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Cultural-Prudential Regulation

Micro and macro have company

Findings:

- **Banking regulators globally are linking firm culture and employee behavior, launching a third wave of regulation that goes beyond macro and micro**
- **Recognizing a connection between culture and conduct, banks are increasingly focusing on cultural initiatives that curb risk and improve performance**
- **Culture is not like capital. There is not a standard template that can be applied across the industry, placing real constraints on regulators**

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Since the Financial Crisis, we have seen three distinct waves of regulatory activity in the financial sector. An initial focus was placed on micro-prudential rules targeting individual institutions, such as setting higher capital standards and liquidity levels. This was followed by an emphasis on macro-prudential tools targeting the financial industry, including guidance on leveraged lending and the countercyclical capital buffer.

With much of Dodd-Frank and Basel implementation now on track, we seem to have entered a third phase, which we will call cultural-prudential (Figure 1). Financial firms are being told that they must ensure that their culture is one that promotes good behavior on the part of their employees. A defining element of this third regulatory wave is that it goes well beyond ensuring that their employees do not engage in bad acts. Rather, the goal is "good compliance, not mere compliance," and Members of Congress appear more than ready to hold regulators accountable for delivering results.

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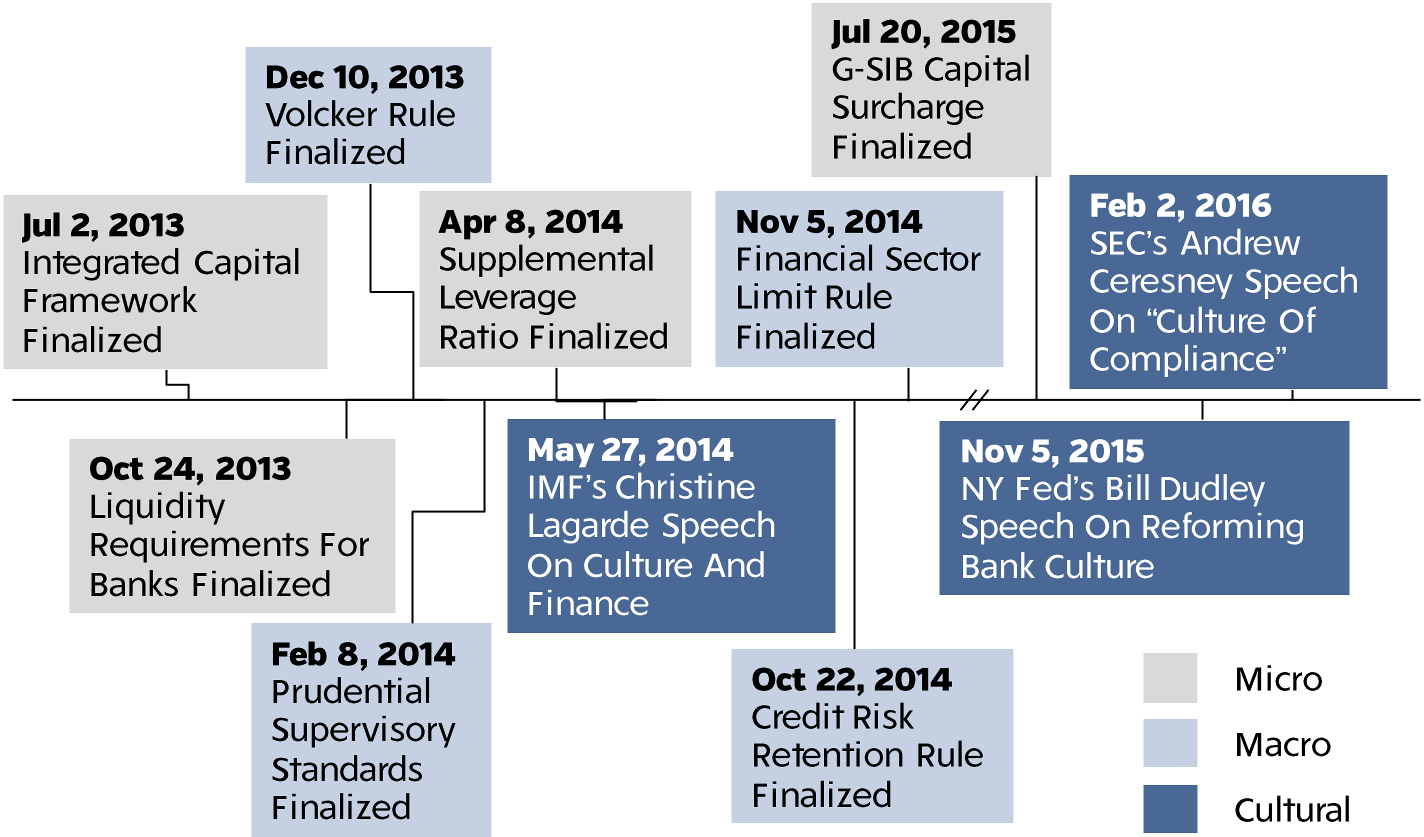
Timeline Of Third Wave

"Context drives conduct," argued New York Fed President Bill Dudley late last year. "Culture relates to the implicit norms that guide behavior in the absence of regulations or compliance rules — and sometimes despite those explicit restraints," he explained. "[It] exists within every firm whether it is recognized or ignored, whether it is nurtured or neglected, and whether it is embraced or disavowed."[1]

Fig. 1: Timeline Of Regulatory Waves



Source: Federal Reserve, IMF, NY Fed, SEC

Regulators across the globe have taken up this line of thinking, and similar arguments have come from Janet Yellen at the Fed, SEC enforcement director Andrew Ceresney, FINRA chief Richard Ketchum, IMF Managing Director Christine Lagarde, and Bank of England Chair Mark Carney.

Macro And Micro Versus Cultural-Prudential Regulation

Culture is not a new concept in business. Countless academic research papers and management books endorse the value of a strong company culture, and data suggests that companies with a "high-trust culture" outperform peers.

Companies with good internal trust dynamics are able to act more nimbly; permit

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more effective, decentralized decision-making; foster greater knowledge sharing, collaboration, and innovation; and promote greater cohesion around a shared purpose pursued through common values and without rules-driven management.

Bank leaders themselves recognized the relationship between culture and conduct prior to the Financial Crisis, but recent trends highlight a ramped-up focus on this dynamic. Eleven of the 16 largest banks defined conduct risk in their 2014 annual reports. For instance, as Risk.net recently observed, "Barclays did not mention conduct risk in its 2011 annual report ... but in 2014, the term was mentioned 97 times." Further, at least 11 of the 16 banks were found to have board or senior-level committees with a mandate that includes conduct. JPMorgan launched a culture and conduct risk program for EMEA in 2014. Efforts such as these, with the aim to "operationalize" culture, are clearly driven by more than just optics or regulatory concern.[2]

However, cultural-prudential regulation is not like macro or micro. The central challenge to cultural-prudential regulation is the lack of acceptable metrics, derived from credible data. There is no cultural capital ratio. One cannot easily stress test culture or compare one institution to another at the end of each quarter. In such an absence, success today appears to be defined in the negative: firms with few infractions of laws and norms may be presumed to have good cultures. Yet, this conclusion isn't so straightforward, as the lack of a symptom doesn't confirm the lack of a disease.

According to Risk.net, the U.K.'s Financial Conduct Authority would rather not define conduct risk. "Conduct risks are idiosyncratic," says an FCA spokesperson. "It will always turn on the circumstances of a firm, their operations, and activities. Firms need to make a judgement about the conduct risks they face and how they might mitigate these."[3]

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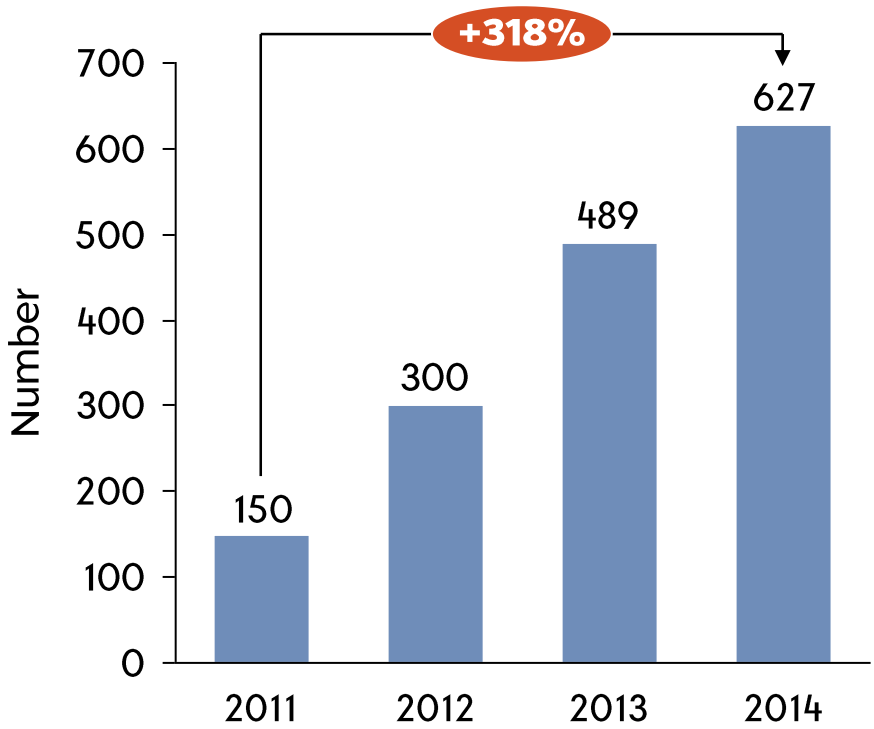
Fig. 2: Mentions Of Culture In Bank Annual Reports Among 16 Major Banks



Source: Risk.net

At the same time, institutions can benefit from measuring their culture strategy so they can understand developments at their companies and explain their progress to stakeholders. New technologies, including data analytics, help to measure culture in a practical and applied context, targeted to the specific circumstances of individual firms. But applying one measure across institutions without understanding that context could be useless at best, and misleading at worst. Markets value risk-weighted capital requirements for similar reasons.

Culture Versus Compliance

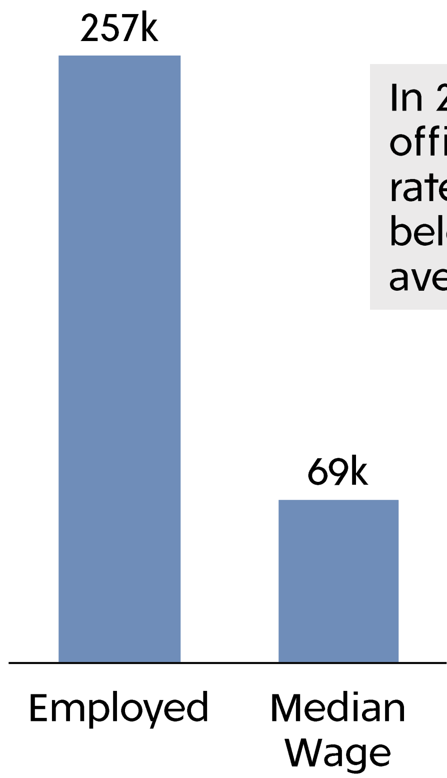
Increases in micro- and macro-prudential regulation have resulted in a spending binge for compliance officers. Notably, JPMorgan has had to add 8,000 compliance jobs since the crisis. Those holding such jobs also saw significant pay increases and greater scope as regulators demanded more independence from business operations. However, in recent months, fears of legal consequences, including personal liability, for compliance failures are on the rise (Figure 3).[4]

Cultural management may, in fact, be a more desirable approach as compared to the compliance needs of the current regulatory environment. And if cultural management can solve problems of risk management, then heavy investment in compliance may not be as necessary in the future. Recent regulatory commentary suggests two broad views on compliance vs. culture. One view emphasizes a top-down approach, the other one from the bottom-up.

SEC enforcement director Andrew Ceresney has persistently urged firms to work toward a "culture of compliance." Ceresney posits compliance officers as the Commission's de facto agents within companies, counting on them to serve as "good partners," and sanctioning them personally should they fail. In this context, "culture" is seen as being imposed from the outside-in.[5]

This sits in stark contrast to the views emphasized by the NY Fed. While Dudley considers culture in banking to be "a possible source of systemic risk," he recognizes that, "the solution needs to originate from within the firms." His approach is less concerned with the behavior of a few "bad apples" – which will always be a concern – but more on the "quality of the barrel" itself. The NY Fed sees culture as essentially an "internal" matter, operating from the inside-out.[6]

Fig. 3: Compliance Officers By The Numbers



In 2014, compliance officer unemployment rate was 1.5 percent below that of national average

Source: DOL

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The Politics of Regulation

Whether emphasizing a top-down or bottom-up approach to culture prudence, regulators are not immune to politics and, indeed, political pressures may dictate which of these two approaches is emphasized going forward. From grillings at hearings to public shamings, politicians apply pressure on regulators in an attempt to bend to their will and to shape the regulatory landscape. Regulators are called before Congress to answer questions – including ones concerned with culture – and they will continue to focus on this issue.

For Sen. Elizabeth Warren (D-MA), it is now business-as-usual to release a report denigrating an agency, a letter questioning the resolve of a particular regulator, or even to hold agency nominations hostage to her views. Clearly, financial institutions must engage with regulators on their own approach to improving their firm's culture.

Legislators and regulators should understand the limits of this third phase of regulation. Culture is not like capital. It cannot be assessed industry-wide with a broad brush stroke, nor standardized to apply across different businesses. At the same time, culture represents a critical business interest, and is a top priority for virtually all senior leaders in banking and finance. Fortunately, technology companies in the so-called “RegTech” space are bringing to market new tools that address the relationship between culture, behavior, risk, and performance, and are doing so in way that is data driven and unique to each firm. This is a welcome development, allowing financial services firms to become quantitative and proactive as they undertake culture-initiatives aimed at reducing risk and boosting performance.

Citations

1 Bill Dudley, “Opening Remarks at Reforming Culture and Behavior in the Financial Services Industry: Workshop on Progress and Challenges,” New York Federal Reserve, 11/5/2015.

2 Paige Long, “UK Banks Take Lead In Tackling Conduct Risk,” Risk.net, 1/26/16.

3 Paige Long, “Banks Take Various Approaches To Tackling Conduct Risk,” Risk.net, 2/23/16.

4 Emily Glazer, “The Most Thankless Job on Wall Street Gets a New Worry,” WSJ, 2/11/16.

5 Andrew Ceresney, “Keynote Address,” National Society Of Compliance Professional, 11/4/15.

6 Ibid.

About Us

Hamilton Place Strategies is a consulting firm founded on the philosophy that a better understanding of business and economics leads to more effective communications and ultimately better outcomes for the global economy and its participants.

Starling is a predictive behavior analytics company. Its tools produce data-driven and actionable insights into employee behaviors, allowing customers to work proactively to mitigate conduct risk and to optimize organizational performance.