. Puis, à la suite des analyses effectuées et basées sur l'enquête réalisée, selon la qualité de son comportement, la banque pourrait bénéficier d'une diminution ou au contraire subir une augmentation des fonds affectes au Concut Buffer.

Based on BSB surveys, I suggest a broader evaluation of bank behaviour based on three similar tests for all three stakeholder groups: customers, employees and shareholders. The evaluation would be conducted every six months by the local financial supervision authority. The survey would assess a bank's internal culture, procedures and policies, business priorities, the adequacy of products and services, and customer service. As discussed earlier, the cost of the survey would be covered by banks participating in the survey, subject to the principle of proportionality. The results and ranking of banks in terms of conduct would be available to the public, and all cases of misconduct would have legal effects[8].

Based on the survey results regarding the bank's conduct, it could enjoy a reduced additional capital requirement, as a reward for high ethical standards; or suffer an increased requirement, as a penalty for low standards. This solution would enable banks to be ranked in three categories:

1. **Ethical banks**: Institutions with top 10% scores. These institutions would have a reduced CCB value, which would earn them a reward for ethical behaviour.
2. **Conventional banks**: Institutions without any outstandingly ethical behaviour but not pursuing bad practices either. They would not be rewarded for good conduct, but as they do not violate the law, they would not suffer any penalties or costs for misconduct.
3. Unethical banks: Institutions subject to judicial or administrative proceedings, or which have otherwise displayed misconduct. This category would suffer a double penalty. Their CCB score would be increased and, additionally, they would be obliged to pay penalties and be liable to judicial or administrative sanctions.

An incentive designed in this manner would have a significant impact on ROE and would therefore motivate shareholders to put pressure on management to develop strategies that would make banks behave more ethically. While the inspiration for such survey is taken from the UK's BSB, the suggested assessment would feature the following differences:

8 The UK survey is not public, as it is a bottom-up initiative of banks themselves. In the proposed solution, CCB would be a regulatory requirement and would ensure banking sector transparency. It is noteworthy that since 2018 the UK's Financial Conduct Authority (FCA) and Competition and Markets Authority (CMA), have obliged banks under the BCOBS7 regulations to publish Service Quality Indicators and FCA Metrics. These measures disclose the quality and speed of rendering individual services such as issuing or blocking bank cards and drawing down credit facilities. UK banks must also publish the results of survey questions for bank customers in several basic categories: for example, "Would you recommend this bank to your business partners/family members?" Banks must display the results in a visible place at each branch and publish them on their websites.

Je suggère que l'enquête soit élaborée sur la base de consultations de l'industrie (qui devraient inclure dans le cas de la Pologne: les banques polonaises, l'Association des banques polonaises, la Banque centrale polonaise et l'Autorité de surveillance financière polonaise). En raison de la nature de l'institution, je suggère que le responsable de la conception de l'enquête soit le Bureau de la concurrence et de la protection des consommateurs (qui est l'organe le plus proche de la Financial Conduct Authority du Royaume-Uni en Pologne). L'enquête elle-même auprès des banques serait réalisée par l'Association des banques polonaises. Sur la base des résultats de l'enquête, l'Autorité de surveillance financière polonaise déciderait tous les 6 mois d'augmenter ou de réduire le capital minimal requis de 1% sur le capital requis total imposé à une banque.

- It would be carried out once every six months
- The full results would be available to the public i.e. the banks' ranking in terms of conduct
- It would be carried out among both bank employees and customers
- It would have regulatory implications

CCB: How it would work

I suggest that in Poland the survey should be developed following industry consultations with banks, the PBA,[9], the central National Bank of Poland and the PFSA. . The leader of the survey design should be the Polish Competition and Consumer Protection Office (CCPO),[10] the body which most closely compares with the UK's FCA. The survey among banks would be carried out by the PBA. Based on the results of the survey, the PFSA would decide every six months whether to raise or lower the soft capital requirement by one percentage point on the total capital requirement imposed on a bank[11].

Such a procedural design would ensure the cooperation and mutual control of all communities concerned, making the most of experience, knowledge and different perspectives on particular cases. This is important, given the lack of clear guidelines or an agreed, tight definition of conduct.

The choice of the supervision body for the banking market as the ultimate decision-maker is dictated by its knowledge, access to information, competence and mandate to regulate capital requirements. The risk of a non-objective approach and excessive arbitrariness must be noted. However, it should be emphasised that over the years, institutions such as banking supervision authorities, especially in developed countries, have employed highly qualified personnel and displayed strong resistance to external influence, regardless of whether they are a separate institution or integrated with the central bank (Barth et al., 2006). Nonetheless, in order to ensure the maximum level of objectivity, this paper proposes the involvement of the banking industry through the PBA and the CCPO, which, as a separate institution, could balance any potential bias by the PFSA.

9 The PBA already conducts surveys examining the quality of services. However, they are not comprehensive or binding.

10 The CCPO and the Consumer Ombudsman also undertake similar activities in fields such as unfair market practices, as defined by law. However, they are not specialised regulators of the financial market and lack the analytical competence, information resources and financial sector data to detect and prevent banking risks...

11 The author does not propose detailed questions or a design for translating survey results into an increase or a reduction of the requirements. These elements are beyond the scope of this study and would need to be clarified following several months of industry consultations.

One possible objection to the proposed solution is that it provides for the simultaneous introduction of conduct measurement, publication of results and implementation of penalties and rewards. Such a workload would be very difficult for banks to manage in a short period of time. An alternative solution could be to stagger the approach, starting with measuring and publishing the conduct level in banks' reports and statements, with an expectation on investors and customers to respond first.

However, as noted above, the current experience indicates that the market does not measure the level of conduct effectively. I therefore doubt the real impact of the requirement to publish a bank's conduct level on the actual decisions of investors, on the bank's market capitalisation and then on its operations. It is also rare that a bank's customers read its financial statements, so this information would in fact not be visible to them.

CCB would not make banks riskier

The concept of reducing capital requirements based on non-financial features is already discussed in relation to green finance. It was suggested by the European Banking Federation in 2017 and is being considered by the European Commission (2018) and the FCA (2018). Some commentators such as Matikainen (2017), suggest that such a solution might lead to additional risk-taking by banks. I accept Matikainen's point that capital is for loss absorption and that lowering its level to promote specific investments like *green finance* can threaten a bank's financial sustainability. Yet I believe that the CCB approach can avoid this risk.

First, as noted before, empirical studies show that ethical banks – the desired outcome of the CCB - are more financially stable. Second, my proposed surveys would only evaluate ethical behaviour. ,They would not target specific financial activity, such as promoting credit to people or institutions based on purely non-financial features like gender, locations, or types of activities. •

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