APRIL 2020

Culture & Conduct Risk in the Banking Sector

Why it matters and what regulators are doing to address it

starling

Our social connections are greater than the current need for social distancing. Amidst the COVID-crisis, we wish our readers good health and the comfort of knowing that we're all in this—together.

ABOUT STARLING

A globally-recognized RegTech pioneer, Starling is an applied behavioral sciences company that helps customers to create, preserve, and restore value. Combining machine learning and network science, Starling's Predictive Behavioral Analytics platform allows managers to anticipate, and to shape, the behavior of employees and teams. Starling reveals how relational trust dynamics within an organization impact business performance—predictably. Its proprietary algorithms generate actionable insights that allow leaders to optimize performance and to identify and mitigate culture and conduct risks before they cascade into crises. Starling enables management by foresight.

AUTHORS

Stephen Scott is the Founder & CEO of Starling. A risk management expert, he has led successful engagements in over 50 countries and has lived and worked in New York, Washington, London, Frankfurt, Madrid and Shanghai. Stephen served as the lead international investigator for a US Senate inquiry into espionage and corruption during the 1996 Presidential election. He later led a forensic inquiry into the collapse of the largest banking group in a Caribbean nation, amidst a multi-billion dollar corruption scandal, as a condition of that nation's continued receipt of IMF support. Later, he built and led the China operations of the restructuring firm that wound down Lehman Brothers, Alvarez & Marsal. Stephen holds degrees from Cornell University, the London School of Economics, and a dual-MBA degree from Columbia and the London Business School.

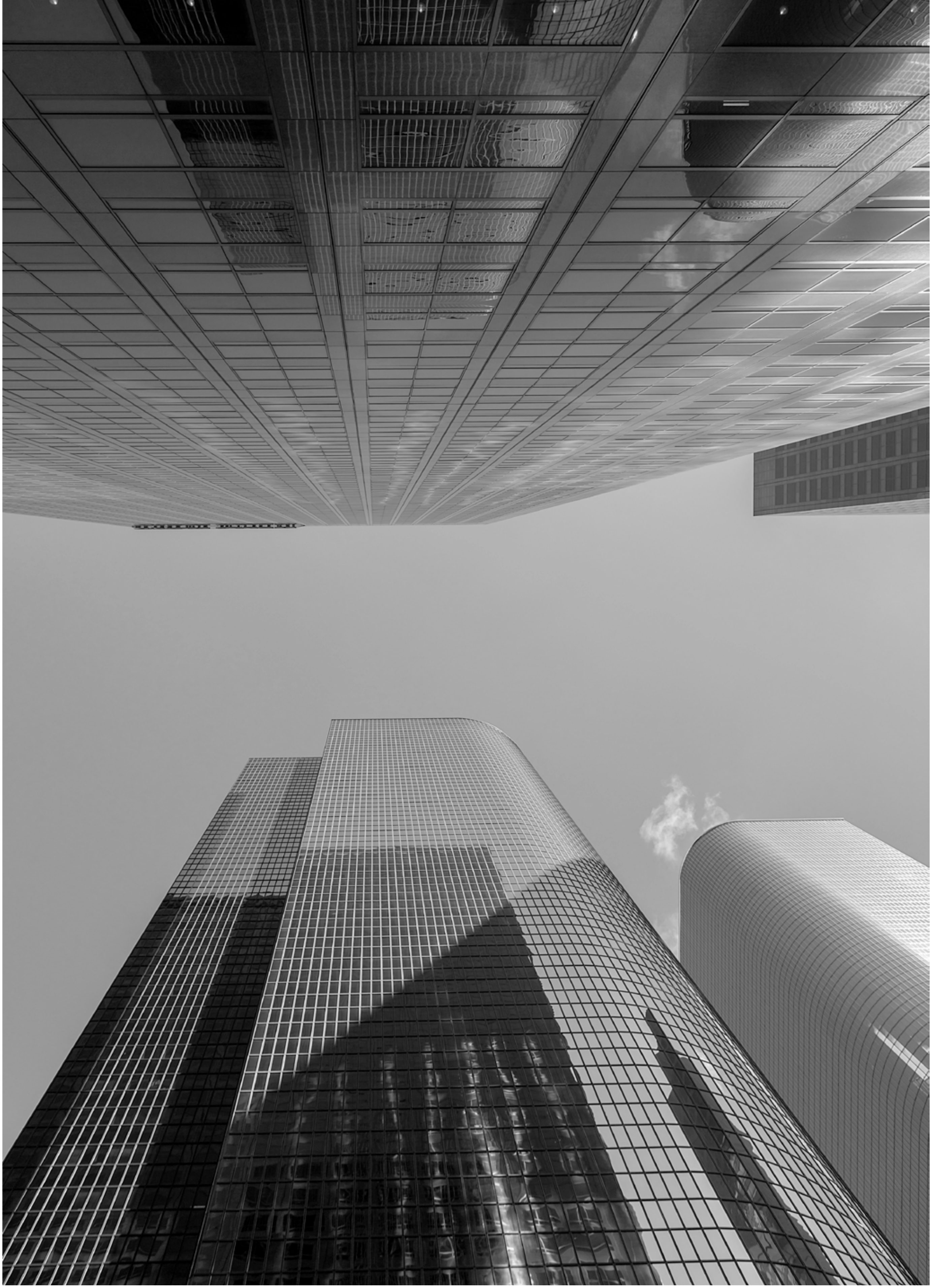
Grigory McKain is Principal Researcher with Starling. A lawyer by training, "Grisha" is a Research Associate at the University of Cambridge Centre for Alternative Finance where he looks at industry and public sector applications of financial, regulatory and supervisory technology, as well as Open Finance initiatives. Grisha is the co-author of a course in 'FinTech and Regulatory Innovation' for Central Bank and Securities Regulators, in which he tutors a module in Payments and Open Banking. He previously worked in legal and compliance at two financial technology firms in London and prior to this obtained his Honours degree in Law, specializing in International Private Law, from the University of Edinburgh.

Klien Hilliard is Research Associate with Starling. Klien was awarded her J.D. from the Seattle University School of Law, where she served as the Executive Editor of Lead Articles for the *Seattle University Law Review*.

Stephen Leacock is the award-winning graphic designer and illustrator who has handled the layout and design of Starling's *Compendium* since its inception, and shaped it in to the enjoyable and easy-to-use reference that it has become. Learn more about him at leacockdesign.com.

Our thanks go also to co-authors of past issues of this annual report, **Jeff Kupfer** and **Anne Chiou**. Without their early efforts, counsel and friendship, this series of reports would not have become what it is.

To learn more about Starling, please visit us at *www.starlingtrust.com*.



Our Advisors

RISK & GOVERNANCE ADVISORS

GARY COHN

Gary Cohn served in the White House as Director of the National Economic Council from 2017-18, managing the US economic policy and regulatory reform agenda. Before his time in government, he was President and Chief Operating Officer of Goldman Sachs.

"We need reliable forward-looking metrics for non-financial risk governance and accountability, allowing for more meaningful horizontal reviews. That capability becomes all the more important in light of the current pandemic, which has dislocated our workforce, made the future of work less clear, and which makes misconduct within firms all the more damaging."

SIEW KAI CHOY

Siew Kai Choy was a Managing Director at Singapore's sovereign wealth fund (GIC) where he was Director of the Data & Analytics Department, Head of Governance and IT in the Public Markets Group, and founder of GIC Innovation Labs.

"Regtech firms have demonstrated that it is possible to distill signal from standard company data sets that tie to critical company performance outcomes – including risk and governance related outcomes that are of key concern to boards, shareholders, and supervisors. This is sure to be of interest to anyone looking to better address the issues outlined in this report."

MARK COOKE

Mark Cooke joined HSBC in 2014 serving as Group Head of Operational Risk, before taking a sabbatical in 2020. He is also the Chairman of ORX, the financial services industry association for Operational Risk Management.

"An over-reliance on surveillance & monitoring systems and systems of record across the Three Lines of Defense has not resulted in desired nonfinancial risk management outcomes. It is clear that new approaches are needed, and this makes Starling's annual Compendium a must read for operational risk managers – in financial services or any sector struggling with behavioral risk."

ACADEMIC & SCIENCE ADVISORS

JOHN SEELY BROWN

"JSB" was Chief Scientist at Xerox and director of its renowned Palo Alto Research Center (PARC). He has served on many public and private boards, to include those at Amazon, In-Q-Tel, and the MacArthur Foundation. JSB has published over a hundred scientific papers, nine books, and holds 11 honorary degrees.

"Invisible networks of social ties within organizations facilitate the flow of critical but intangible dynamics, like trust, identity, and social capital. These dynamics shape how we think, what we believe, and how we behave. By making such forces visible and actionable, we may begin to work proactively to mitigate behavioral risks and to optimize organizational performance."

KAREN COOK

Karen Cook is the Ray Lyman Wilbur Professor of Sociology at Stanford University, where she directs the Institute for Research in the Social Sciences and researches social networks and trust. For the Russell Sage Foundation Trust Series, she edited *Trust in Society* and *Trust and Distrust in Organizations*.

"The move away from hierarchical forms of authority to more horizontal and networked ways of managing businesses makes trust ever more central to their success. The trust of clients or customers is rarely seen when trust is lacking internally. And because internal trust dynamics shape performance outcomes materially, they warrant management tools and attention."

NICHOLAS A. CHRISTAKIS

Nicholas A. Christakis is the Sterling Professor of Social and Natural Science at Yale University, where he directs the Human Nature Lab and Co-Directs the Yale Institute for Network Science. He is widely known for his research in social networks and public health, and is author of Blueprint: The Evolutionary Origins of a Good Society.

"People are connected, and so their behaviors are connected. This fundamental fact has tremendous relevance for diverse management challenges, as both good and bad behaviors spread contagion-like within and between organizations. Combining these ideas with the right data sets, computational social science tools allow us to forecast 'epidemics of behavior.'

THOMAS MALONE

Thomas Malone is the Patrick J. McGovern Professor of Management at the MIT Sloan School, founding director of its Center for Collective Intelligence, and founding co-director of the MIT Initiative on "Inventing the Organizations of the 21st Century." The acclaimed Superminds summarizes decades of his essential research.

"What I call 'superminds' are very powerful in shaping the cultures of firms. A kind of collective intelligence, they go unrecognized in most management circles. But superminds not only exist, they are observable and measurable, which implies that they may also be managed meaningfully. This may be of particular value in the culture and conduct risk management context."

SENIOR REGULATORY ADVISORS

THOMAS CURRY

Thomas Curry was US Comptroller of the Currency. As Comptroller, he also served as ex-officio member of the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) and the Financial Stability Oversight Council.

"Managing the operational risk associated with culture and conduct remains an ongoing area of concern to bank management and their supervisors. For both constituencies, Starling's *Compendium* is a valuable resource, offering ideas and capturing emerging best practices for those working to better assess and mitigate such risks."

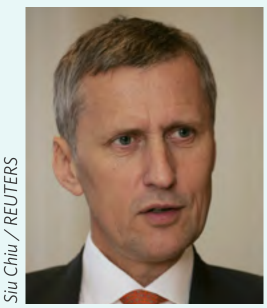
RICHARD KETCHUM

Brendan McDermid / REUTERS

Richard Ketchum served as Chairman & CEO of FINRA, CEO of NYSE Regulation, Chief Regulatory Officer of the NYSE, President at both the NASDAQ and NASD, and Director of the Division of Market Regulation at the SEC.

"The emphasis a firm's leadership places on measuring compliance with their proclaimed cultural values tells you a lot about whether they're committed to assuring that employee behavioral norms are consistent with the proverbial tone-from-the-top. Starling's Compendium outlines good guidance for those seeking to move beyond mere window-dressing."

MARTIN WHEATLEY



Siu Chiu / REUTERS

Martin Wheatley helped to form the Financial Conduct Authority and served as its inaugural CEO. The FCA is the principal conduct regulator the UK's financial sector. Earlier, he served as CEO of the Hong Kong Securities & Futures Commission.

"It is clear from numerous scandals in the financial services sector that mere compliance with a rule book is not enough, and that good outcomes will only be seen if there is a fundamental change of mindset among firms – and not just a few well-meaning speeches from the CEO. As an industry reference, Starling's Compendium advances that change of mindset usefully."

CONTRIBUTORS

In the production of this annual *Compendium*, we strive to curate and present information without imposing our own views of such—except in those sections cleverly entitled, **Our View**. This year's report has three such segments, contributed by our esteemed advisors.

Our thanks go to:

Siew Kai Choy, former MD at Singapore's sovereign wealth fund (GIC), where he was Director of the Enterprise Data & Analytics Department and founder of GIC Innovation Labs. ▸ **PG. 30**

Thomas J. Curry, past head of the US OCC; **Gary Cohn**; former Director of the US National Economic Council and President/COO of Goldman Sachs, and **Martin Wheatley**, founding CEO of the UK FCA and past head of the Hong Kong SFC. ▸ **PG. 116**

Thomas W. Malone, Patrick J. McGovern Professor of Management at the MIT Sloan School of Management and founding director of the MIT Center for Collective Intelligence. ▸ **PG. 40**

Despite best efforts to be neutral observers and reporters, bias will inevitably intrude in any such reporting exercise, if only in the choices we make about what to include and exclude from this report. We seek to mitigate that bias by inviting input from those whose opinions we seek to convey, and this we do in two ways:

- first, by forwarding a questionnaire ▸ **PG. 125** to relevant figures in all major global financial centers, to better assure that we capture their views as fully and accurately as possible; and
- second, by inviting their specific remarks, appearing throughout the report, and more fulsome contributed commentary, some of which appears in several **In Focus** segments herein.

We were delighted to receive comprehensive survey responses and other commentary from the UK Financial Conduct Authority, the Hong Kong Monetary Authority, the Monetary Authority of Singapore, the European Banking Authority, and the Dubai Financial Services Authority, among others. Their contributions are captured throughout this report, greatly enriching it. We are grateful to them for taking the time to share their thoughts and perspectives. Particular thanks go to:

- **Dr. Dirk Haubrich**, European Banking Authority Head of Conduct ▸ **PG. 47**
- **Ravi Menon**, Managing Director of the Monetary Authority of Singapore ▸ **PG. 76**
- **Peter Smith**, Head of Policy & Strategy at the Dubai Financial Services Authority ▸ **PG. 104**
- **Christopher Woolard**, CEO of the UK Financial Conduct Authority ▸ **PG. 62**

Lastly, our special thanks go to those who took the added time to provide us with detailed remarks appearing in this year's **In Focus** segments:

Mark Cooke, Chairman of the UK-based Operational Risk Exchange (ORX), a global association of Chief Operational Risk Officers, and an advisor to Starling ▸ PG. 38

James Hennessy, Senior Vice President and director of the New York Federal Reserve Bank's Culture Initiative ▸ PG. 89

Marion Kelly, Chief Executive Officer of the Irish Banking Culture Board ▸ PG. 51

Shee Tse Koon, Country Head of DBS Singapore & Chairman of the Association of Banks in Singapore's Culture and Conduct Steering Group ▸ PG. 79

Greg Medcraft, Director of the Directorate for Financial and Enterprise Affairs of the OECD and former Chairman of the Australian Securities & Investment Commission ▸ PG. 28

Wijnand Nuijts, Head of Department, Expert Centre for Governance, Behaviour and Culture at *De Nederlandsche Bank* ▸ PG. 15

Cris Parker, Director of the Australian Banking & Finance Oath ▸ PG. 100

Samuel Tsien, Group CEO of OCBC & Association of Banks in Singapore Chairman ▸ PG. 79

Simon Wills, Executive Director of the Operational Risk Exchange (ORX) ▸ PG. 38

We hope that this 2020 update to our annual *Compendium* will help to prompt further informed discussion among banking industry executives and their regulators regarding: the role that culture plays in driving misconduct risk; how such risks are to be better managed, supervised, and mitigated; how we might come to benefit by leading indicators of such risks through the use of data technologies; and how employee conduct may be managed proactively to drive desired performance outcomes.

As always, we welcome any questions, comments, or criticisms, along with suggestions as to how we may improve next year's report. Please reach us at info@starlingtrust.com.

Key Takeaways

1 CEO turnover – Misconduct was a principal driver of CEO turnover in the last year, which saw far higher than usual CEO churn. The banking sector saw the resignation or removal of CEOs at Westpac and NAB in Australia, HSBC in the UK, Credit Suisse in Europe, and Wells Fargo in the US; all firms that had suffered from prominent misconduct challenges.

2 Personal liability – The last year has seen a continued emphasis on individual accountability and personal liability schemes, often modelled on the UK's Senior Managers & Certification Regime. In the US, the OCC assessed ex-Wells Fargo senior executives with multimillion-dollar fines in one of the most pronounced examples of personal liability seen to date.

3 Culture supervision – For regulators emphasizing the importance of culture, attention over the last year has focused on how supervisory attention to culture and conduct risk is best operationalized, and how financial institutions are expected to better audit such risks and to evidence their success in related risk management and culture reform efforts.

4 Cross-border collaboration – Structured cross-border regulatory collaboration has continued to expand significantly. The Global Financial Innovation Network, for instance, grew from a few dozen to over 50 participating entities. Regulators prioritizing culture and conduct risk supervision are actively sharing lessons-learned and seeking to benefit by one another's experiences.

5 Behavioral science – Principal global regulators are turning to behavioral science to discover how culture drives propensities towards misconduct, and what it may teach us about how best to drive good culture, good conduct, improved firm performance, and beneficial customer outcomes. A concern for company "purpose" is an increasingly prominent element in this context.

6 Anticipating outcomes – Regulatory efforts around culture and conduct risk have become grounded in an overt concern for customer outcomes, which has been at the fore in much public commentary regarding related supervisory priorities and initiatives. With this, we have seen greater emphasis on the need for leading indicators of harm that permit for proactive interventions.

7 Standardized metrics – An increased focus on anticipating customer outcomes, and a desire for leading indicators of potential harm, have prompted some to work towards developing a standard set of relevant risk metrics to help overcome the "If you can't measure it, you can't manage it" problem. The default argument that culture can't be measured is no longer accepted.

8 New technologies – In key markets worldwide, regulators are deeply engaged in an effort to upgrade their data collection capabilities and their ability to extract value from such data. Many are actively engaging with the fast evolving RegTech and SupTech ecosystems in this regard—some with a view to bringing greater scale, timeliness, and efficiency to their supervisory capabilities.

9 ESG mandates – A focus on 'stakeholder capitalism' in the last year reflects and helps drive a growing emphasis on ESG interests among institutional investors. Concern for good governance and beneficial social outcomes has become especially prominent amidst the Coronavirus pandemic, making the potential for misconduct scandals in over-stressed financial systems a heightened risk for firms.

10 Social Capital – In the last year, politics and public policy debates in most major world markets have featured social divides and us-them antagonisms. The COVID-19 crisis demands that we rebuild depleted stores of 'social capital' and work together to craft mutually beneficial solutions. Going forward, there will be very low tolerance of firms that engage in misconduct and cause social harm.

Contents

A Behavioral Approach to Bank Supervision: the experience of *De Nederlandsche Bank*

by **WIJNAND NUIJTS**
Head of Department, Expert Centre for Governance, Behaviour and Culture

Wijnand Nuijts

It is an honor to contribute to Starling's annual *Compendium*, which has—over the years—played an influential role in the emerging field of behavior and culture. With this Preamble, I hope to start where last year's report left off. In the last section thereof, it was suggested that future progress in the field of behavior and culture would relate to:

- the *operationalization* of the supervision of behavior and culture; and
- the development of *"the ability to act on 'lead indicators' rather than the current reliance on 'lag indicators' where firm culture may lead to conduct challenges"*.

In this Preamble, I would like to discuss related implications for supervisors and firms. I will do so by roughly sketching the development of *De Nederlandsche Bank's* (DNB) approach to behavior and culture since its inception in 2010—ten years ago now.

In the first years, DNB's supervision of behavior and culture focused on the examination of top echelon behavior, examining matters such as board effectiveness and strategic decision making. This focus was deliberate, as management and psychological research clearly demonstrate that executive decision making, as well as top managers' behavior, impact a firm's financial performance and integrity. In nearly 100 examinations, we learnt how to identify a variety of important leadership styles and behavioral patterns, like group-think or the quality of debate and challenge. While we did not rate culture or seek to qualify it as either good or bad, we did address whether behaviors contributed to or impeded a firm's soundness or integrity based on specific context. We also learnt how to report our findings to executive teams constructively and how to encourage them to work on behavioral change. We experienced that, generally, executive teams and firms are willing to follow up on such findings.

After a couple of years, we added two extra perspectives to our work. First, we expanded our behavioral approach to consider areas like organizational transformation, risk culture, and ethical conduct. This was because i) we learnt that a focus on executive functioning leaves many organization-wide issues out of scope, and ii) international developments had called for extra attention to these topics.

Our involvement in such supervisory matters grew out of our experience that behavioral patterns often 'act' as root causes of supervisory issues.

Secondly, we had become increasingly involved in solving the central problem of financial supervision in general: how to ensure that firms solve problems relating to capital, liquidity, risk management, and ethical conduct *sustainably*. Supervisors experience that such problems are often recurring and persistent. Despite their good intentions and best efforts, firms have difficulty making desired changes 'stick'—and certainly so when it comes to changing day-to-day behaviors on an organization-wide scale.

Our experience is that behavioral patterns often 'act' as root causes of supervisory issues. These root causes may involve organizational structure and organizational culture. Both are known to impact behavior; they act in concert and often mutually influence each other.

Hence, to change behavior sustainably—or, in other words, to *operationalize* behavior and culture supervision—firms must start to understand the conglomerate of factors that collectively determine performance. Based on this comprehensive understanding, firms may design intelligent change strategies that address underlying performance drivers through a variety of interventions. In so doing, it is vital that firms roll out their plans incrementally, constantly monitoring progress and learning from prior experiences.

It goes without saying that this is easier said than done.

First, because knowledge and expertise of behavioral science is not abundantly available within most financial institutions and/or is rarely combined with more traditional financial disciplines so as to undertake the aforementioned comprehensive analysis with the necessary rigor. And second, because 21st century transformations imply that firms *"are entering into new territories where traditional organizational models or transformation approaches may not be valid."*[1] No adequate road maps or blueprints exist to guide firms that assure transformational success.

This is where new digital strategies may come in to help (large) organizations in their transformation efforts. Although I am a strong believer in qualitative research into behavior and culture (through interviews and observations, etc.), organizations are simply too large and too complex to allow us to grasp behavioral patterns efficiently on an organization-wide scale. Digital tools may help to identify these patterns, however, and to monitor potential changes in behavior at scale. This should, of course, be done in an anonymous manner so as to prevent privacy issues. Moreover, digital efforts may complement qualitative efforts and the two may reinforce one another: for example, by directing us to organize qualitative deep dives into patterns that had been identified through initial digital research. The next years will undoubtedly spur further development in this area.

Organizational transformations pose new challenges for supervisors; how can a supervisor monitor a transformational change process given inherent uncertainties about the processes that are to be followed and outcomes to be delivered?

Over the last couple of years, we have experienced that supervisors can play an instrumental role, even in the face of these uncertainties. First, by encouraging firms to explore deeply and to think through the nature and extent of the changes and challenges their organizations confront. This helps to ensure that firms design transformation plans to match these challenges and helps to facilitate subsequent results monitoring as managers take action.

Second, supervisors can help by pointing to established concepts from the social sciences that help to explain the circumstances under which people are most receptive to changing their behavior willingly. There are certainly more intervention options available to us than just the proverbial carrot and stick (promotions and financial incentives vs. rules and penalties). Using these other behavioral options has enabled us to encourage and monitor firms without "advising," and to give direction without "prescribing." This approach leaves our supervisory role intact while leaving responsibility for action with the firm.

The DNB will continue to develop its behavioral supervisory methodologies. As explained above, behavior and culture supervision is aimed at identifying behavioral root causes of supervisory problems. As such, it is forward-looking and preventive in nature and many of our behaviorally oriented indicators (either qualitative or quantitative) can be perceived as lead indicators for such problems.

In addition, we are currently attempting to develop lead indicators that are predictive of the behaviors themselves. These indicators may further enhance the forward-looking capabilities of supervision.

Such indicators may be based on research from the social sciences and may refer to top echelon behavior as well as cultural conditions within the organization more broadly. We are convinced that the value of such indicators will be enhanced if developed with input from other supervisors and industry participants. And we are certain that digital technologies can contribute to the value of these indicators, by contributing broader coverage and deeper analysis of an institution, thus enhancing the availability of insightful data.

Finally, the combination of data-driven metrics and more qualitative approaches may contribute to trust. On the one hand, data-driven tools may contribute to the early detection (and hence prevention) of ineffective or harmful behavioral patterns. On the other hand, qualitative approaches may contribute to constructive engagement between supervisors and firms. Our experience is that financial institutions feel encouraged when supervisors appear interested in their actions and motives and when we abstain from immediate judgment when it is not clear upfront whether a firm will be successful in its culture and conduct management efforts. Trust can be a powerful energizer for firms.

Greg Medcraft opened Starling's *Compendium* last year in a similar vein, with an acknowledgement of the vital role that trust has played in business and in society as a whole—a role which it will undoubtedly continue to play in the future.

Charlie Bibby, © Financial Times Ltd.

Introduction

In the production of this annual report, we seek to remain neutral chroniclers of events that have transpired over the last year, curating and collating information from around the world regarding a regulatory and supervisory reform agenda that addresses culture and conduct related risks in the financial sector. We work to identify emerging consensus views and key points of departure, and we endeavor to establish a platform across which industry participants may address one another usefully. We also try to look ahead and to offer suggestions as to what we are likely to see in the coming year—not aiming to "predict" the future per se, so much as to feel along its edges in an attempt to trace the shape of it.

Among the Key Takeaways featured in our 2019 *Compendium*, we listed the expectation that we would see increased attention to culture as a key driver of behavior within firms. Against a backdrop of proliferating individual accountability regimes, we anticipated attention would shift from whether culture was a proper management and supervisory concern to how we may best operationalize culture and conduct risk governance and supervision. We argued that behavioral science would play a growing role in this context. We felt that a trend towards greater knowledge-sharing and coordination among regulators worldwide would expand. An emerging ecosystem of regulators, financial institutions, and technologists was expected to explore emerging 'regtech' tools more closely. We observed that the culture and conduct reform dialogue had come to embrace broader social interests that fall more typically under the ESG agenda—gender parity being one such. We noted that firms were struggling to evidence their success in mitigating culture and conduct risks and we argued that this may result in calls for agreed industry-standard metrics—both for internal governance purposes and to report up to regulators and other interested stakeholders. We got a lot of that right.

But nothing would have allowed us to anticipate the circumstances under which we write this year's report. The pages that follow detail how the trends we listed in our 2019 *Compendium* have played out over the last 12-months—and there is much to report in that regard. As we write, however, the world is gripped by the COVID-19 global health crisis and all of its attendant economic consequences. This forces us to "zoom out" to encompass Big Picture trends before "zooming in" to consider the past year's detail with adequate perspective.

So, permit us to zoom out a bit...

Contagion and Community

It has become an unfortunate and trite truism that these are 'unprecedented times.' Henry Kissinger lent that phrase some appropriate gravitas recently, when he wrote that the COVID-19 crisis recalls to mind his time with the 84th Infantry Division at the Battle of the Bulge. "Now, as in late 1944," Kissinger intoned, "there is a sense of inchoate danger, aimed not at any particular person, but striking randomly and with devastation."[2]

For those whose memories may not stretch as far back as Dr. Kissinger's, the present Coronavirus crisis may call to mind more recent dislocations: 9-11 and the Financial Crisis. After the attacks of September 11th, 2001, we were forced to conclude that "over there" was "over here"—and that there is no retreating from the world. This inspired a pervasive sense of vulnerability and the concomitant priority of increased vigilance regarding "them."[3] It was against this backdrop that the events of the Financial Crisis played out. Not yet a decade after 9-11, in 2008 we were made sharply aware that everything everywhere touches everything everywhere. 'Globalization' meant that vague and impersonal economic 'contagion effects' triggered deeply personal and lasting economic consequences. This, in turn, has shaped much of our current political tenor.

"Many still feel that banks first caused the crisis and then benefited at the taxpayer's expense," Gary Cohn, Tom Curry, and Martin Wheatley remind herein. **OUR VIEW ▸ P. 116**. Whether this sentiment is fair is immaterial: it is a pervasive *political reality*. The lingering anger[4] that followed the Crisis mandated a subsequent inquiry into banking sector culture and raised questions as to why it appears to cause persistent social harm. Public anger towards banks has since grown, stoked to a higher temperature by a steady series of misconduct scandals that have taken place in every major global market.

The COVID-crisis exploded amidst this 'background radiation' of vulnerability, fear, and anger. Mental health experts warn that fallout from the pandemic may entail post-traumatic stress disorder (PTSD) on a scale that is hard to calculate. "This is a mass community disaster," one said, "But it is also a little bit like terrorism in that the fear component is there, ongoing fear."[5]

A sense that the virus is invisible and everywhere adds to our anxieties. As Bill Gates recently remarked, "We can't defeat an enemy if we don't know where it is."[6] In 1944, the enemy was "over there;" in 2001, the enemy was "over here;" and in 2008, the enemy was "among us." Today, the worrying implication unavoidably embedded in the imperative of social distancing is: "the enemy might be *you*."

Too harsh? The evidence abounds. For years, pollsters and others have tracked a persistent erosion of trust in our core social institutions: government, the media, business, bankers, etc.[7] But now the World Economic Forum sees a "a deepening distrust in each other – not just in institutions – with growing tribalism and intolerance of those with different beliefs and backgrounds."[8] Democracy itself appears to be in retreat across the globe, Freedom House laments.[9]

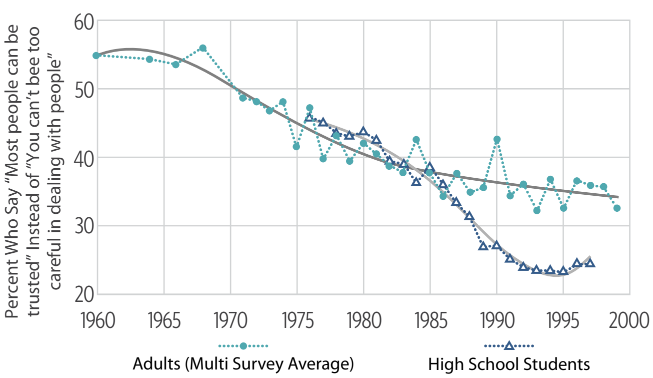
Protest movements worldwide in the last year were fueled by this miasma of distrust, vulnerability, and fear. And while such civil unrest may suggest a

Seth Herald / REUTERS

Danish Siddiqui / REUTERS

Scott Heppell / AP Photo

1. Four decades of dwindling trust: Adults and teenagers 1960-1999



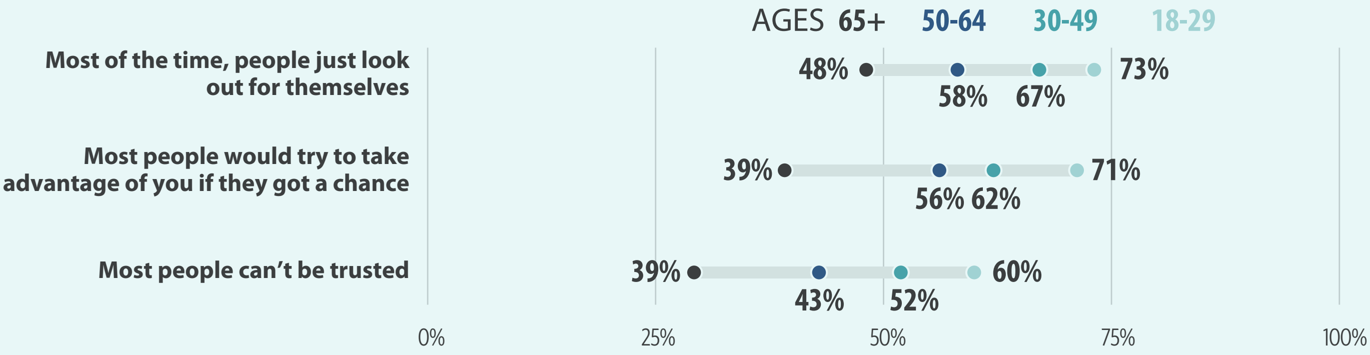
Balkanization of society, it is in fact far worse than that. In many parts of the world we appear today to be engaged in a process of social *atomization*—observed and remarked upon extensively in the 25-years since the publication of Robert Putnam's 1995 classic, *Bowling Alone*.[10] "Most Americans today believe that we live in a less trustworthy society than our parents did," Putnam wrote. "Every year more and more of us caution that 'you can't be too careful in dealing with people.'"[11] Five years later, he outlined the significance of this decline in social capital:

> *The most startling fact about social connectedness is how pervasive are its effects. We are not talking here simply about nostalgia for the 1950s. School performance, public health, crime rates, clinical depression, tax compliance, philanthropy, race relations, community development, census returns, teen suicide, economic productivity, campaign finance, even simple human happiness—all are demonstrably affected by how (and whether) we connect with our family and friends and neighbors and co-workers.*[12]

But we are not connecting as we once did, and our social atomization appears to be driven less so by us-them antagonisms and increasingly more so by the me-you sort. Putnam's reference to nostalgia for the 1950s was perhaps more purposeful than rhetorical; he includes in *Bowling Alone* the chart at left which reflects a decline in generalized social trust over a 40-year period that began in the early 1960s and persisted through 1999. The trend has worsened since, as Pew and Edelman have tracked and detailed in the charts below—particularly among the young.

2. Most young adults in U.S. see others as selfish, exploitative, untrustworthy

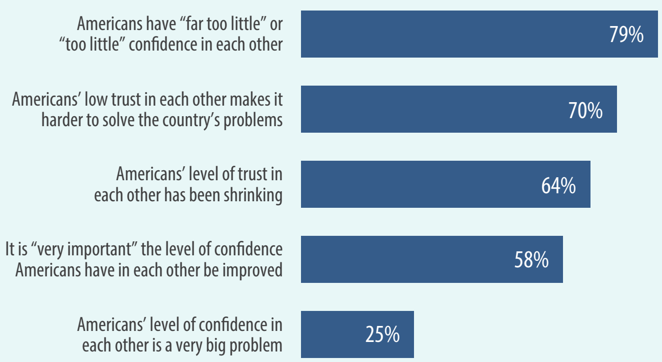
% of U.S. adults in each age group who say ...



Source: Pew Research Center Survey conducted Nov. 27 - Dec. 10, 2018

3. Americans are worried about the declining level of trust citizens have in each other

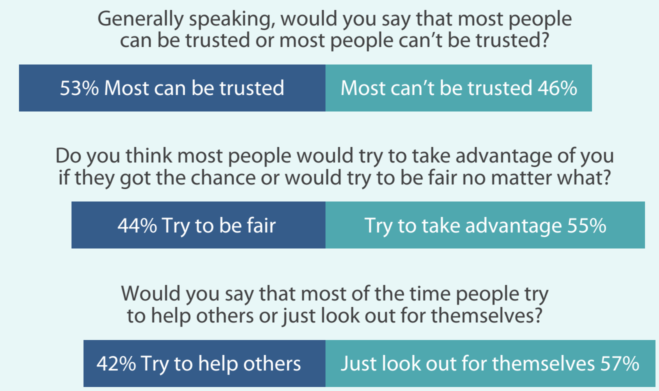
% of U.S. adults who believe ...



Note: Respondents who gave other answers or no answer are not shown.
Source: Pew Research Center Survey conducted Nov. 27 - Dec. 20, 2018
"Trust and Distrust in America"

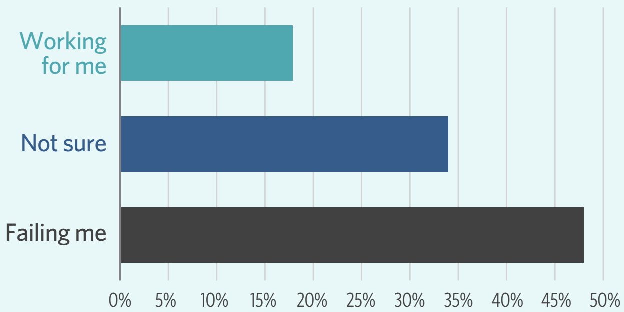
4. Components of the personal trust scale: Are people trustworthy, fair, helpful?

% of U.S. adults who choose each response



Note: Those who did not give an answer are not shown.
Source: Pew Research Center Survey of U.S. adults conducted March 19-24, 2020

5. Percentage of people surveyed who agree that the system is...



Source: Edelman Trust Barometer online survey of 32,200 adults conducted Oct. 19 - Nov. 18; margin of error: +/- 0.6 percentage points

Much of the forgoing draws heavily on data specific to the US, but data from many other countries reflect similar patterns. "Trust—or the lack of it—has become one of the defining social, political and economic features of our time," the OECD's Greg Medcraft wrote in the Preamble to our 2019 report. "There is a strong expectation—from consumers, employees, investors and other stakeholders," he argues herein, "that business behaviour complies with the spirit of a 'social license' to exist, which in turn derives from wider societal values." IN FOCUS ▸ P. 28

But what if those societal values are themselves splintered?

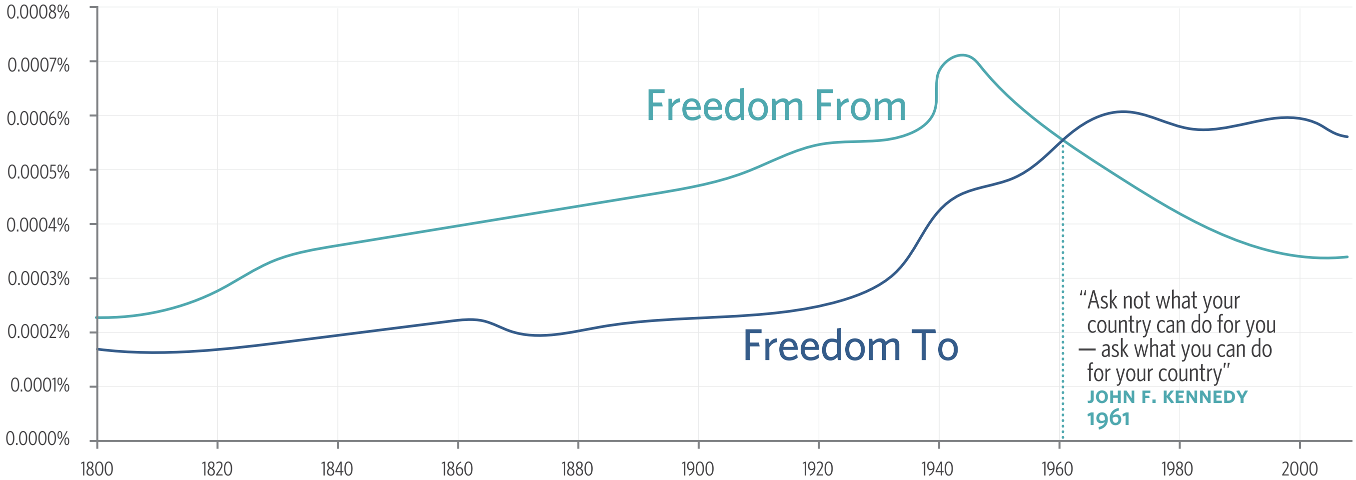
Google's nGram Viewer charts the frequency of word usage from among millions of books printed since 1800. By dividing the number of times that a particular word or phrase appears in a given year by the total number of words in the entire corpus of work produced that year, Google calculates the frequency of single word *grams*, or two-word *bi-grams*, and so on. In this admittedly limited fashion, Google's tool permits researchers to explore micro-trends. We conducted some research of our own with the nGram Viewer, tracking the usage over time of the closely worded bi-grams: 'freedom from' and 'freedom to.'[13] The results appear below.

The modest prepositional shift is significant. Laudable 'freedoms to' include things like the freedom to assemble, to worship as we please, to speak freely, to due process, and to trial by jury. These freedoms are deeply valued in liberal societies. But equally important 'freedoms from' also hold high social value. The Universal Declaration of Human Rights enshrines "freedom from fear and want" as the most highly sought after among "the common people," but freedom from tyranny, from unreasonable search and seizure, and from cruel and unusual punishment also rate pretty highly for most of us.

One way to consider the difference between the two formulations is to think of 'freedoms to' as being individualistically-minded: *my* freedom to do, have, be, etc. By contrast, 'freedoms from' are more pluralistically-minded: *our* shared freedom from those things we wish not to suffer. If one accepts this distinction, then it is notable that the two trend lines appearing in Google's nGram viewer cross paths in 1961—the same year that John F. Kennedy felt it necessary to chasten, "ask not what your country can do for you—ask what you can do for your country."

It seems reasonable to conclude that the nGram micro-trend we spotted reflects a shift in our priorities, in a direction perhaps more befitting the *Me Generation*. "Over the past two hundred years, the earth's population has grown from less than one billion to nearly seven billion, and more than half of this increase has occurred since 1960," social scientists Nicholas Christakis and James Fowler observe.[14] It is unclear whether the shift in prepositional priority we call out above was distributed evenly across that population growth, but we submit that most readers here will find that the suggestion fits well with anecdotal evidence. Since 1960, we have grown exponentially in number but we have declined in mutual trust.

Fig. 6



We believe this offers at least some explanation for the broad based and globally distributed deterioration in social capital that has been observed over the last several decades. Journalist David Brooks writes of an epidemic of alienation and loneliness that has left our social fabric in tatters—a struggle between *Forces of Connection* and *Forces of Division*, as he calls them. "The chief struggle of the day," he writes, "is sociological and psychological, not ideological or economic." Brooks then adds this crucial point: "The substrate layer of American society—*the network of relationships and connection and trust that everything else relies upon*—is failing. And the results are as bloody as any war."[15]

But perhaps the COVID-19 pandemic will force us to re-prioritize a pluralistic interest in 'freedom from' (e.g., the virus) and to rehabilitate awareness that we exist within shared communities of fate.[16] "Hovering over every conceivable divide in this country is the new truth that we are all equal before the disease, and therefore we all need each other equally," author, film-maker, and occasional war-correspondent Sebastian Junger recently remarked.[17]

While many refer to the Novel Coronavirus as The Invisible Enemy, it is our view at Starling that a marked and global decline in social trust may be as significant a threat to our shared peace, prosperity, and indeed even our health.[18] While visible in its macro-trends, this erosion of trust and social capital goes largely unnoticed on a day-to-day basis and is, therefore, also an Invisible Enemy of sorts. But the phenomenon is real, measurable, and it matters for business—perhaps most especially for the banking sector.[19] "Banking is built on the foundation of trust," reminds Samuel Tsien, Group CEO of OCBC and Chairman of the Association of Banks in Singapore (ABS), in the **In Focus** insert herein ▶ **P. 79**, co-authored with Shee Tse Koon, Country Head of DBS Singapore and Chairman of the ABS Culture and Conduct Steering Group.

"I don't know how to explain human behavior."

As noted by MIT Professor of Management Tom Malone, when former CEO John Stumpf was asked by the media why anyone would risk their career by engaging in the misconduct chronicled at Wells Fargo, Stumpf voiced a frustration that is common to C-suites and boardrooms at many firms: "I don't know how to explain human behavior."[20] **OUR VIEW ▶ P. 28**

But, increasingly, CEOs and boards are being asked to do precisely that, and particularly in the wake of misconduct scandals. The immediately preceding section sheds some light on what behavioral science teaches us in this context. "The term social capital emphasizes not just warm and cuddly feelings," Putnam writes, "but a wide variety of quite specific benefits that flow from the trust, reciprocity, information, and cooperation associated with social networks."[21]

This is critical in the context of workplace dynamics. "Germs are not the only things that spread from person to person. Behaviors also spread," warn Christakis and Fowler.[22] "Interconnections between people give rise to phenomena that are not present in individuals or reducible to their solitary desires and actions. Indeed, culture is one such phenomenon."[23]

Organizational behavior patterns flow from organizational structures, from the networks of social ties that operate within firms, and from the trust that binds the people in those networks. "Our experience is that behavioral patterns often 'act' as root causes of supervisory issues," Wijnand Nuijts writes in the Preamble to our report this year. ▶ **P. 15** "These root causes may involve organizational structure and organizational culture. Both are known to impact behavior."

Behavioral economists agree: "Instead of asocial, transactional, self-regarding utility maximizers, humans are intensely social, highly cooperative, and other-regarding creatures who make decisions inductively, heuristically, mimetically, and through group reasoning," many now emphasize.[24] But even more 'traditional' economists have begun to recognize that, "In every social context, people have a notion of who they are, which is associated with beliefs about how they and others are supposed to behave," as Nobel prize-winner George Ackerlof writes.[25] "Effective management encourages workers to be insiders, who identify with the goals of the firm," he continues, "but many studies have found that workers typically identify with their immediate workgroup rather than with the organization as a whole."[26]

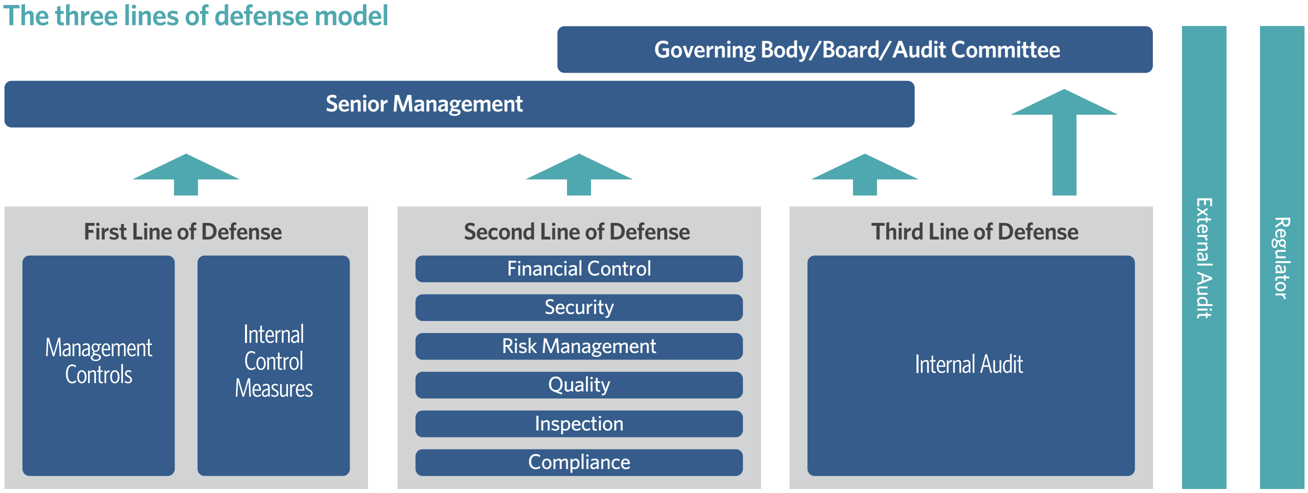
This should be expected. Neurologically, human beings crave social connection just as we crave food, a newly released MIT study reports.[27] "Our brains and bodies are designed to function in aggregates, not in isolation," write social neuroscientist John Cacioppo and founding editor of the *Journal of Life Sciences* William Patrick. "That is the essence of an obligatorily gregarious species."[28] As with ape societies and in all human cultures, Cacioppo and Patrick observe, "we see infractions against the social order being punished by the denial of social connection—the deliberately induced pain known as ostracism."[29]

Research finds that social isolation triggers physiological deterioration and an increased risk of early death at levels akin to what is seen in the case of smoking, obesity, high blood pressure, and lack of exercise.[30] Ostracism is intolerable.[31] By evolutionary design, it leaves us feeling anxious and fearful in precisely the same way we do when we are physically threatened, distorting cognition and our very perceptions of reality. "When we discover we are out of step with everyone else, our amygdalae spasm with anxiety, our memories are revised, and our sensory-processing regions are even pressured to experience what is not true," writes neuroscientist Robert Sapolsky, "All to fit in."[32]

Such findings call to question the common view that 'Tone from the Top' is most essential in shaping the behavioral norms within an organization. While C-suite signaling as to what behaviors are considered acceptable is important, we attend more closely to social cues among our workplace peers. And when there is conflict between the cues from our peers and the Tone from the Top, this results in what we have called a "coercive competition"—and it is one in which our peers tend to prevail.[33]

"The idea that dishonesty can be transmitted from person to person via social contagion suggests that we need to take a different approach to curbing

7. The three lines of defense model



Adapted from ECIIA/FERMA *Guidance on the 8th EU Company Law Directive, article 41* dishonesty," behavioral economist Dan Ariely writes.[34] Regulators are turning to behavioral science in this connection and many have established internal behavioral science units.[35] Banks have been slower to move in this direction, but that is beginning to change, due both to regulatory example and because traditional non-financial risk management methods have proven enormously costly and yet repeatedly unsuccessful. "Behavioural science is, at its core, the science of making better decisions about human behavior," write ORX Chairman Mark Cooke and Executive Director Simon Wills herein. **IN FOCUS ▸ P. 38** "If we aim to restore trust in our industry, nonfinancial risk managers must become behavioural engineers."

Upstream Intervention

Studying the surface of a pair of dice does not position you to say much about the outcome of a roll, network scientist Duncan Watts writes.[36] While this is obvious, an awareness of this has not featured in the design of non-financial risk management systems, such as the industry standard Three Lines of Defense (3LoD) model **FIGURE 7 ▸ P. 25**. A principal problem with the 3LoD approach is that it is based on the idea that company org charts accurately reflect how people operate in practice, day-to-day.[37] By failing to focus on "the company behind the chart,"[38] 3LoD models produce false comfort and immense frustration at a huge cost. Operational risk management frameworks based on the 3LoD may produce adequate systems of record, useful for assigning accountability, recording risk events, and conducting forensic inquiries after risk management failures become evident. But because they fail to account for the dynamics of social influence ('culture'), they do little to permit for proactive insight into the likelihood of such events.

In our efforts to anticipate human behavior, we rely on common sense, "the loosely organized set of facts, observations, experiences, insights, and pieces of received wisdom that each of us accumulates over a lifetime, in the course of encountering, dealing with, and learning from, everyday situations."[39] When such common sense fails us—as it regularly does—we throw up our hands in disbelief and resignation: "I don't know how to explain human behavior." The implication is that human behavior is deemed explicable only when it conforms with our expectations and, when it does not, we conclude that it is simply inexplicable. But this is the problem with common sense:

> *By providing ready explanations for whatever particular circumstances the world throws at us, commonsense explanations give us the confidence to navigate from day to day and relieve us of the burden of worrying about whether what we think we know is really true, or just something we happen to believe. The cost, however, is that we think we have understood things that in fact we have simply papered over with a plausible-sounding story.*[40]

Perhaps this is why "assessing culture remains a key challenge for many banks," as the HKMA notes herein. **IN FOCUS ▸ P. 74** The HKMA argues that qualitative and quantitative indicators of culture from different sources are all important, and a more sophisticated approach is to allow for the different culture indicators to be "triangulated." Elsewhere herein, **▸ P. 69** we note that HKMA Deputy Chief Executive Arthur Yuen has observed that banks in Hong Kong have initiated various culture reform initiatives—but, Yuen cautions: "The important point here is not how many culture initiatives have been launched. Rather it is important to assess whether the culture initiatives are effective in driving behavioral changes among bank staff."

The challenge before supervisors and risk management experts alike is one of anticipating culturally primed behavioral outcomes, rather than merely reacting to alerts from surveillance and monitoring systems when they indicate that something may have gone awry. "When you spend years responding to problems, you can sometimes overlook the fact that you could be preventing them," writes Duke Senior Fellow Dan Heath.

"Downstream actions react to problems once they've occurred. Upstream efforts aim to prevent those problems from happening."[41]

The trends outlined here reveal that bank supervisors are focusing on cultural dynamics in an effort to move upstream. "To succeed upstream," Heath advises, "leaders must detect problems early, target leverage points in complex systems, find reliable ways to measure success, pioneer new ways of working together, and embed their successes into systems to give them permanence."[42]

To date, regulators appear to be at the fore in promoting upstream efforts. "The regulators are driving change because the industry has a chequered history of being able to do so successfully itself," writes **Cris Parker**, Director of the Australian Banking & Finance Oath. **IN FOCUS ▸ P. 100** However, "The problem with regulator-driven change," she warns, "is that such change may not be long lasting as other priorities take over." For this reason, "Boards must prioritise culture as a strategic asset, endeavour to assess the culture of the organisations they oversee, and develop an appreciation for how that culture may lead to behaviour with material consequences," urges **Siew Kai Choy**, former Director of the Data & Analytics Department at Singapore sovereign wealth fund GIC. **OUR VIEW ▸ P. 30**.

While regulators may be leading the charge, firms have also been placing an increasing emphasis on culture and conduct risk. Collaboration between regulators and industry innovators has great value. "It is increasingly clear that the problem of misconduct will not be resolved with one-off statements, discussions, or declarations," the New York Fed's **Jim Hennessy** observes. **IN FOCUS ▸ P. 89** "Rather, it will take a long-term, multi-disciplinary effort among a variety of stakeholders to achieve these goals." We remarked on the development of this 'ecosystem approach' in our report last year. Our present update provides an interesting example of such, offered by CEO of the Irish Banking Culture Board (IBCB), **Marion Kelly**. **IN FOCUS ▸ P. 51** "The IBCB is not a regulator, and is not an industry body, its remit is to work with all stakeholders in the industry—the banks, their customers and wider Irish Society to improve bank culture and contribute to a restoration of trust in the sector."

Going forward, we expect to see a cross-border sharing of lessons-learned among multi-stakeholder bodies like the Irish Banking Culture Board, Singapore's Culture and Conduct Steering Group, and the Australian Banking & Finance Oath. Perhaps industry associations like the G-30, which has been featured prominently in our past years' reports, and the Operational Risk Exchange (ORX), which features herein, might also come to collaborate with those multi-stakeholder bodies. Doing so in close collaboration with a multi-regulator consortium, like the Global Financial Innovation Network, would promote efficient knowledge-sharing and accelerated learning that may benefit all parties. Leading financial firms would advance their own self-interests by engaging with such groups—and may find that they are prompted to do so by their boards and the expectations of their institutional investor base.

Those themes emerge clearly in the pages that follow, and we hope that organizing this material as we have done here will prove useful in advancing the associated dialogues—to the benefit of the financial industry, its regulators, and its stakeholders worldwide.

Stephen Scott
Founder & CEO, Starling
30 April 2020

In Focus:
Trust Matters

An Interview with GREG MEDCRAFT DIRECTOR OECD DIRECTORATE FOR FINANCIAL AND ENTERPRISE AFFAIRS

Steven Saphone / REUTERS

Greg Medcraft

STARLING: *In his Preamble to our report this year, the DNB's Wijnand Nuijts emphasizes the importance of behavioral sciences in supervising culture and conduct related risks in the banking sector. The OECD has also been saying a lot lately about the growing importance of behavioral science[1] in an economic context. What are your own thoughts in this regard?*

As the former chair of the Australian Securities and Investments Commission, I oversaw a sharper focus on company culture in its market monitoring and investigation activities. The reason was simple: behavioural science teaches us that culture is the unwritten code of how things are done in a business, and so, it is a good predictor of poor conduct.

Behavioural science is only increasing in its strength as a tool for predicting conduct issues, and this is for two reasons. First, it requires the large datasets that are now available to us which, when combined with machine learning and predictive models of behaviour, can be used by regulators and compliance functions to detect potential misconduct before it even arises.

Second, these data-driven models provide a window into individual teams across an organisation. Culture is not uniform across a company—it exists in many different layers right down to small units.

Behavioural science provides valuable insights into where culture is going right, and where it's not, which is crucial in the pursuit of restored trust in the industry.

S: *You mention trust, which was a key theme to the Preamble you so kindly prepared for us last year. In the year since, the OECD has been emphasizing the "materiality" of trust in the course of your Trust in Business Initiative.[2] Can you say a bit about this?*

Our Trust in Business Initiative is based on the recognition that companies today face a new business environment where conduct matters to their bottom line.

There is a strong expectation—from consumers, employees, investors, and other stakeholders—that business behaviour complies with the spirit of a "social license" to exist, which in turn derives from wider societal values. At the same time, social media allows information to flow freely and people to mobilise quickly, which means companies are far more likely to be caught out and face consequences for doing the wrong thing.

The consequence is that materiality effectively moves in line with the social license. The way to manage this—and turn it into competitive advantage—is by building a culture of trust right through an organisation. It is this thinking that underscores our Initiative.

S: *There was much discussion of ESG (Environmental, Social, and Governance) at Davos this year, and many of the views articulated were directly tied to the Business Roundtable's statement last year on the primacy of stakeholder capitalism. Yet discussion regarding ESG concerns tend to focus on the* ***E*** *and the* ***S*** *bit. How should we regard the* ***G*** *piece? How does governance[3] tie in to the materiality of trust?*

We have numerous studies showing the positive link between trust and business performance, including from the OECD. In that context, the Business

Roundtable statement contained some promising messages. But there is an inherent tension when it comes to putting those words into practice: what happens when the interests of shareholders, which are enshrined in law, do not align perfectly with the interests of stakeholders? Absent a shift in the legal foundation of the corporation, companies can only resolve this tension by clearly articulating how nurturing trust within a wider social context builds sustainable, long-term business value.

S: *"If you can't measure it, you can't manage it," the adage goes. With this in mind, the OECD's work on developing relevant and reliable trust metrics[4] is quite interesting. Given the view that trust is material and the argument that ESG concerns will increasingly shape capital allocation, what might this imply for the use of trust metrics in connection with the **G** bit of ESG?*

While much of our work on measuring trust is at a societal level, recent OECD analysis has underlined just how weak the information in the ESG markets is, including for Governance aspects.

ESG risk performance metrics often measure different things between indices or companies; ESG risk ratings can be proprietary and opaque; and the link between a particular ESG risk metric and material business performance is not always well established. So, we have a long way to go in making ESG a tool that can guide investors towards better, more sustainable long-term investments.

Policymakers and businesses both have a role here. From a policy perspective, market supervisors should be formulating a common language around ESG risk management, and communicate expectations on ESG risk reporting to the market. Businesses should, at a minimum, rise to the challenge of voluntary reporting for their particular market. For example, see the *NASDAQ ESG Reporting Guide*, which contains some very useful metrics.

S: *Thanks for that, Greg. Any closing comments? What do you expect to see in connection with all the foregoing over the course of 2020 and into next year, particularly given the current COVID-19 pandemic and the economic stresses it has triggered worldwide?*

The pandemic has created an extremely challenging environment where businesses large and small have needed to change their operations in response, sometimes very quickly. This is a real test for companies, like those who signed up to the Business Roundtable statement, who are committed to meeting expectations regarding that "social license." They need to show they can walk the walk not just in the good times, but the bad as well. They need to show they have governance mechanisms in place that allow them to be agile while staying true to their values.

For example, with the disruption to global supply chains, companies have scrambled to find new suppliers in new jurisdictions. Without proper due diligence, companies risk engaging suppliers whose practices do not reflect the company's values or the values of their stakeholders. Managing these kinds of risks means measuring and disclosing performance of internal governance processes *and* of outcomes and impacts on stakeholders. Such transparency goes a long way in maintaining trust in such difficult times.

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Our View: The Stewardship Mandate

by SIEW KAI CHOY

Siew Kai Choy

"Better Business" was one of the main themes of Davos 2020 this past January, amidst calls for a new kind of capitalism entailing a better balance between government, markets, and civil society. Business leaders resolved to better serve the interests of those identified in the 1973 Davos Manifesto:[1] customers and clients, workers and employees, shareholders, societies, and other stakeholders.

A focus on Governance, Stewardship, and Engagement principles appears set to stay for the long term, and even the world's largest passive investors will likely struggle to remain passive owners in the days ahead. Institutional investors have a stewardship interest in promoting the long-term health of the companies in their portfolios. By acting to ensure that boards pursue effective corporate governance objectives, institutional investors align company interests with the investors' own. This engagement between stewards (investors) and trustees (boards) is healthy. Boards should recognise that they benefit by such engagement; institutional investors are often well placed to contribute necessary expertise and experience in the discharge of their stewardship responsibility.

It is obvious to state that it pays to invest in better-run companies. Oddly, it appears less obvious to some that good governance usually leads to better returns. However, in my 20-years' experience with GIC, Singapore's sovereign wealth fund, we saw that companies with superior governance practices, at both the board and management levels, were better run and tended to deliver greater returns.

We also found that boards which had opted for constructive engagement with investors fared better with building broad investor support—and were usually more effective in warding off activists when they faced inevitable difficulties. All businesses will go through periods of difficulty. Consistent engagement with long-term oriented investors fosters shareholder support so that it is in the offing when most needed. Collaboration around corporate governance builds such investor trust.

In the last five years, many institutional investors have come together to state the shared expectation that firms must work to raise their governance standards. For instance, the International Business Council of the World Economic Forum published "The New Paradigm:[2] A Roadmap for an Implicit Corporate Governance Partnership Between Corporations and Investors to Achieve Sustainable Long-Term Investment and Growth," whilst the Investor Stewardship Group implemented the "Framework for Stewardship and Governance."[3] And a business-led effort by the Business Roundtable saw dozens of CEOs at America's largest companies sign up to a new set of "Principles of Corporate Governance,"[4] emphasising stakeholder capitalism to a greater degree than ever seen before in the United States.

Prominent global investors have also been individually vocal in emphasising a desire for enhanced governance and sustainability efforts in service of stakeholders. For instance, BlackRock and State Street have made repeated and strong statements indicating that the companies in which they invest must be managed with a long-term mindset if they are to deliver desired returns over time. Along with this long-term focus, they have made clear their conviction that corporate "purpose," a concern for sustainability, and governance mindfulness must be integrated across their portfolios if they are to enjoy better risk-adjusted returns. They are thus looking to incorporate environmental, social, and governance (ESG) factors into their investment analysis and decision-making.

Going forward, we should expect that culture and conduct concerns will be seen as a critical component of any reliable governance assessment in this institutional investment context.

Regrettably, however, when it comes to culture and conduct related risks, we have not yet developed easily usable and consistently applicable frameworks to support investors in the exercise of their stewardship interests, or boards in their discharge of oversight responsibilities. As a consequence, management of such matters has not been terribly successful in recent years; there are countless unfortunate examples of failure coming from across the globe and in just about every industry. Where culture and conduct risks have been ignored and allowed to perpetuate, we have seen downside hits to reputation and brand-value, in addition to ruinous regulatory penalties.

Culture and conduct concerns will be seen as a critical component of any reliable governance assessments.

This harms the interests of institutional investors, who will look to boards in the first instance when assigning accountability.

Sticking to the letter of the law or internal compliance rules is not enough. Employees can operate within the boundaries of such rules while still behaving in ways that do not reflect the values of the organisation, resulting in behaviours that generate unacceptable risk. Allowed to fester, such behaviours multiply, further harming all stakeholders. This is unacceptable.

Boards are responsible for safeguarding the interests of stakeholders and assuring that management has adequately addressed the potential violations of public trust that such behaviour may entail. Assuring effective culture and conduct risk management is thus a board level responsibility. Boards must prioritise culture as a strategic asset, endeavour to assess the culture of the organisations they oversee, and develop an appreciation for how that culture may lead to behaviour with material consequences. Investors will increasingly insist upon this and hold boards—and individual board members—accountable for repeated culture and conduct risk management failures.

In the words of Lord Cadbury, writing in 1992, “Governance is the system of rules, procedures and processes by which a company is directed and controlled. Specifically, it is a framework by which various stakeholder interests are balanced and efficiently and professionally managed.” This lies at the heart of directors’ responsibilities and should serve as their guide-star.

Concern for the environmental impact of business activity has been increasing in recent years. More recently, the current global health crisis has made all of us more sensitive to the social impact of business. As we rebuild our economies following this crisis, our attention will shift to place a greater emphasis on corporate purpose, practice, and governance. Boards should realise that this will inevitably entail consideration of corporate culture and the behavioural propensities it sustains.

We need new governance tools; ideally tools that provide leading indicators of trouble rather than systems that merely record problematic events for subsequent forensic inquiry. To achieve effective governance, management must blend qualitative measures of risk with quantitative measures, and report results up to their boards, enabling them to engage more effectively with investors around governance concerns—as they appear in real-time. Ideally, we may strike upon a set of standard metrics for such 'soft risks' which will serve to facilitate ESG-minded investment decision-making.

In times of unprecedented change, such as we are currently experiencing, mindsets are more open to alternative solutions and new ideas. As the current pandemic forces us to reset our business practices and to revisit our expectations of firms, investors and boards should give thought to how we might better serve a shared interest in assessing the effectiveness of firms' governance practices. Firms that lead in this regard will warrant greater support from institutional investors.

Siew Kai Choy was a Managing Director at Singapore's sovereign wealth fund (GIC) where he was Director of the Data & Analytics Department, Head of Governance and IT in the Public Markets Group, and founder of GIC Innovation Labs.

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A Compendium of Regulatory Priorities Aimed at Culture and Conduct Challenges in the Financial Sector

This section comprises the main body of our annual report—the "*Compendium*" proper. It is broken out by global regions and specific national jurisdictions in each. Where practicable, we have broken the information out further to highlight specific regulatory or supervisory agencies, standard setting bodies, and other industry organizations of relevance.

We highlight here the activities and priorities that were in evidence over the last year, both with regard to the supervision of culture and conduct risk concerns and in terms of expectations for the governance thereof within firms. Some markets have experienced more significant public activity, often driven by scandal and public reaction to such. Others have featured less public activity, which may or may not mean that they are actually devoting less attention to issues of culture and conduct.

We are pleased, therefore, that our efforts to curate and collate relevant information has been complemented by the many contributions that we have received from across most major jurisdictions. You will see that input incorporated throughout this report, significantly enriching it.

Please note that the following summary seeks not to make qualitative judgements but, rather, simply to provide our readers with some organized information concerning the global culture and conduct risk supervisory agenda. As last year, this main body of our annual *Compendium* begins with a discussion of the international organizations that help to shape global regulatory priorities through their role as standard setters. These organizations often serve as a bellwether regarding emerging consensus views, or highlight key points of departure where international consensus is lacking.

A "no-win" situation or an opportunity for "rehabilitation"?

Recent headlines heap scorn upon the banks for failing to act swiftly enough to get money to suffering businesses and households, but we must remember that banks are being asked to provide needed credit and liquidity to individuals and firms under severe economic and political stress. The banking system is the conduit through which much of the extraordinary fiscal stimuli and emergency liquidity facilities are being delivered by central bankers and governments. This requires banks to take on additional risks that they would not otherwise be likely to assume. Moreover, in certain instances, in doing so they may risk violating prudential rules that regulators have imposed upon the banks since the last crisis. For these reasons, among others, banks might be viewed as doing an unrecognized public service.

CHARACTERISTICS OF GROUP A

- Formal mandate and high level of activity regarding Culture & Conduct
- Dedicated teams devoted to a Culture & Conduct reform agenda
- Significant emphasis on Senior Manager Accountability, related assessments and enforcement activities
- Most are directly assessing Culture & Conduct risk management in some manner
- Consistent engagement with the Regtech community, established innovation labs, etc.
- Making active use of behavioral science in advancing their supervisory function
- Complementary application of 'hard' and 'soft' regulatory powers

CHARACTERISTICS OF GROUP B

- High level of formal activity regarding Culture & Conduct
- Dedicated teams devoted to a Culture & Conduct reform agenda
- Most are directly assessing Culture & Conduct risk management in some manner
- May be anticipating new legislation, regulation, and implementing/expanding an Executive Accountability regime
- Consistent engagement with the Regtech community, established innovation labs, etc.
- Making active use of behavioral science in advancing supervisory function
- Focus is on ('soft') convening power, e.g., hosting conferences, promoting collaboration, innovation, etc.

CHARACTERISTICS OF GROUP C

- Moderate level of formal activity regarding Culture & Conduct
- Less likely to have dedicated teams devoted to a Culture & Conduct reform agenda
- Likely to directly assess/audit Culture & Conduct risk management and to take related supervisory actions
- Efforts to influence industry tend to be focused on innovation labs and engaging with Regtech community
- Emphasis is on ('hard') examination and regulatory powers

CHARACTERISTICS OF GROUP D

- Low level of formal activity regarding Culture & Conduct
- Culture & Conduct is not an emphasized supervisory priority; may have informal mandate but no formal team
- If Culture & Conduct related actions are taken, they are likely to include targeted assessments and supervisory actions
- May be experimenting with innovation labs and engaging with Regtech community

CHARACTERISTICS OF GROUP E

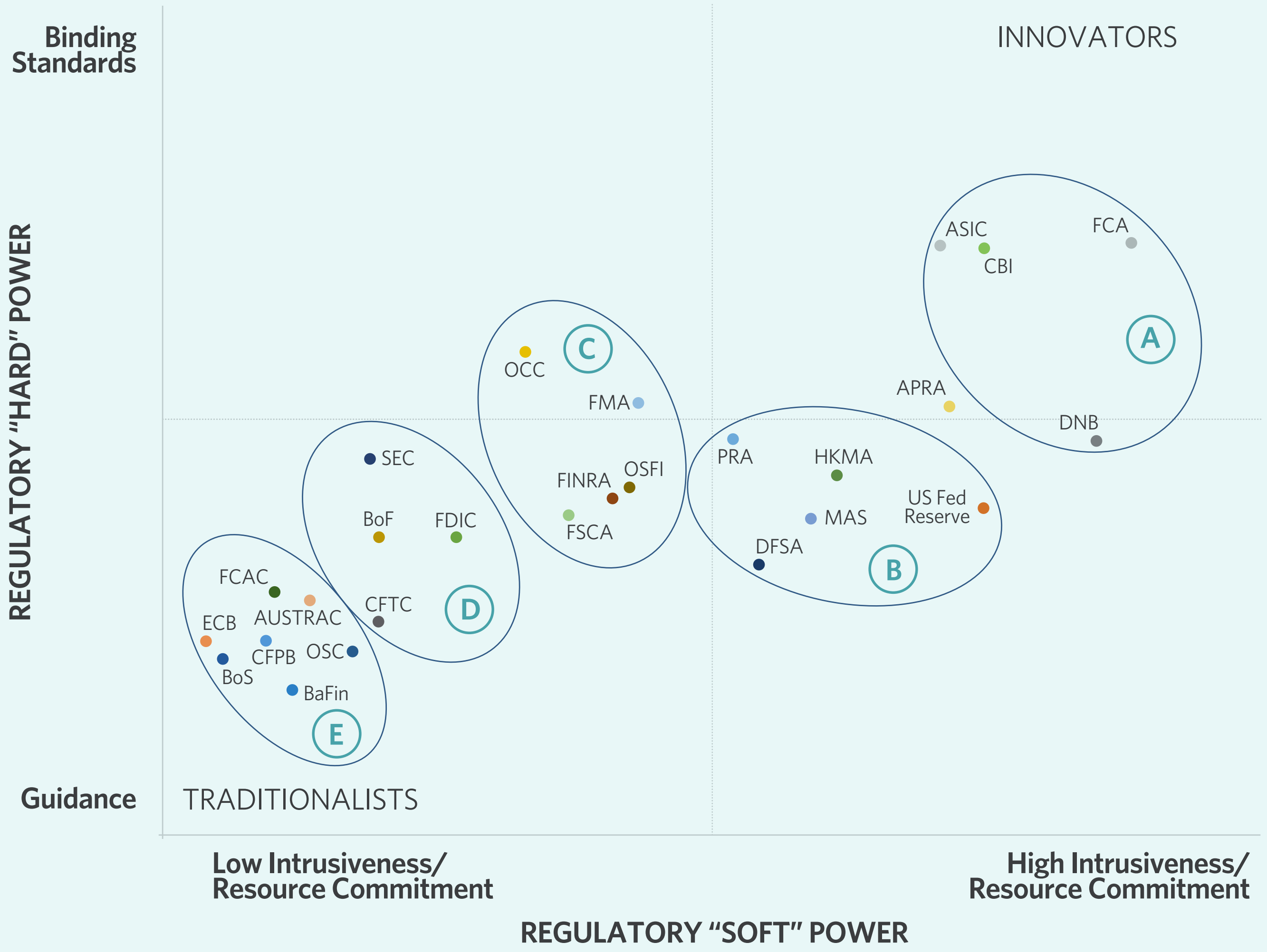
- Low level of formal activity regarding Culture & Conduct
- Culture & Conduct is not a supervisory priority; may have informal mandate but no formal team
- May be experimenting with innovation labs and engaging with the Regtech community

ABBREVIATIONS & METHODOLOGY ▶ P. 126

Instead, however, the public appears ready to assume the worst about banks at nearly all points. This reflects the lingering anger towards the banking sector that followed on the heels of the Financial Crisis, and which has worsened as a consequence of the many misconduct scandals that have been seen in the decade since. The industry would not be served by a further deterioration in public sentiment. It would thus be a major setback if prominent banks were to become embroiled in another series of misconduct scandals—this time reflecting poor behavior taking place amidst a global health crisis and in the course of economic rescue efforts. Regrettably, past events suggest that the risk in this regard is high.

Some argue that the industry may be in a "no-win" situation.[43] This need not be the case, however. Even as the current crisis represents heightened risks to the public image of the industry, it may also bring an unlooked-for opportunity for "rehabilitation."[44]

8. Culture and Conduct Risk Regulatory Landscape



"A doubling down on non-financial risk management should be an industry-wide priority," say Starling advisors Tom Curry, Gary Cohn, and Martin Wheatley. **OUR VIEW ▸ P. 116** Tom Curry added the following caution:

> *The banking industry as a whole would benefit by seizing the moment to shore up weak or inadequate conduct risk management capabilities. This is especially important as many regulators have felt that pandemic relief efforts warrant a relaxing of regulatory guardrails and trusting in the banks to do the right thing in the absence of much of their usual formal oversight.*
>
> *And regulators must also see this as a priority. After the Financial Crisis, and in the wake of subsequent misconduct scandals from the U.S. to Ireland to the UK to Australia – and in just about every market in between – regulators have also won the public's ire.*
>
> *If current circumstances mandate a decreased use of regulatory hard powers, then bank regulators should reach for their soft power tool-kits to help convene an industry consensus around the importance of mitigating the culture and conduct risk management failures that have destroyed reputations for some and trust in the industry more broadly.*

Senior NY Fed legal counsel make a similar argument. "Accountability demands that the official sector answer the question: 'If misconduct is a grave problem, are you doing all you can to stop it?' If we are not looking at all the possible root causes of misconduct, including organizational culture, we may not be able to respond to that question with an honest 'yes,'" write Michael Held and Thomas Noone.[45] "Regulators and supervisors should be concerned about the industry's culture because an industry characterized by misconduct reflects poorly on its regulators and supervisors," Held and Noone conclude.

Chart 8, above, (Culture and Conduct Risk Regulatory Landscape) seeks to posit various global bank regulators and supervisory authorities on a grid, reflecting their propensities towards the use of *hard* and *soft* powers in advancing the culture and conduct reform agenda outlined in this main body of our report. In producing this chart, we relied on responses to our annual Survey ▸ **P. 125** and as much 'hard data' as was otherwise available. Our full methodology in compiling this chart can be found at the Appendix to this report ▸ **P. 127** along with a list of Abbreviations ▸ **P. 126**.

But this is unavoidably an interpretive exercise. It represents how various regulatory and supervisory bodies have positioned themselves publicly and, as such, does not reflect any guidance they may have issued privately in specific circumstances. Moreover, we should note that our analysis is fluid: regulators respond to events and the political pressures they may bring, and it may perhaps be assumed that current events and politics will drive changes to the regulatory stances reflected here.

As the industry evolves, as regulators roll out new initiatives, and as new information becomes available to us, we will of course incorporate those developments into future updates to this chart. Readers may have suggestions as to how we might improve on this current work and, if so, we encourage you to be in touch. Please write us at compendium@starlingtrust.com.

In Focus:
The Future of Operational Risk Management

By MARK COOKE & SIMON WILLS

Mark Cooke,
ORX Chairman

Current approaches to the management of operational risk need to evolve rapidly to be effective in today's digital environment. Also referred to as nonfinancial risk, these fall outside the standard set of financial risks (credit, market and liquidity, etc.). Rather, the operational risk portfolio includes things like cybercrime, outsourcing, data security, AI use, and the risk of employee misconduct and poor company culture.

Simon Wills,
ORX Executive Director

The current standard approach to managing such non-financial risks relies overmuch on 'systems of record' and administrative processes that seek to categorize risks, register their controls, assess those controls on a periodic basis, and then create inventories of the issues that appeared and actions that were taken. This approach has a high cost and is not delivering the required outcomes.

At ORX we believe that the digital businesses of tomorrow will require a far more dynamic and embedded approach, one that works *proactively* to prevent failure as part of ongoing operations, and not as some bolted on after-thought. That embedded approach requires a focus on fostering the right behaviours, combined with exploiting newly available unstructured data sets and making smart use of latest generation technological tools.

The financial industry is undergoing considerable change driven by technological disruption. As a consequence, so is risk management across our industry. The risks we face are evolving quickly and we will need different techniques and methods to manage them effectively going forward. At ORX, we have been working with our members to support them through this time of transition, by providing a platform across which we can act collectively to identify emerging challenges, share evolving best practices, and create standards that can help the industry to better manage the risks we face together.

ORX is a not-for-profit financial industry association that works with its members to build a safer global financial system, promoting sound nonfinancial risk management practices, while providing a platform to share risk and loss data. The association has developed standards that enable the sharing of such data and insights—something that is only possible and meaningful through cross-industry collaboration. Such collaborations are at the core of other industries, such as aviation, where data is shared between airlines to ensure that highest levels of safety are maintained by all.

The overarching aim at ORX is to promote, within the financial industry, practices and behaviours that address past failures—which have done so much harm to public trust in the financial system—and to get ahead of newly emergent risks. Over the recent past months, we have been working with industry participants on two specific agendas that relate to the future of risk management: first, the promotion of a common risk taxonomy across the financial services industry; and, second, we are looking at how digital disruption will require the industry to reshape its risk management practices going forward.

Taxonomies don't sound exciting, but they should be recognised as essential. They are the means by which we describe problems, the basis from which we collect and categorise data, and the manner in which we then conduct analysis and collate learnings. Try and describe the natural world without a taxonomy and you'll quickly run into trouble. The current taxonomy for operational risk was invented before the iPhone and, although it has stood up surprisingly well, it has started to show its age. A taxonomy that doesn't contain information security risk, model or third-party risk, etc., simply isn't fit for the present, let alone the future.

Risk managers should become behavioural engineers.

The new ORX Reference Taxonomy is based on the actual taxonomy used among approximately 60 ORX members. The result reflects a combination of machine learning and human judgement. We describe operational risks by what risk events took place and, this year, we are working to agree on how we best describe the impacts and the causes of such risk events. (As a service to the industry, our work is published on the ORX website.)

Our work on taxonomy is emblematic of the changes we see in the operational risk profile across our industry—changes that will drive new ways of managing risk. One example, addressed by our new taxonomy, is the focus on specific material risks such as cyber. Peer-sharing of related risk information, data, practices, expertise and experience regarding cyber risks will enhance the development of effective and efficient risk management, and ORX is leading the way with its Cyber Service, launching during 2020.

Like our business colleagues, we are focused on the potential to access and analyse new data, to automate previously low value manual tasks, and to embed robust nonfinancial risk management into the day-to-day processes of our businesses. These are the low hanging fruits of digitalisation that make most sense to our current generation of managers.

However, the digital playbook presents other less obvious opportunities. What is the potential for shared platforms in the risk space? How can we help to develop a vetted ecosystem of regtech applications and suppliers? If we go this route, then what compromises might we need to accept in terms of standardisation of data and functionality? Might risk management need to become more 'commoditised' in the main so as to free up resources to apply to really unique problems and opportunities? The industry needs to wrestle with these questions collectively, now, if we are to capture the fullest opportunity for improvement.

Banking has had a difficult decade. After the Financial Crisis, the industry suffered a long tail of losses associated with conduct and culture. Over the last few years, we've started to escape from our past and we now need to look to the future. Perhaps the biggest opportunity here lies not in the application of computer science but behavioural science.

The risk function exists to inform and bound better decision-making. Behavioural science is, at its core, the science of making better decisions about human behaviour. Currently, it is applied most often to efforts aimed at influencing the decisions of consumers and others external to the firm. The future should be about how to positively influence the behaviour *within* our organisations and among our managers and employees. If we aim to restore trust in our industry, nonfinancial risk managers must become behavioural engineers.

Our View: Superminds & Supervision

By THOMAS MALONE

When asked by the media[1] why anyone would risk their career by engaging in the misconduct chronicled at Wells Fargo, former CEO John Stumpf voiced a frustration that is common in C-suites and boardrooms among many firms, and in most industries, worldwide: "I don't know how to explain human behavior."

Thomas Malone, Director, MIT Center for Collective Intelligence

That inability cost Mr. Stumpf his job, tens of millions of dollars in punitive fines, cries of derision from the public and Congress, and a lifetime ban from the financial industry. It has cost his firm billions in fines and continuing stock price impairment vis-à-vis peers. Recently announcing a new $3 billion dollar fine and deferred prosecution agreement, US Justice Department attorneys said the case against Wells Fargo illustrated, "a complete failure of leadership[2] at multiple levels within the bank."

But many company leaders struggle to manage misconduct risks, as daily headlines attest. Why?

Perhaps it is because their approach to non-financial risk management seems akin to trying to practice medicine while knowing only about bones—and nothing about hearts, lungs, nerves, and all the other parts of human anatomy. Attention goes to the risk management *framework* only, while essential parts of the broader system and its *dynamics*, are routinely ignored or assumed to follow simple rules of cause and effect such as those enshrined in rational actor theory.

Instead, non-financial risk managers might give thought to the "*superminds*"[3] at work throughout their firms. "Powerful combinations of many individual minds," superminds have a kind of *collective intelligence*. While it was this, rather than individual intelligence, that allowed our *hominin* ancestors to thrive, this ubiquitous if invisible phenomenon goes unrecognized in most management circles. But superminds not only exist, they are *observable* and *measurable*, as we have demonstrated in my lab.[4]

Hierarchies are the most obvious form of supermind—one that mobilizes large numbers of individuals to achieve the goals of whoever it is that controls the hierarchy. Because hierarchies are easy to see, most companies have produced organizational charts that map them in great detail. But those who assume that the "org chart" reflects the only relevant supermind at work in their organization will likely find themselves surprised—and probably unpleasantly so, as appears to have been the case for Mr. Stumpf.

To avoid such surprises, one must see the company *itself* as a supermind—a group of individuals acting together in ways that seem intelligent (at least sometimes). The company-as-supermind is, in turn, composed of many smaller superminds, including the formal *hierarchy* but also many (usually informal) *communities*. These smaller superminds interact with one another through an internal *ecosystem*, which is yet another form of supermind. It is to these various nested "organs" of corporate anatomy that we must look if we wish to better explain human behaviour in organizations.

In a pure hierarchy, group decisions are made by delegating authority to individuals in the group. Managers at higher levels of the hierarchy make decisions that those below them are expected to follow. By contrast, within communities, decisions are made by *informal consensus* and *shared norms* of behaviour, enforced through reputations and mechanisms of peer pressure like shame and ostracism. A member who upholds community norms wins the admiration and respect of peers, while those who flout them risk losing such status and access to resources (material or other).

Like the parts of a circulatory system in a body, most companies of any size have many different sub-communities in different parts of the company. For instance, a community of senior managers may have very different norms from those of the sales force in Tokyo, the accounting group in Cleveland, or the smokers congregating outside the New York headquarters building. All these different superminds interact within the overall ecosystem that constitutes the entirety of the company.

Community norms and concern for reputation create the culture of a company.

Community norms and concern for reputation create the *culture* of a company. When the behaviour-shaping influence of the community conflicts with the directive authority of the hierarchy, we say that a firm has "cultural problems."

While many today recognize that culture is important in shaping company performance, we haven't had very good ways of measuring or managing it. Thus, we manage culture and conduct risk as though we were doctors who knew that people bleed when cut, but who had only vague ideas about how and where blood flows within the body. How, then, to stop the bleeding?

Though we may sometimes believe hierarchical managers can control the communities and cultures in their organizations from the top down, anyone who has ever tried to do this knows that it is much easier said than done.

For instance, when a managerial hierarchy decrees that people must act in a certain way, but these rules conflict with the community norms in the company, it is often the community's norms that prevail.

This appears to have been the case at Wells Fargo. Top executives were made aware of the various misconduct issues as far back as 2004, when an internal investigator called the problem a "growing plague."[5] Why did they take so long to implement effective corrective measures? Many argue that management at the firm was "wilfully blind." But perhaps, without a metaphorical *Grey's Anatomy* to guide them, they simply misdiagnosed how the parts interacted to make the system itself "toxic."[6]

The Bank for International Settlements recently released a study[7] on operational risk in the banking sector. It finds that an average of 435 days elapse between the occurrence of an operational risk event and the recognition of related losses. "Internal fraud events and failures as a result of negligence or improper business practices are less likely to be discovered than other events," the BIS reports. More, it typically takes 448 days before internal fraud events are recognized and responded to as such—while 827 days is more common in the case of improper business practices like those at Wells Fargo.

Just as individual intelligence predicts many kinds of real-world performance for individuals, collective intelligence predicts performance for groups. Marvin Minsky, one of the fathers of Artificial Intelligence, wrote of something he called a "society of mind," emerging from the interactions of many "agents," none of which is necessarily as intelligent as an individual but which, collectively, create a *system* that is intelligent. Specific individuals may play a key role in the successful decision-making of a supermind. But, very often, these decisions just *emerge* from the actions of people in the group. Superminds may thus seem to have wills of their own—*different from those of some or even all of the individuals within them*.

So, what are we to do? First, we need to be aware that all these different superminds are operating in our organizations. In other words, we need to be like doctors learning about human anatomy.

But it would be extremely useful if we also had some metaphorical "MRI" that permitted us to see more clearly the size, shape, and location of these different superminds operating within an organization. Fortunately, modern tools like data analytics and machine learning make this possible, in ways barely imaginable a decade or two ago.

Given such new technology tools, our great-grandchildren may find it hard to understand how the organizations we belonged to in the early 21st century could have been run with their managers' eyes, figuratively, closed.

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Global Organizations

Global Collaboration

McKinsey sees the global risk landscape shifting in three primary ways that are particularly relevant for banks. Firstly, the 'digital revolution' is increasing the quantity of potentially useful data and the speed at which decisions are made; secondly, technology innovations are accelerating the pace of change in competitive landscapes; and thirdly, hyper-connectivity is changing the speed of information transfer and changing the way that consumers think and act.[46] These trends are important for regulators as well, making international collaboration particularly helpful, and perhaps even necessary.

A number of inter-regulatory collaboration initiatives were seen over 2019-2020. These initiatives include the development of the Global Financial Innovation Network (GFIN) which now consists of a group of 50 countries,[47] in keeping with the Basel Committee on Banking Supervision's (BCBS) suggestion that different supervisory functions should cooperate, domestically and internationally, to exchange information regarding topics such as prudential risk and the supervision of financial crime.[48]

Another such initiative is the collaboration announced between six central banks and the Bank for International Settlements (BIS) regarding central bank digital currencies. This collaboration resulted in a group co-chaired by Benoít Cœuré of the BIS and Jon Cunliffe of the Bank of England. The initial aims of the group will be, among others, to look into potential applications of central bank digital currencies to assess their cross-border interoperability.[49]

Meanwhile, the *Banque de France* has announced that it will establish its first Asian office in Singapore in early 2020,[50] its second such foreign office after New York, in recognition of the growing importance of Asian financial markets. And Canadian securities authorities have agreed with their counterparts in Singapore to exchange more information relating to industry trends and regulatory responses, and to facilitate referral and support mechanisms to enable reciprocal access for fintech firms in both market regions.[51]

A notable example of international collaboration within the academic sector is the Cambridge Centre for Alternative Finance's tri-annual program in FinTech and Regulatory Innovation. The program brings together regulatory staff from over 90 institutions to share best practices and to consider appropriate regulatory initiatives with a view to developing solutions to emerging FinTech risks.[52]

Such collaborations are part of a trend that is gaining steam and may lead to greater institutionalization of cross-border initiatives, which at present are often agreed only at the MoU level. These trends may also lead to increased standard setting at a technical level—for example around the use of data, AI, and the regulatory boundaries within which these technologies operate.

THE GLOBAL FINANCIAL INNOVATION NETWORK

In 2018, the UK FCA and a dozen other regulators and related organizations formed the Global Financial Innovation Network (GFIN) to improve cross border knowledge sharing among participants. An early stated aim was to, "enhance regulatory clarity and understanding … and promote early identification of emerging regulatory opportunities, challenges and risks"[53] by fostering cooperation among financial authorities on a variety of innovation topics, regulatory approaches, and lessons learned.[54] Members also hoped to create efficiencies for innovative firms that might wish to interact with regulators, by creating a vehicle that permitted them to do so across several different jurisdictions simultaneously.

The organization now has 50 members.[55] Notably, as of October 2019, these members include a number of US regulators such as the Commodity Futures Trading Commission (CFTC), Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), and the Securities and Exchange Commission (SEC).[56] Earlier, the only US body to have shown public interest in the GFIN was the Consumer Financial Protection Bureau (CFPB).[57]

In early 2019, the GFIN proposed to conduct a series of cross-border trials of technology tools, working with startups under a "global sandbox" scheme. After screening applications from interested firms, the GFIN announced in April 2019 that it would continue to work with eight of those applicants[58] to develop testing plans for their cross-border trials. No trials were taken forward, however, as applicant firms struggled to develop a testing plan that satisfied each jurisdiction's criteria. In October 2019, the GFIN met in Montreal to consider the future of its cross-border testing scheme noting, "we've continued to hear that industry is enthusiastic about the support and coordinated services GFIN could provide."[59]

THE ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT

Writing for the OECD's Business and Finance Outlook 2019 report,[60] Greg Medcraft, Director of the Financial and Enterprise Affairs Directorate at the OECD, noted that the 2008 Financial Crisis was a turning point in the way that the concept of trust was considered by governments. "The policy responses to the crisis – unprecedented in their scope and cost – had one underlying goal: to restore trust in the financial sector and the wider business community." In that same direction, the OECD has launched a Trust in Business Initiative, responding to the "urgent challenge" of strengthening trust in business.[61]

The organization's Outlook report[62] explores how strength in the financial sector may be reinforced by policymakers, looking at the problem through five lenses in which conduct and culture are key focal areas. These include company liability and trust in firms to obey the law, trust in financial institutions, and the conduct risks associated with the rising importance of state-owned enterprises.[63]

At the OECD's 2019 Trust in Business Forum,[64] the organization commented on the relationship between trust and compliance: "Compliance is a basic precondition for organisations to regain trust from governments and citizens. However, competing interests, incomplete implementation of recommendations, unresponsive leadership, and/or conflicting incentives often mean that compliance systems remain dormant."[65] The OECD is expected to give continued attention to the nexus between systemic trust, compliance, and the culture and conduct risk agenda.

BANK FOR INTERNATIONAL SETTLEMENTS

A recently released Bank for International Settlements (BIS) Working Paper, on "Operational and Cyber Risks in the Financial Sector" finds that banks take an average of 251 days to discover an operational loss event and, following that, another 184 days to move from discovery to recognition.[66]

Moreover, "Internal fraud events and failures as a result of negligence or improper business practices are less likely to be discovered than other events." The paper reports an average of 448 days elapse before internal fraud events are recognized and responded to as such, and 827 days in the case of improper business practices.

Such findings emphasize the need for improvements across the industry in the management of nonfinancial risks.

Firms are withdrawing from business lines and markets where such risks are deemed to be too high and/or too costly to manage.

For instance, in its Quarterly Review,[67] the BIS commented on a global retreat of correspondent banks, explaining that AML and CFT regulations had resulted in high-profile actions and penalties across the banking industry,[68] particularly in the United States and European Union.[69]

The report finds that "jurisdictions which lack robust implementation and enforcement of international financial standards provide greater scope for actors to engage in illicit financing practices," and that as a result, high-risk countries have seen a considerable level of retreat from active correspondent banks.

Within the BIS, the Financial Stability Institute (FSI) also reported on the development of Suptech in an October 2019 report.[70] It considers Suptech as, "the application of big data or artificial intelligence (AI) to tools used by financial authorities" and notes that, while Suptech is still in its infancy, "it is gaining traction, with a significant number of Suptech use cases found in the areas of misconduct analysis, reporting and data management." The early and experimental nature of such trials, the report notes, underscores a need for further international coordination and collaboration.

In that direction, in June 2019, the BIS launched an "Innovation Hub" program, "to identify and develop in-depth insights into critical trends in technology affecting central banking; develop public goods in the technology space geared towards improving the functioning of the global financial system; and serve as a focal point for a network of central bank experts on innovation."[71] The BIS announced plans for an initial set of "Hubs" in Basel, Hong Kong, and Singapore, to be established in collaboration with the Swiss National Bank, Hong Kong Monetary Authority, and Monetary Authority of Singapore. The opening of the Singapore Hub was announced during the Singapore Fintech Festival in November 2019.[72]

Additional Hubs are planned for the Americas and Europe during in a second phase of the program.

FINANCIAL STABILITY BOARD

In 2018, the Financial Stability Board (FSB) published a "Toolkit" intended for firms and supervisors wishing to see reduced misconduct in the financial sector.[73] Covered at length in our 2019 *Compendium*, the FSB Toolkit sets out a number of points for authorities to consider in addressing culture and conduct issues, including suggestions concerning standards and codes, benchmark setting, guidance on compensation practices, and discussion of governance frameworks that might help to improve corporate culture and the problem of "rolling bad apples."

The FSB's 2019 annual report[74] discusses the implementation of the G20's post-Financial Crisis regulatory reforms.[75] Notably, the report recommends that frameworks for cross-border cooperation between authorities should also be enhanced in order to build trust, to allow the sharing of information, and to preserve an open and integrated global financial system.

The report states that many firms have implemented procedures to reduce the risk of misconduct, but observes that further work is required. In particular, the report argues that compensation schemes are a key driver of culture and may encourage imprudent risk-taking. It recommends that compensation should be tied in part to customer outcomes, market integrity objectives, and alignment with firm values.

Technology has been an important consideration for the FSB over 2019/2020. In a February 2020 letter from FSB Chair Randal K. Quarles to G20 leaders meeting in Riyadh, Quarles wrote, "The G20 Presidency has asked the FSB to submit a report on the range of practices in the use of technology in regulation ('RegTech') and supervision ('SupTech'), which we will deliver in July, followed by a workshop. The report will help regulators identify how the appropriate use of technology can help to make supervision and regulation more efficient."[76]

Quarles' letter notes that the global financial system is constantly facing new challenges; that technology is changing the nature of traditional finance; and that the non-bank sector has grown and requires deeper understanding and coordination among supervisors and regulators. It is yet to be seen whether the FSB will devote attention to the use of technology in connection with culture and conduct related risks.

WORLD BANK

The World Bank launched a data portal platform for users in relation to Environmental, Social, and Governance Data in 2019.[77] The aim of the utility is to help investors align their analyses with sustainable development policy indicators, as well as to increase transparency in private sector investments in emerging markets. Data points included under its Governance Pillar include estimates for regulatory quality, government effectiveness, and rule of law. (However, none specifically address governance in the private sector.)

INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS

In 2019, the International Organization of Securities Commissions, (IOSCO) published its Report on Good Practices for Audit Committees in Supporting Audit Quality.[78] The report shares good practices for audit committees in supporting external audit quality. IOSCO states that audit is "key to market confidence and informed investors, and to the effective functioning of capital markets." The report emphasizes that audit committees should ensure that "management has a tone and the company has a culture focused on financial reporting quality," noting also that an audit firms' culture and professional skepticism are important in ensuring that the firms they audit are held to account properly.[79]

UNITED NATIONS

In 2019, the United Nations (UN) published its six Principles for Responsible Banking, of which Governance & Culture is one such.[80] The aim of the Principles is to align the business strategies of banks with society's goals, to provide a framework for a sustainable banking system, and to demonstrate how this contributes positively to society.

The Principles were launched by 130 banks from 49 countries, representing $47 trillion in assets. Signatories agree to complete a self-assessment and report to the UN annually.[81] The self-assessment template asks three governance and culture related questions. First, the firm is asked to describe the governance structures and processes it has put in place to implement the Principles. Second, firms are asked how their incentive and remedial action structures enforce implementation of the Principles. And third, they are asked how they are implementing or plan to implement a culture of responsible banking among employees. With regard to the third question, signatories are also asked to "include a high-level overview of capacity building, inclusion in remuneration structures and performance management and leadership communications, amongst others."

Europe

In the latest figures from the Operational Risk Exchange (ORX), the not-for-profit industry association, losses resulting from operational risk were down by 10.8% between 2017-2018, with the biggest proportional decreases in internal and external fraud events.[82] However, a study conducted in March 2017 found that less than a quarter of the EU's competent authorities have established dedicated teams or units on conduct risk.[83] Only around half include conduct risk in their supervisory examinations, despite the fact that it represents the vast majority of operational risks expected by Europe's top banks and can lead to significant consumer harm.

Relevant rules and supervisory guidelines have been aggregated in a Scrutiny Paper, commissioned by the European Parliament,[84] with a number of authorities relevant to the supervision of banking-sector misconduct, including the European Banking Authority, the EEA Joint Committee, and the European Securities and Markets Authority (ESMA).[85] Andrea Resti, author of the Paper, comments that "large portions of the rules used to address banking misconduct are country specific, and addressed by domestic law." She finds also that "misconduct rules and principles are implemented by individual EU countries in a heterogeneous manner," to include the functioning of regulatory and judiciary systems.

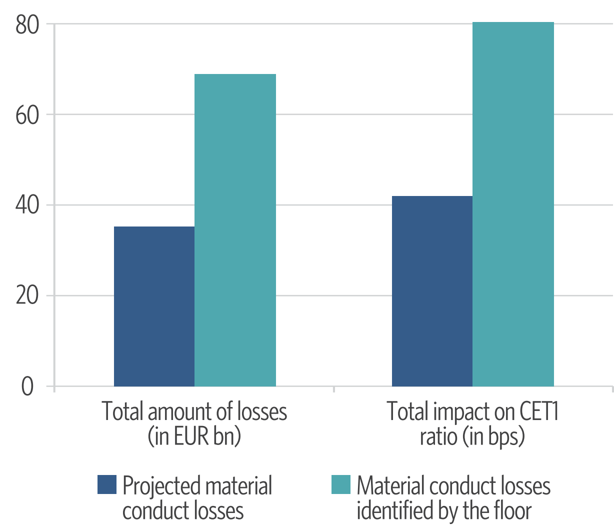
THE EUROPEAN BANKING AUTHORITY

Andrea Enria, Chair of the European Central Bank's (ECB) Supervisory Board and former Chair (2011-19) of the European Banking Authority (EBA), has argued that while the relevant primary legislation is in place to permit for effective conduct risk governance and supervision in the EU, the "key issue is effective application and enforcement."[86]

In a 2016 speech delivered in his capacity as EBA Chair, Enria stated that eradicating conduct issues is a challenge for regulators,[87] noting examples of the mis-selling of financial products, the circumvention of AML rules, and tax evasion at scale. "We need to seriously review the approaches used so far to quantify and mitigate operational risk, also considering the possibility of setting specific requirements for conduct risk," he said. "Efforts should be made to develop methodologies to incorporate conduct risk in stress test exercises."

Indeed, since 2016, the EBA has included conduct risk metrics in its biennial stress tests, albeit in a high-level, outcomes-based approach, measured in costs of litigation.[88] In its latest tests (2018), the EBA's data shows that banks had estimated their conduct risks to represent €35 billion in an adverse scenario. The EBA projected an estimated €69 billion at minimum. "The result of the bank's parallel test will by definition be a lower number than the supervisor's test" suggests Clifford Chance regulatory partner Simon Gleeson, due to the framing of the exercise.[89]

9. Comparison between the projected material conduct risk losses and the floor for material conduct risk losses under the adverse scenario (EUR bn and bps)



Source: EBA 2018 EU-Wide Stress Test

Enria has complained about the impact of conduct risk on the reputation of banks and the banking sector as a whole and has remarked upon an adverse effect on financial stability, as a result of the cost arising from compensation fines and settlements for European banks. Using data provided by other sources, the EBA estimates these to have been more than €200bn between 2007 and 2016 for the 20 largest global banks.

To improve the situation, Enria has called for a strengthening of internal governance controls within organizations, to include improving the quantification and mitigation of operational risk, which might then help to improve the methodologies used in conduct risk stress tests. Finally, he calls for a harmonized and predictable sanctions and enforcement framework relating to conduct issues across EU nations.

The EBA's 2020 stress test guidelines include the need for banks to project losses arising from conduct risk "using their internal models and, in the case of conduct risk, available qualitative information."[90] The tests, however, have been postponed in order to enable banks to focus on their coronavirus efforts and contingency strategies.[91]

The EBA has also published guidelines for effective governance. It states that, "a sound risk culture should promote an environment of open communication and effective challenge in which decision making processes encourage a broad range of views, allow for testing of current practices, stimulate a constructive critical attitude among staff, and promote an environment of open and constructive engagement throughout the entire organisation."[92] It calls upon bank staff to "conduct themselves with honesty and integrity" in addition to complying with any legal requirements and internal policies.[93]

Stress tests aside, the EBA has taken other, more specific measures in 2019, across the three sub-areas of conduct regulation.

First, for instance, in the area of retail conduct—i.e. the conduct of financial institutions towards consumers—the EBA published its first report on the way the industry has implemented the EBA's Guidelines on Product Oversight and Governance Arrangements (POG) in July 2019. The EBA's Guidelines were issued in 2015 to address large-scale retail conduct failure and mis-selling that was observed in the banking sector at the time.[94] The Guidelines aim to ensure that products are developed and brought to market in a way that focuses on the needs and interests of the consumer and, in doing so, reduce misconduct costs and contribute to market confidence. The report identifies a number of good and bad practices, and outlines the next steps the EBA will take including a repetition of the exercise in 2020, with a larger sample of firms from EU Member States.[95]

Second, in the area of anti-money laundering and countering the financing of terrorism (AML/CFT), the EBA published a consultation paper on revised Guidelines on AML risk factors in the end of 2019.[96] The proposed Guidelines include requirements on inter alia risk assessments, customer due diligence for beneficial owners, as well as sectoral guidelines on crowdfunding platforms, corporate finance, and some payment institutions. The EBA will assess received responses, and the final Guidelines are estimated to be published at the end of 2020. In addition, the EBA issued final Guidelines on the cooperation and information exchange between prudential and AML/CFT authorities,[97] and also made preparations for the pending widening of its AML tasks from January 2020 onwards to "lead, monitor and coordinate" the fight against money laundering in the EU's financial services sector.[98]

Finally, in the area of tax conduct, the EBA always has to recognize that taxation is a responsibility allocated not to the EBA or its national member authorities, but to separate tax authorities. Even so, the EBA carried out an inquiry in 2019 into so-called dividend arbitrage trading schemes (also referred to as "cum-cum/cum-ex" schemes) with national prudential and AML authorities across the EU in order to assess potential threats to the integrity of financial markets. The EBA summarized its findings in a report and set out its expectations of supervisory authorities towards such schemes under the current regulatory requirements. Additionally, the EBA published an Action Plan for 2020/2021 with a view to amend and tighten future prudential and AML requirements in the context of such schemes.[99]

In January 2020, the EBA released a report assessing challenges relating to the roll-out of big data and advanced analytics in the banking sector—in particular, those that enable banks to gain deeper insights from their data, to make predictions, or to generate recommendations from the various types of data coming from various sources.[100] The report identified four pillars necessary to the successful roll-out of such technologies and identified certain difficulties faced by banks in their uptake. These include encouraging the collaboration between stakeholders as well as the training needed to effectively address challenges. The EBA also identified certain 'elements of trust' needed for the technologies to be appropriately integrated:[101]

- Ethics
- Explainability and interpretability
- Fairness and avoidance of bias
- Traceability and auditability
- Data protection
- Data quality
- Security
- Consumer protection

EUROPEAN CENTRAL BANK

The European Central Bank's (ECB) Supervisory Review and Evaluation Process (SREP) is an annual assessment of the way banks deal with risks, in order to identify key objectives needed to address such risks successfully. A key part of the assessment focuses on governance and management-related risks. Trends in internal governance scores are an area for supervisory concern—of the 109 banks evaluated in 2019, only 13% achieved a good score for operational risk management, while 87% achieved the second-to-worst available score.[102] In the internal governance category, 82% of institutions scored a 3 or 4 (low) score on a four-point scale, up from 75% in 2018.

Within the category of governance and management-related risks, the ECB assesses internal governance and risk management only from a qualitative (risk control) perspective,[103] including an effort to form a view regarding an organization's risk culture. When assessing an organization, the ECB takes a 'wide perspective' in order to assess its overall competence and capacity. The reviews encompass "all of an institution's rules and behavioral standards, including its corporate culture and values, which aim to ensure that the institution or group is properly managed."[104] The formal review of governance is more limited, however, focusing on internal policies and the organizational chart in an examination of key functions and committees, reporting lines and responsibility allocations, and the knowledge, skills, experience, and reputation of key function holders.

ECB supervisors are particularly concerned about poor board effectiveness, weak risk management, control of outsourcing related risks, and poor data aggregation capabilities, with many banks demonstrating weak alignment with BCBS 239 principles. The ECB finds that the greatest challenges appear to be among Globally Systemically Important Banks (G-SIBs) and Corporate/Wholesale Lenders.[105]

In Focus: Irish Banking Culture Board

By MARION KELLY, CEO

Marion Kelly, IBCB CEO

The Irish Banking Culture Board (IBCB) was established in April 2019, and is an independent industry initiative, fully funded by the five retail banks operating in Ireland (Allied Irish Banks, Bank of Ireland, KBC Bank Ireland, Permanent TSB & Ulster Bank) with the aim of rebuilding trust in the sector through demonstrating a change in behaviour and overall culture.

The backdrop to the establishment of the IBCB is comprised of heavy public, media, political and regulatory criticism of the behaviour of the sector pre, during, and after the Financial Crisis of 2008/2010 which resulted in the Irish State 'bailing out' a number of the retail banks operating in the sector at that time at a cost of approximately €42 billion. However, the key catalyst contributing to the establishment of the IBCB is the behaviour of the sector in relation to the sale, and subsequent withdrawal of so-called 'Tracker Mortgage'[1] products in Ireland. Each of the five Irish Retail Banks has been the subject of a specific regulatory inspection by the Central Bank of Ireland (CBI) in relation to the sale of Tracker Mortgages, which has resulted in significant redress programmes and which will result in regulatory sanctions. In July 2019[2], the CBI reported that lenders had paid €683 million in redress and compensation and over 40,000 customers had been identified as impacted at that point. At the time of writing, just one of these inspections is complete, which culminated in the imposition of a fine of €21 million on Permanent TSB—the largest fine to date imposed by the CBI in Ireland under its powers of enforcement.

In tandem with the Tracker Mortgage investigation, the CBI commenced Behaviour and Cultural Reviews of the five Retail Banks in 2017 using a model based on that developed by the Dutch Central Bank, resulting in the publication of its report 'Behaviour and Culture in Irish Banks' in July 2018. During this period, culture programmes were established in each of the individual banks, however it was recognized that in addition to individual bank programmes, there was scope for the industry to cooperate to focus on the issue of culture and behavior, and as a result the IBCB was established.

The IBCB is not a regulator and is not an industry body. Its remit is to work with *all* stakeholders in the industry—the banks, their customers and wider Irish Society to improve bank culture and contribute to a restoration of trust in the sector.

There is understandably much scepticism around the independence of the IBCB given it is funded by the sector and there is also scepticism around the ability of the IBCB to really influence cultural and behavioural change.

In relation to the first of these issues—IBCB independence, the corporate governance structure that has been put in place has been designed to ensure and demonstrate independence. The role of Chairman of the IBCB Board was publicly advertised and the selection process was run by a panel entirely independent of the Irish banking sector. This process resulted in the appointment of Mr. Justice John

Hedigan to the role of IBCB Chair. Mr. Justice Hedigan is a former Judge of the Irish Court of Appeal, High Court and Commercial Court. He also served as a Judge of the European Court of Human Rights from 1998-2007.


Mr. Justice John Hedigan, IBCB Chairman

The IBCB Board is comprised of fourteen members in total, with the majority being non-bank. In addition to the Chair and the CEO, there are seven members drawn from across Irish society. Three non-Executive Directors represent the interests of Consumers, two others represent other bank customers—most notably SMEs and Farmers. There is a member drawn from the Financial Services Trade Union and a respected academic with expertise in corporate governance and culture. In addition to these seven members, each of the founding member banks of the IBCB is represented on the Board at C-suite level.

Culture means many things to many people. It was necessary to focus the initial activities of the IBCB on particular aspects of cultural change which would resonate with key stakeholders. For this reason, we decided to ask for, listen to, and act on the views of those two cohorts of stakeholders most impacted by this culture—bank staff and bank customers. We conducted two pieces of research in this regard. Firstly, we commissioned the UK Banking Standards Board (BSB) to conduct a survey in October 2018 of the 25,000 bank staff across our founding member banks to gauge their views on the internal culture of their institutions. Secondly, we conducted a Public and Stakeholder Consultation exercise. Through a website, yoursaybankingculture.ie, which was supported by a press and radio advertising campaign, we received hundreds of responses from members of the public in relation to bank culture. The stakeholder consultation exercise involved 38 face to face interviews with individuals and organisations from right across Irish society, including consumer organisations, small and large business, farmers, charities, youth groups, students, trade unions, the elderly, media, politicians and regulators.

The findings of these two pieces of research were published in two separate reports in April 2019. These findings have set the baseline of what the perceptions are of banking culture in Ireland and what needs to change. These findings have also been used to inform the IBCB's initial work programme. This work programme is comprised of two pillars of focus: one focussing on internal aspects of bank culture—including issues such as Ethics & Behaviour, Speaking Up and Psychological Safety, and the second pillar focussing on external and more customer impacting issues such as Communications, Supports for specific Customer groups such as Vulnerable Customers, Financial Education and Awareness, etc.

The IBCB is a relatively unique construct, many of the members of the Board would not previously even have been in the same room together and they are now committed to working collectively as a Board to improve bank culture.

We are only at the very early stages of this journey. We recognize that the restoration of trust in an industry which has been the subject of so many challenges and issues will not be easy but, we are confident that, over time, we can contribute to positively changing bank culture to the benefit of the two cohorts most impacted by this culture—bank customers and bank staff.

Further details can be found on www.ibcb.ie

REFERENCES

1 'During a period of increased competition in the Irish mortgage market between 2003 and 2008, tracker mortgages – which tracked the European Central Bank ('ECB') interest rate by a margin – grew in popularity as a product. When interest rates started to rise between 2006 and 2008, many customers on variable interest rates (including tracker interest rates) decided to fix their interest rate for a period in order to have certainty about their monthly mortgage repayments. From 2008, due to the economic and banking crises, lenders' funding costs rose and were no longer aligned to ECB rates. As a result, all lenders in the market stopped offering tracker interest rates to new customers. However, in doing this, lenders sometimes failed to take account of their obligations to existing customers, including customers who had a contractual right to a tracker rate of interest - or the legitimate expectation of a tracker rate based on documentation or other influencing factors - when their fixed rate mortgage expired. In particular, some customers who had chosen to fix their interest rates between 2006 and 2008, lost that tracker interest rate, or were not offered that tracker interest rate, during the remaining term of their agreements. This resulted in often significant overcharging of customers, over a prolonged period of time in some cases.' *The Tracker Mortgage Examination – Final Report, July 2019,* Central Bank of Ireland. https://centralbank.ie/consumer-hub/tracker-mortgage-examination

2 Ibid.

Ireland

CENTRAL BANK OF IRELAND

Within the Central Bank (Amendment) Bill of 2019, the Central Bank of Ireland (CBI) set out detailed proposals for the introduction of a Senior Executive Accountability Regime (SEAR), with firm culture squarely in its purview.

The Bill follows on the 'Tracker Mortgage Scandal' that has produced national uproar. Allegations are that leading Irish retail banks either denied customers the right to a cheaper mortgage or placed them on one at an incorrect rate,[106] resulting in home loss for many and financial harm to others.[107] The Bill followed recommendations the Central Bank had made in the Irish Law Reform Commission's Issues Paper, "Regulatory Enforcement and Corporate Offences."[108]

The CBI's proposed accountability regime (SEAR) is modeled on the UK's Senior Managers and Certification Regime[109] and includes an enhanced 'Fitness and Probity Regime' for relevant individuals.[110] It will oblige firms and senior executives to set out where decision-making authority lies, will strengthen the CBI's powers to reprimand or disqualify executives, and grants statutory power to enforce binding obligations regarding expected conduct standards.

"What we would like to see is that the tone for a positive culture is set from the top at the firms, cascaded throughout the entire organisation—and echoed from the bottom up. We believe that these proposals to strengthen individual accountability are an important step in that direction," CBI Head of Financial Conduct Derville Rowland said in describing the regulator's current priorities.[111]

The accountability regime will make it easier for the Central Bank to fine bankers—at present, it may pursue individuals only in limited circumstances—and the rules will extend also to insurance companies and asset management firms. The CBI's Derville Rowland has also argued that professional advisers must play a role in improving culture among financial firms: "the Central Bank expects the conscientious professional to advise firms to comply not only with the letter of the rules, but also with the spirit."[112] The reforms follow still more recent scandals in the country, which saw a €21m fine for Permanent TSB as a result of overcharging customers, a €1.6m fine for JPMorgan for "serious regulatory failings," and a €5.9m fine for Wells Fargo, after it failed to detect non-compliance in relation to its capital reporting, liquidity testing, and internal documentation, reflecting a "poor compliance culture."[113]

The CBI also published a "Dear CEO" letter, in April 2019, which addresses firms' obligations under the Fitness and Probity Regime, noting that there was a lack of general awareness of such among firms.[114] The letter states that the CBI expects CEOs and boards of firms to explain how issues under the letter have been considered, and to demonstrate steps taken to address shortcomings.

IRISH BANKING CULTURE BOARD

A survey conducted by the Irish Banking Culture Board (IBCB), found that more than a third of bank staff had wanted to raise concerns in the past 12 months. These concerns primarily relate to their employers not acting in the best interests of their customers. Two in five staff reported that they did not speak up for fear that either nothing would come of it, or the action would be held against them.[115]

The IBCB was established in 2019 with funding from the 'Big Five' Irish retail banks, with the aim of rebuilding trust in the sector through the transformation of culture and behavior. **IN FOCUS ▸ P. 51** For Justice John Hedigan, Chair of the IBCB and former judge at the European Court of Human Rights, after a decade of crisis and scandal that has led to a great loss of public trust in the Irish banking sector, "this is no time for business as usual."[116]

Recent public statements suggest that at least some in the industry agree. For instance, Francesca MacDonagh, Bank of Ireland Group CEO, commented that improving culture is in a firm's enlightened self-interest, enabling a firm to stand out and to build customer, employee, and investor loyalty. *"To some, culture sounds soft, 'happy clappy', 'motherhood and apple pie' stuff. It isn't. Corporate culture is significant and hard to change,"* she said.[117]

The IBCB will consider and consult on ethical behavior, customer respect, financial literacy, and the creation of an environment where employees feel comfortable speaking up.[118] To date, the IBCB has focused on three areas—how to make it easier for staff to speak up, how services for bereaved customers can be improved, and financial education for the general public.[119]

The IBCB published its first employee survey in 2019, with responses from 58.7% of the staff working within Ireland's Big Five retail banks. The survey was conducted with the support of the UK Banking Standards Board and aimed to set a baseline against which future survey results may be measured.[120] The survey does not seek to measure or rank 'culture' but, rather, asked employees about the extent to which they believe that their firms demonstrate certain characteristics: honesty, respect, openness, accountability, shared purpose, and others. The survey found strengths in the areas of honesty, respect, and competence, but weakness in the areas of resilience, responsiveness, accountability, and openness.

According to Justice Hedigan, IBCB participants "accept that cultural change is required."[121] Its fourteen-member board is comprised of five senior bankers and seven non-bank members such as consumer advocates, business representatives, and academics. Not all are positive about reform in the sector. John McGuiness, Chair of the Government's Committee on Finance, Public Expenditure and Reform commented that the IBCB faces an uphill struggle. "They're a heartless bunch," he said, referring to bankers, "I don't know how you are going to release them from that sort of make-up."[122]

Netherlands

DE NEDERLANDSCHE BANK

"Human behaviour and governance are essential aspects in determining sound and ethical business operations," argues *De Nederlandsche Bank* (DNB).[123] As such, the DNB places high importance on monitoring the cultural aspects of its supervised institutions. This is reflected in Wijnand Nuijts' kind Preamble to this report and in the introductory remarks to our report last year, which feature a detailed description the DNB's pioneering use of behavioural science in bank supervision.

The DNB performs on-site inspections relating to governance, behaviour, and culture. It looks in particular at the impact of organizational structure at the group level, group dynamics in evidence among people, and the mindset that they reflect in their words and actions. In conducting its assessments, the DNB combines qualitative and quantitative methods of investigation including desktop research, surveys of staff, interviews with executives, and boardroom observations.

The DNB also places a high value on knowledge sharing with peers, participating in and organizing governance, behaviour, and culture initiatives, at both a national and international level. Behavioral scientists from the DNB have been invited to share their experience conducting "deep dive" culture and conduct risk audits with their counterparts in many jurisdictions,[124] and to provide training in their methodologies for regulators in Singapore, Hong Kong, and Australia, among many others.[125]

Its ground-breaking publication, *Supervision of Behavior and Culture: Foundations, Practices & Future Developments*—which the DNB refers to as "a book for our colleagues"—remains the gold-standard global reference on the topics and methods it describes.[126]

At the start of 2020, the DNB announced that it would adopt a more data-driven approach and focus on opportunities to incorporate new digital technologies into its supervision work.[127] In so doing, it will engage banks, insurers, pension funds, and payment institutions through an Innovation Forum (the "iForum") that was launched at the end of 2019. In its Supervision Outlook 2020,[128] the DNB lays out its priorities for the year ahead and describes efforts to become a "smart supervisor" by automating routine tasks where possible and adopting a data-driven supervisory methodology.

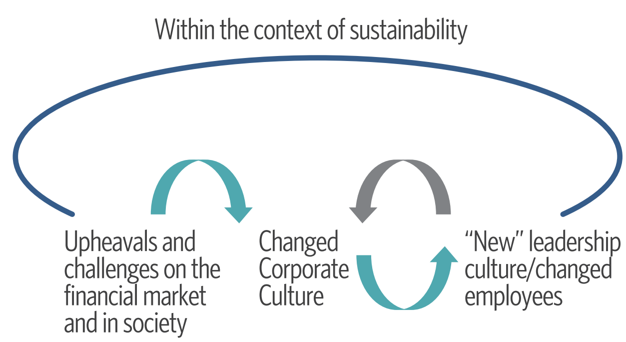
Germany

FEDERAL FINANCIAL SUPERVISORY AUTHORITY (BAFIN)

BaFin supervises some 2,700 banks, 700 insurers, and 800 other financial services firms operating in Germany. Sustainable finance is a current stated priority for BaFin. In the organisation's second *Perspectives* report, President Felix Hufeld emphasizes that sustainable finance encompasses a concern for social welfare and justice, in addition to preserving ecological resources.[129] He references a German Council for Sustainable Development articulation of sustainable businesses as those that are "based on a culture of sustainability characterised by a respect for nature, social knowledge and creativity," and that work to reduce the use of natural resources "to a level that is consistent with sustainable development."[130]

Within BaFin's *Perspectives* report was a featured section entitled "What has to change in the financial industry?" With a focus on care for the environment, the report states, "now more than ever, banks, insurance companies and asset management companies need people who question the existing order, [and] who are prepared to leave the mainstream path."[131] The authors go on to assert that culture is key to sustainability efforts. (See Figure 10 below) They lament, in this regard, that few leaders, "especially in the financial industry," possess an understanding of systems theory. They also complain of a reliance on the "*homo economicus*" model of human behavior and a poor appreciation for the "interdependencies between the players" that are central to the management of complex systems.

10. Changes in society and companies within the context of sustainability



Source: BaFin Perspectives Issue 2 (2019)

Much prominence was given to the idea of sustainability in Deutsche Bank's 2019 Non-Financial report.[132] "Sustainability is finally being given the status it deserves in economic life," reads the introduction from the bank's Chief Executive, Christian Sewing. The report notes an increased focus on non-financial objectives among stakeholders and the general public, and emphasises the bank's commitment to fostering a culture of "speaking up," respect, collaboration, and ethical decision-making. A prominent investigation into alleged criminal misconduct in the British Virgin Islands resulted in a dramatic 2018 raid at Deutsche Bank's headquarters, involving 170 armed police. Charges were settled in December 2019 with a €15 million fine, but a bank spokesman says the series of events had a "heavy impact" on the firm.[133]

In a 2020 speech delivered at the London School of Economics,[134] BaFin President Hufeld pointed to "fundamental gaps and failures in financial regulation" that preceded the 2008 Financial Crisis, exacerbated by supervisors who, "often could or would only practice light-touch supervision."

Yet Hufeld then goes on to call for "proportionality" with regard to conduct regulation which, he observes, "is playing an increasingly important role both in the community of regulators and in the public debates." He notes that several new European requirements take conduct into specific account, pointing to the guidelines on complaints handling issued by the European Supervisory Authorities, for instance, and the MiFID II directive. "At their heart, these moves are right," Hufeld states. "However, it's also possible that we are running the risk of creating a regulatory density and complexity," he adds, concluding that conduct regulation "requires a process of careful deliberation that demands a degree of sensitivity from regulators and policymakers." It is unclear how these remarks are reconciled with the above-noted BaFin commentary on sustainable finance.

BaFin has not made any significant changes in the way operational risk is assessed according to the regulator's latest Annual Report.[135] However, it does see opportunities for the use of Big Data and Artificial Intelligence in the creation of industry "utilities," that may be used by multiple firms "to allow for better analyses, achieve cost advantages and pursue similar interests." Such use cases, BaFin allows, might facilitate compliance with supervisory and regulatory requirements, improved money laundering prevention, and the development of know-your-customer tools that operate at a more desirable scope and scale.

Advances in technology may represent opportunities but they are also an apparent primary concern for BaFin. It sees systemic risks arising as a consequence of Big Data and Artificial Intelligence, which represent significant challenges in the context of third-party management.[136] Hufeld notes that, in order to be able to supervise such services appropriately, BaFin may establish conduct of business rules for third party providers and monitor compliance with these rules.[137]

France

In an early 2019 speech,[138] Deputy Governor of the *Banque de France* Denis Beau remarked:

> *[F]inancial technologies should not only be seen as opportunities for the provision of new products and services or as a further threat to financial stability. Financial technologies can also be an asset to enhance compliance with regulation or risk management practices: that's what we call "Regtech". They can also help the supervisor to perform its task more efficiently: we then speak about "Suptech" (supervisory technology). In both areas, the prospects are promising.*

He goes on to discuss supervisory efficiency gains that may be achieved through the application of Big Data and Artificial Intelligence tools to "the huge amount of quantitative and qualitative data" collected by the *Banque*. He highlights in this regard the advantages that might accrue when "backward looking monitoring tools" may be refashioned "into predictive processes." Development of such capabilities, Beau argues, is a priority that ties to supervisory credibility. "A supervisor who engages in the 'suptech journey' gives a clear and positive signal to market players: he is willing to accompany an evolving sector so that supervisory methods can be adapted and remain relevant and consequently, the financial system can remain safe and trustworthy." As an example of efforts to lean into the opportunities represented by technology, Beau points to the creation of a "Fintech Hub" within the *Banque*'s supervisory department, and *Le Lab*, which aims to foster greater innovation efforts throughout the organization.

In a May 2019 speech,[139] Beau makes note of interest in sustainable finance in France and across Europe. Notably, he suggests that related activities must be integrated into the function of traditional risk departments, and he calls for improved metrics. Next steps in that direction to be led by the *Banque*, Beau states, will involve organizing "work streams" with banks operating in France, "in order to specify together the best practices of the sector in terms of governance and to reflect on scenarios and metrics to best assess the vulnerability of banks."

It is unclear whether a proposed focus on the application of technology to the management of risk will incorporate any focus on culture and conduct related risks. However, in a February 2019 speech,[140] Beau observed that the 2008 Financial Crisis had prompted changes in the way financial institutions operate. "One of the most visible ones is that risk and compliance functions have now become an essential part of their organisations," he noted. "In a more subtle way, there have also been changes in the culture of these institutions, with greater emphasis now being placed on good governance and on the 'purpose' of certain activities or the 'service' provided to clients."

Spain

Juan Medina / REUTERS

Ana Botín, Santander Group Executive Chairman

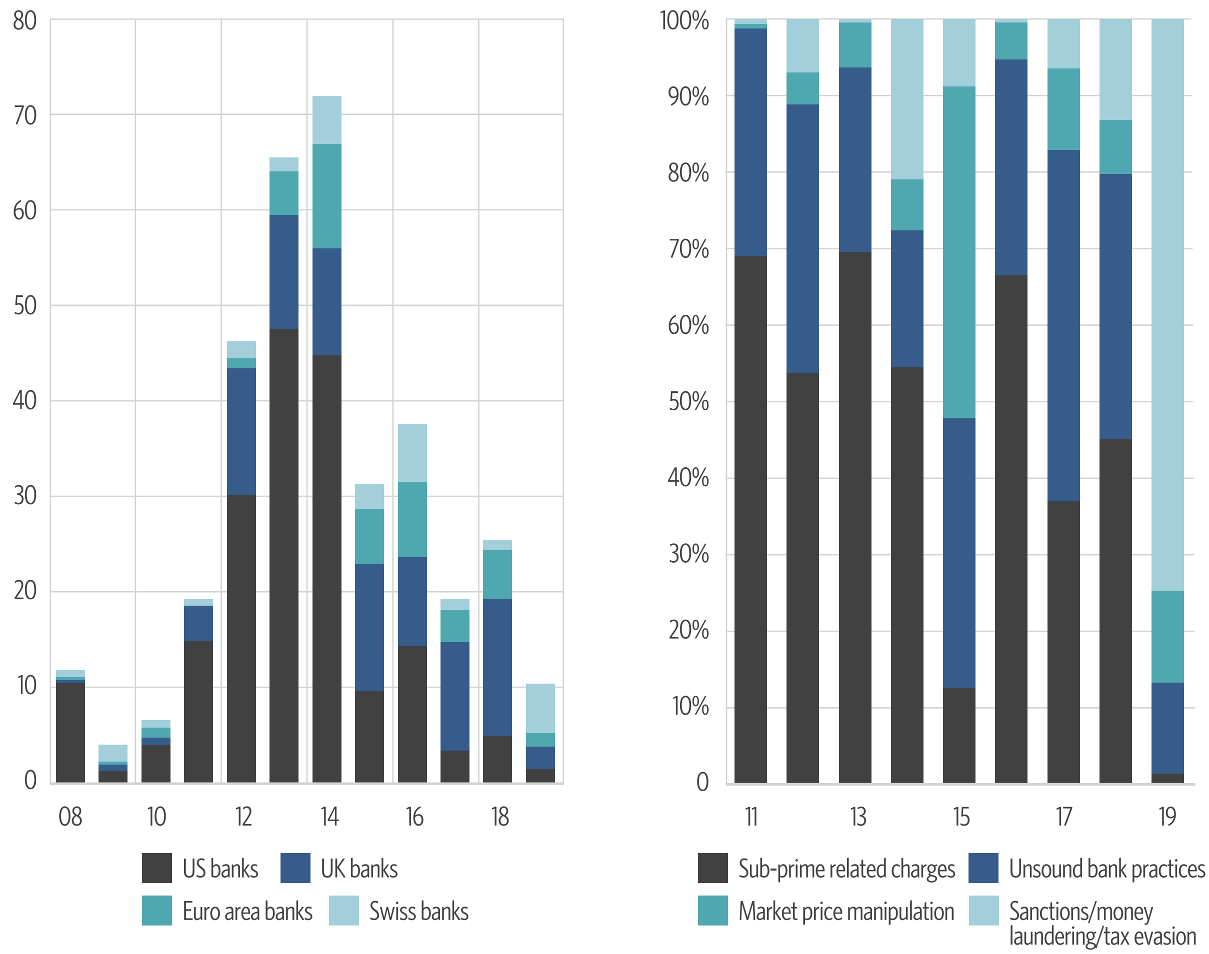
Late last year, Banco Santander Chairman Ana Botín observed that bankers remain distrusted around the world, more than a decade after the 2008 Financial Crisis, and suggested that this contributes to current political populism worldwide.[141]

Pablo Hernández de Cos is *Banco de España* Governor, an ECB policymaker, Chairman of the Basel Committee on Banking Supervision and of the European Systemic Risk Board. Consistent with Botín's view, in February this year de Cos urged bankers to work to restore their damaged reputations.[142]

It is notable that de Cos pointed to restoring reputation as an industry priority at a time when he has been occupied by COVID-crisis response efforts. In a speech from which those remarks were drawn,[143] de Cos observed that financial institutions faced a number of new risks and uncertainties, listing misconduct risk among them and noting that these were appearing "against a backdrop of rising environmental, social and governance (ESG) concerns."

We note that these remarks were made in the context of a speech that focused on risks to global financial stability and that, in the course of his remarks, de Cos presented the information at **FIGURE 11 ▸ P. 59**, below. In concluding his speech, de Cos stated that "the relevance of misconduct costs became painfully clear in the aftermath of the global Financial Crisis," and noted that, "If we also include the reputational costs associated with these forms of malpractice, the actual damage to the banking sector goes far beyond the standard estimates presented."

11. Global banks' misconduct costs (USD Billions) and type of misconduct



Source: ECB Financial Stability Review - November 2019

Like many European counterparts, Spanish regulators are readying for a digital transformation of the country's financial sector, with a new draft law—on "the digital transformation of the financial system"[144]—relating to the creation of a regulatory sandbox, recently signed off upon by ministers.[145] The scheme will be supervised by the *Banco de España*, the *Comisión Nacional del Mercado de Valores*, and the *Dirección General de Seguros y Fondos de Pensiones*, and will enable firms to test new products through a simplified authorization process.

United Kingdom

With the UK set to leave the European Union, 2020 was always going to be a turbulent year. More than a thousand banks, asset managers, other financial firms were expected to open UK offices following Brexit.[146] At the same time, an estimated 7,000 jobs were also expected to be relocated to financial hubs abroad.[147] But that was before the COVID-19 crisis put banks at the fore in policy responses to the ensuing economic fallout. The Prudential Regulatory Authority (PRA) directed major UK banks to halt shareholder dividend payments so as to shore up their capital buffers and available lending capacity.[148] Bonuses and pay increases were also expected to be sacrificed to Coronavirus relief efforts, amidst political pressure and concern for optics.[149] To the chagrin of some shareholders, the banks resisted only briefly before capitulating.

Chris Woolard, Financial Conduct Authority (FCA) interim CEO, cast the COVID-19 pandemic as the first real test of banking rules introduced since the Financial Crisis.[150] In an interview with the *Financial Times*, he emphasized that the FCA is closely monitoring how the UK's COVID-19 emergency relief loan scheme is being administered by firms.[151] "One thing I have said, both inside and outside the FCA, is that I am utterly determined not to see the kind of misconduct we have seen in the past," Woolard stated.[152]

Regulators have consciously sought to ease some standard obligations so as to allow firms to focus on relief efforts. In addition to the EBA's cancellation of its 2020 bank stress tests,[153] Britain's regulators have postponed non-critical work in response to the COVID-crisis and have encouraged firms to focus on the needs of their customers.[154] A joint statement from the FCA, the Financial Reporting Council (FRC), and the PRA relaxed various rules and granted firms additional time within which to publish annual audited reports, so that banks may supply added credit to the market and provide other support to essential market functioning. An increase in permissible uncertainties in financial reporting[155] acknowledges that it will be difficult to hold people accountable for mistakes that may occur during crisis relief efforts. At the same time, while they acknowledge that audit difficulties will inevitably follow, the FRC "encourages Boards to… continue to operate an effective control environment."[156]

A crackdown on mis-selling and financial crime drove FCA-issued fines to £391.8 million in 2019,[157] the highest level in four years. The regulator's most recent statistics also show a record number of open investigations.[158] Of the 650 cases opened since March 2019, 70 concerned 'culture and governance.'[159] A number of prominent misconduct cases made headlines in the last two years,[160] with Barclays' Chief Executive Jes Staley reprimanded and fined for trying to uncover a whistleblower,[161] HSBC responding to sexual harassment claims,[162] Royal Bank of Scotland having been found to mistreat small business customers of its Global Restructuring Group,[163] and Lloyds Bank failing to disclose information regarding a £245 million fraud scandal, for which six people were imprisoned.[164]

The Banking Standards Board (BSB) released a damning report regarding Lloyd's of London and the UK's insurance and reinsurance marketplace. In May 2019, Lloyd's had commissioned the BSB to conduct an independent survey of its culture.[165] The survey found that, within the preceding 12 months, nearly 500 workers claimed to have experienced sexual harassment. CEO John Neal of Lloyds' described the findings as "truly terrible" and saw them as reflecting a corporate culture described by the BSB as being "much less positive" for women than men "in every measurable way."[166] Despite a well-crafted code of conduct, 22 percent of the BSB survey respondents claimed their colleagues willfully ignore inappropriate behavior. An independent advisory group has now been appointed, with a mandate to establish clear and achievable metrics to gauge Lloyd's culture reform efforts.

In a January 2020 "Dear CEO" letter, the FCA made CEOs of insurance firms aware of its expectations.[167] "We expect you to identify what drives this behaviour and, where appropriate, modify those drivers to shape proper conduct," wrote the FCA's Jonathan Davidson, executive director of supervision, retail, and authorizations, adding that "a senior manager's failure to take reasonable steps to address non-financial misconduct could lead us to determine that they are not fit and proper." In its 2019/20 Business Plan, FCA Chair Charles Randell wrote that the regulator will be redoubling its international engagement "to ensure that the UK continues to influence global standards of conduct regulation."[168] Mr. Randell continued to say that there will be a sustained focus on culture and governance at the FCA. Bank of England Deputy Governor and PRA chief Sam Woods also indicated that those hoping for less strict regulations after Brexit would be disappointed.[169]

Early 2020 also saw the FRC's new Stewardship Code take effect,[170] following its review of corporate governance codes among listed companies.[171] The FRC is the UK's independent regulator for auditors, accountants, and actuaries. It publishes reporting standards and guidance documents such as the Wates Principles of Corporate Governance for Large Private Companies.[172] Signatories of the new Code agree "to create long-term value for clients and beneficiaries leading to sustainable benefits for the economy, the environment and society."

Earlier this year, the FRC had complained that UK companies were paying mere "lip service" to its Code.[173] With reference to section 172 of the FRC's Wates Principles, which states that businesses have a duty to promote the success of audited companies for the benefit of stakeholders, Suzi Woolfson, Head of PwC UK's private business practice, offered the view that "reporting now requires substance over form and this is causing businesses to evaluate what they've done previously."[174]

Meanwhile, the UK's Chartered Institute of Internal Auditors (CIIA), which represents 10,000 internal auditors, has increased its pressure on companies to improve corporate governance,[175] publishing a principles-based Code of Practice and list of recommendations to enhance the power of the internal audit function. The CIIA recommends that internal auditors should have unrestricted access to critical functions and records, and more direct reporting lines to senior executives.

Other CIIA recommendations state that the scope of internal audits should include the risk and control culture of organizations, which include appraisal and remuneration processes, 'tone at the top,' and observed behaviors being in line with the organizations espoused values and ethics. In the same vein, the Institute of Directors (IoD) set out a new code of conduct which sets ethical standards for boardrooms.[176] The IoD also recommended that the government create a public service corporation that works to address the interests of a company's workers, supply chain, and other stakeholders as well as shareholders.[177]

FCA

FCA POLICY SHIFT

Tackling non-financial risk is high on the FCA's 2020 agenda.[178]

At an annual meeting of financial sector leaders, Christopher Woolard, the FCA's current Interim Chief Executive and former Director of Strategy and Competition, announced that the FCA would look to undertake a major review of the UK's financial services regulations. He noted that the FCA would change its entire outlook towards a system that focuses on outcomes for consumers,[179] stating that "we live in a very different world to the one in which our rules were framed"[180] and that, in certain instances, previous approaches focused overmuch on process and too little on outcomes—"with our knowledge of behavioural economics," Woolard added, "it seems like too low a bar."

Culture and conduct reform efforts have been an FCA priority for several years,[181] and the regulator has implemented a number of initiatives in this regard. "Culture Sprints" for mid-level managers, for instance, seek to identify innovative solutions and tools that facilitate cultural transformation.[182] In his introduction to the FCA's latest annual Business Plan, former CEO Andrew Bailey stated, "Our principles and rules help to shape culture and represent a minimum standard for the behavior of financial services staff... We believe that a healthy culture is good for business as well as for consumers and for markets as a whole."[183]

The FCA will conduct culture reviews in the coming year, with the outcome of such reviews shaping an understanding of what a healthy culture looks like and allowing the regulator "to review the evidence for a causal linkage between healthy cultures and business models and healthy outcomes for consumers, markets and firms." It will also consider the role bonuses and other incentives play in driving behaviors.[184]

FCA VIEW OF CULTURE

Culture's impact on conduct has been a priority for the FCA since at least the rebranding of the Financial Services Authority to the Financial Conduct Authority. The regulator organizes roundtable discussions, webinars, and culture sprints to encourage conversation on the subject. It also publishes a considerable amount of thought leadership on the subject, including a collection of essays from field experts and academics regarding "Transforming Culture in Financial Services"[185] and "Driving Purposeful Culture."[186]

In remarks offered to Starling for inclusion herein, CEO Chris Woolard noted that culture and governance remain an important focus for the FCA, adding:

> *Senior managers and Boards should embed healthy cultures, which will lead to better outcomes for consumers and markets, which are also good for businesses and employees. There is no one-size fits all culture, but there are common elements that are important to a healthy culture. Leaders need to create an inclusive environment where employees feel safe to speak up and feel listened to when they do, and must take responsibility for setting the tone and cultural environment for the rest of the organisation.*
>
> *The Senior Managers and Certification Regime (SM&CR) came into force for solo-regulated firms in December 2019, and is an integral part of the FCA's focus on culture and governance in firms. It has been in place for banks and building societies since 2016 and for insurers since 2018. Senior managers should be clear about what they are accountable for and should be thinking about what their accountability means in practice, including how they will embed a healthy culture in the firms that they run.*
>
> *By 9 December 2020, solo-regulated firms must ensure that all staff in certified roles (including financial advisers, mortgage advisers and some managers) are Fit and Proper to perform their roles. The FCA expects firms to take certification seriously and has said that it does not expect to see staff certified where they do not meet appropriate levels of competence or conduct. Firms must also ensure that all financial services staff are trained in the Conduct Rules. Simple e-learning packages or short presentations are not likely to meet the standard required in most cases.*

"Senior managers and Boards should embed healthy cultures, which will lead to better outcomes for consumers and markets, but which are also good for businesses and employees."

Chris Woolard, Financial Conduct Authority interim CEO

Chris Woolard

The FCA attaches great importance to the Certification Regime and the Conduct Rules and there are specific senior manager responsibilities for these aspects of the regime. They are critical to driving culture change across the industry and raising professional standards.

For Jonathan Davidson, Executive Director for Supervision in Retail and Authorizations, *"While healthy cultures can be diverse, the consensus is that they can also share common elements. Two particular elements have come up in our conversations time and again: healthy cultures are purposeful and they are safe."*[187] His remarks make clear the FCA's view that non-financial misconduct relevant for its supervision includes bullying, discrimination, favoritism, exclusion, intimidation, sexual misconduct, and sexual harassment.[188] To counter these elements of poor culture, the FCA targets both individual perpetrators who may be found to have breached one or more of the FCA's Conduct Rules, or a firm's handling of such breaches—which the FCA regards in the same manner that it handles allegations of market manipulation. *"Non-financial misconduct can only be effectively addressed if there is appropriate leadership,"* Davidson remarked.[189] To this end, the FCA works together with firms to embed healthy cultures with a focus on behavioral drivers such as purpose, reward, governance, and leadership.[190]

The Four Drivers of Culture, according to the FCA

Leadership: Senior managers will be held accountable should they fail to handle non-financial misconduct in a proper way. What's more, boards are expected to consider prior actions when deciding if an individual is a suitable candidate for a senior management role.

Purpose: Firms must have a clear, and well communicated, purpose that employees and customers alike can identify with.

Approach to people management and reward schemes: A firm's incentive and reward scheme structures must be consistent with the purpose identified above.

Governance systems and controls: All systems and controls should be made compatible with a firm's purpose. For example, having whistleblowing procedures and processes in place fundamentally aids a company with a focus on transparency.

Sources: Jonathan Davidson, "Dear CEO," Letter, Financial Conduct Authority, Jan. 6, 2020.
Financial Conduct Authority, "Business Plan 2020/21," July 4, 2020.

SENIOR MANAGERS & CERTIFICATION REGIME

Managing conduct, and instilling personal accountability for misconduct, became a focus of a new regulatory framework—the Senior Managers and Certification Regime (SM&CR) which was operational in 2016. This followed an eleven-month Parliamentary commission into banking standards which produced five separate reports and drew on over a decade of UK conduct regulation.

The SM&CR holds senior managers personally accountable for the actions that take place within their firms and ambit of accountability. It enables the FCA to punish individuals for failures that take place on their watch, as well as for any wrongdoing by such managers themselves. Examples of the detailed rules include an obligation for firms to exchange employment references relating to conduct for risk-taking employees and senior decision-makers, and to ensure that senior managers receive a statement of responsibilities under the SM&CR. Traders and others who might cause harm to customers, the firm, or markets must be 'Certified' as 'Fit and Proper'[191] to perform their functions, with conduct rules such as 'acting with integrity' applying to specific jobs.

In 2019, the regime was reviewed following a period of interviews with firms, trade associations, and in collaboration with the Prudential Regulation Authority and the Banking Standards Board. The review found that most firms had begun a process of culture change before the regime was implemented. Factors driving such initiatives included past misconduct issues, the impact of ring-fencing in the UK banking sector, and the remuneration code.[192] However, the review also found that, often, training was not suited to specific job roles and that many firms were not yet able to explain what a conduct breach looked like in the context of their business.[193] Similarly, while firms often made statements regarding their values, the FCA found insufficient evidence that firms had clearly mapped the FCA's conduct rules onto their stated values.[194] Christopher Woolard commented in particular that, "Simple e-learning packages or short presentations are not likely to meet the standard required in most cases."[195]

In 2019, the FCA extended its SM&CR conduct standards to all 59,000 of its regulated firms. This scope includes firms' foreign branches,[196] which means that senior managers of foreign firms with UK subsidiaries will have responsibilities under the scheme. Full completion of the regime is slated to take place in 2020, with other regulators in Ireland and Singapore expected to introduce similar requirements, modeled on the UK's regime.[197] The FCA has stated that it "will continue to build on the links between the SM&CR and firm culture." Making the link between culture and conduct more direct, it notes that "the SM&CR is an important way to establish a culture of accountability for conduct and aligns with our cross-sector business priority to continue to work on firm culture and governance."[198]

NEW ASSET MANAGEMENT RULES

The FCA has also set new rules for asset managers that aim to address past misconduct issues. The rules came into force from September 30th 2019, with the first related reports to be published in 2020.[199] The rules require that fund managers conduct self-assessments with a view to determining whether they provide demonstrable value to investors. Firms must publish the results of these self-assessments and, where appropriate value delivery has not been demonstrated, they must set forth a list of corrective actions that will be taken.[200]

FCA DIRECTORY

In March 2019, the FCA published its final rules regarding the establishment of its Directory, a public list of individuals in key roles within financial firms but who are not on the FCA's current Register under the SM&CR. The aim is to increase transparency in the financial sector, with a view to enabling consumers, law enforcement agencies, regulators, and professional bodies to monitor the market and identify decision makers. The list was due to go live in March 2020 for banks and insurers, and by December 2020 for all other relevant firms.[201]

REGULATORY TECHNOLOGY AT THE FCA

The FCA has been open to innovation and has met with a number of technology providers to explore the impact RegTech might have in the supervision and governance of culture and conduct related risks.[202] The FCA has stated three priorities for its developing use of technology. First, it will continue to explore and experiment with methods of data exchange between the financial industry and regulators, including exploring whether such communication can be converted into a machine readable and executable form. Second, the FCA will continue to work to find better and more cost-efficient solutions in the anti-money laundering and financial crime compliance sphere. Finally, the FCA will assess how technology is able to assess vulnerable customers, such as those with health or financial difficulties.[203]

According to Christopher Woolard, the FCA has made significant investment in its data capabilities over the past few years. In comments provided to Starling for inclusion herein, Mr. Woolard stated that this includes investment aimed at, "better monitoring to spot harm early and intervene quickly; an improved view of historical activity and patterns of behaviour which informs predictive analytics looking at future issues; prescriptive and automatic interventions where the decisions we make are binary; and integrating core information workflows and datasets into our regulatory processes to make us more efficient overall." Some specific examples of these types of projects include "the use of web scraping to help us analyse products and services being marketed to consumers; experiments with network analytics to help understand patterns and controls; and predictive analytics as a way to help spot individuals and companies with a higher risk profile."

BANKING STANDARDS BOARD (BSB) ANNUAL SURVEY

BANKING STANDARDS BOARD

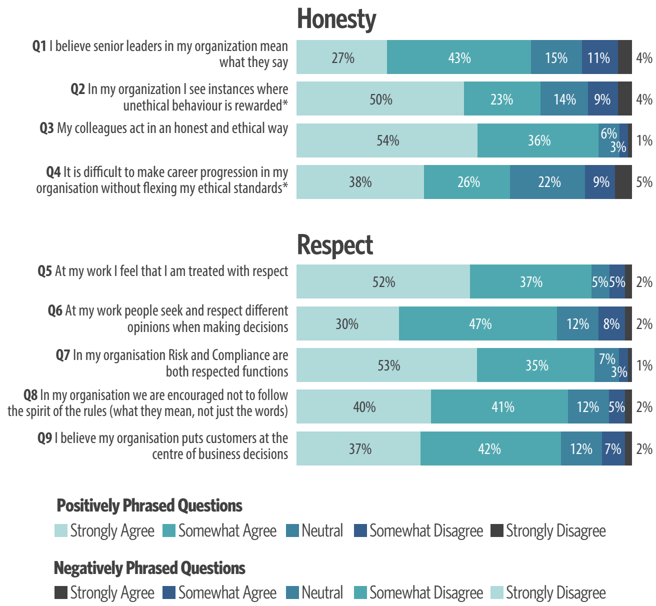
In January 2020, the BSB released the results of its fourth annual Assessment of Behaviour, Culture, and Competence in the UK banking sector.[204] The survey was the largest of its kind, with 81,000 employees from 29 UK banks participating. The questions posed were consistent with those that the BSB has been asking since its 2016 first report, with a view to building a time-series concerning conduct to enable the results to be assessed in both absolute and relative terms year-on-year.

The BSB does not seek to measure culture directly but, rather, it asks which of the nine characteristics shown in **FIGURE 12 BELOW** a firm values, so it may compare results as relative to other firms' responses. The BSB comments that ethical and professional frameworks underpin its approach and states that "there is no uniquely good (or bad) organisational culture against which all others can be measured."[205] Reacting to the BSB's latest review, the now-former Bank of England Governor Mark Carney, commented that the creation of "sound cultures… requires leaders who are prepared to ask uncomfortable questions." More importantly, he added, they must be "prepared to listen to uncomfortable answers."[206]

Figure 12

Source: BSB - https://www.bankingstandardsboard.org.uk/pdf/banking-standards-annual-review-2018-2019.pdf

The latest survey's results showed little change over the previous year. Commenting on the results, the BSB stated that, "the overall picture is one of improving scores in 2017 followed by a sideways trend."[207]



Source: Banking Standards Board, "Assessment Results 2019," Jan. 28, 2020, p. 9. https://bankingstandardsboard.org.uk/bsb-assessment-results-2019/

Alison Cottrell, CEO of the BSB, wrote that "*Culture has consequences. It shapes outcomes. Managing culture and raising standards of behaviour and competence across the banking sector, is a challenge for firms, individually and collectively*."[208] Only 70 percent of respondents indicated that they believe senior leaders in their organisation mean what they say. Only 10 percent could confirm they believed that colleagues act honestly and ethically. And only 53 percent "strongly agreed" that Risk and Compliance were respected functions in their organization. However, respondents did believe that senior executives were willing to take responsibility when things went wrong, with 66 percent agreeing in 2018, compared 58 percent in 2016.[209] While firms have been encouraging individuals at all levels of the business to speak up, a quarter felt that that such efforts were futile.[210] Only 63 percent of those who had wanted to raise a concern about something at work indicated that they had done so, and 40 percent of those who did speak up said they had not felt listened to or taken seriously.[211] The nature of the concerns raised by employees also tend to relate to business rather than non-financial concerns such as bullying or discrimination—although such non-financial concerns may have been the more prominent matters.

RELEVANT UK BEHAVIORAL SCIENCE RESEARCH

London School of Economics researchers have been developing a methodology to place corporate culture at the same level of empirical scrutiny as profit and loss.[212] In an article published on the FCA's Insights page,[213] the authors note that there are more than 176 different definitions of culture and multiple frameworks, some of which look at the values that guide people, while others look at systems of formal and informal structures. They explain that "the science is fragmented across different academic silos: business ethics, anthropology, organizational behavior, management, psychology and sociology."[214] In another article published on the FCA Insights website, the authors advocate for operational leaders to use behavioral science in the course of management interventions.[215] The result of the LSE research has been the Unobtrusive Corporate Culture Tool (UCCAT),[216] developed by Dr. Tom Reader and Dr. Alex Gillespie. The tool is a methodology for analyzing and benchmarking corporate culture. Removing the need for employee interviews and questionnaires, the tool analyses publicly available data such as financial reports and press releases. It is unclear how widely the tool has been deployed and to what effect.

THE FINANCIAL REPORTING COUNCIL

FRC

In its annual report concerning the UK's corporate governance code, the Financial Reporting Council (FRC) stated that companies need to improve their governance practices if they are to demonstrate their positive impact on the economy and wider society.[217] The FRC's Code came into force in 2019, and analysis of its impact finds some good examples of firms increasingly using non-financial related incentives based on a long-term strategic-mindedness. However, there was also a struggle to define purpose and effective culture, an insufficient consideration of the importance of culture and strategy, and limited reporting on diversity.[218] Notably, the FRC has itself been under heavy criticism recently following a recent government review.[219]

The Council recently re-evaluated the effectiveness of its Code, which it has published for the past 25 years,[220] and found that many large listed companies prioritized "strict" compliance, while not improving firm culture, diversity, or considering the views of all shareholders.[221] The FRC Chief Executive Jon Thompson commented that this was "paying lip service to the spirit of the code and does a disservice to the interest of shareholders and wider stakeholders."[222] FRC Chairman Simon Dingemans argues that widespread adoption of the Code would reinforce "the attractiveness of the UK as a place to do business and deliver real benefits to the economy, the environment and society more broadly."[223]

The FRC's 2020 Stewardship Code asks that asset managers consider governance factors, as well as environmental and social factors, at the companies in which they invest.[224] They are also asked about their own organizations' culture, strategy, and purpose, and to spell out efforts to assure that they have implemented appropriate staff incentive schemes.[225] Although application of the code is voluntary, the FCA requires asset managers not electing to follow the Code to provide the regulator and shareholders with additional information as to why this may be.[226]

BANK OF ENGLAND

BANK OF ENGLAND

In a mid-summer 2019 speech, Anna Sweeney, director of insurance supervision at the Bank of England, stated her view that all regulated firms must have "a culture which allows staff to speak up where they see things going wrong... which could affect the financial soundness of firms."[227] Sweeny emphasizes with this statement that the perceived inability to "speak-up" may prove to be a financial and systemic risk. Sweeny went on to mention some of the mechanisms that firms and regulators might use to meet prudential regulations relating to workplace culture. Examples included seeking to attract wider pools of talent from ethnic minorities and career returners, working to ensure the retention and development of staff to minimize turnover, developing inclusive cultures, and challenging 'groupthink.'

We note that statements to this same effect are increasingly heard in many jurisdictions and all across the UK regulatory system. Less clear is who regulators will hold accountable for driving results in this regard, outside of the CEO. Within firms, priorities such as those described by Sweeny might be seen as occupying the attention of HR departments. Yet it is clear that the risk and compliance function must also be involved. And, increasingly, IT experts and data-owners within firms are looked to for critical collaborative input. However, a happy marriage between these diverse functions is rarely evident and hard to test for. "Accountability mapping" pursuant to the SM&CR, for instance, may not take cross-functional dynamics among such groups into consideration at the necessary depth.

It is, therefore, notable that the Bank of England (BoE) recently announced it will begin to collaborate more closely with the FCA in adopting common data standards and reviewing the potential for, implications of machine-readable reporting. "Alongside investment in new technology and increased use of external data," the FCA's Christopher Woolard stated, "the

FCA will pursue a broader transformation, investing in skills and new ways of working to enable it to better understand and use data and innovative technology."[228] The Bank of England will also be working with the FCA on a joint Discussion Paper on "Transforming data collection from the UK financial sector."[229] A key focus of that work will be how best to improve the timeliness and efficiency of data collection from firms across the financial system. It will be interesting to see if attention goes also to the quality of data collection from across any given firm.

In a joint announcement, the BoE and FCA stated that the new strategy outlines their "increased focus on the use of advanced analytics and automation techniques" to deepen an understanding of how markets function and to allow the FCA "to efficiently predict, monitor and respond to firm and market issues."[230] Mr. Woolard commented that, "in keeping with our Mission, a data-driven approach to regulation allows us to anticipate harms before they crystallise, better understand the effect on consumers of changing business models and to regulate an increasing number of firms efficiently and effectively."

The two regulators previously collaborated on a joint report concerning the uptake of Machine Learning in the UK's financial sector,[231] which found that these technologies will play an important part in the design and delivery of financial services in the future. The BOE's now-former Governor Mark Carney commented that the Bank was working with the FCA to establish a Public-Private AI forum which will seek to understand the practical challenges of using artificial intelligence and machine learning within financial services. It will also assess potential risks, and seek to determine where new principles, guidance, or regulation might be appropriate to support the safe use of these technologies.[232]

PRUDENTIAL REGULATORY AUTHORITY

BANK OF ENGLAND
PRUDENTIAL REGULATION AUTHORITY

Housed within the Bank of England, the Prudential Regulatory Authority (PRA) works to set standards and to supervise banks, building societies, credit unions, insurers, and major investment firms.[233] The PRA is habitually tight-lipped. It was thus highly unusual when, in November 2019, news was made public that HSBC had been warned by the PRA for two years running regarding inadequate non-financial risk controls.[234] Conduct risk was specifically mentioned in this connection. This followed on the heels of the release of the BSB's survey results which found that, out of seven UK investment banks, HSBC's ranked last when respondents remarked about their colleagues internal reputation for "acting honestly and ethically," "flexing ethical standards to make career progression," and "turning a blind eye to inappropriate behavior."

This news was made public by a now removed HSBC senior banker, rather than the PRA itself. However, again in November last year, the PRA was perhaps atypically outspoken when it warned UK insurers that they must work to improve their culture in the wake of wide-spread allegations of harassment and bullying at Lloyds and across the insurance industry more broadly. "These issues also raise broader questions about whether firms are promoting a culture where staff feel able to speak up about poor practices or unidentified risks within their organisations," reads a 'Dear CEO' letter written by Gareth Truran, PRA acting director for insurance supervision.[235] "We remind Boards that they have a collective responsibility for articulating and maintaining a culture of risk awareness and prudent management of risk for their organisation," Truran added.

Hong Kong

REGULATORY BACKGROUND

Asia-Pacific regulators have been particularly vocal in recent years concerning the importance of culture and conduct, and those in Hong Kong have been prominent in this regard. At an Annual Banking Conference held in September 2019, Deputy Chief Executive of the Hong Kong Monetary Authority (HKMA) Arthur Yuen listed key 2020 priorities: sustainable finance, fintech, and bank culture reform.[236]

The HKMA complements its regulatory requirements on banks' conduct and business practices with a bank culture reform program. Under section 7(2) of the Hong Kong Banking Ordinance (Chapter 155 of the Laws of Hong Kong), the functions of the HKMA include, among other things, promoting and encouraging proper standards of conduct, sound and prudent business practices amongst banks, and taking all reasonable steps to ensure that any business carried on by banks is conducted with integrity, prudence, and the appropriate degree of professional competence.

Like other regulators elsewhere, the HKMA does not assert any 'one-size-fits-all' approach when it comes to culture, instead expecting that individual firms will adopt a holistic and effective framework for fostering a sound culture, giving particular attention to what the HKMA refers to as the "three pillars": (1) governance, (2) incentive systems, and (3) assessment and feedback mechanisms. As noted in our past years' reports, the HKMA issued a circular in March 2017[237] to the Chief Executives of all authorized institutions (AIs) relating to its "three pillars" and sound corporate culture. In remarks offered for inclusion in this report, the HKMA indicated that these 2017 efforts were aimed at encouraging banks:

> *... to develop and promote a sound corporate culture that supports prudent risk management and contributes towards incentivising proper staff behaviour that will lead to positive customer outcomes and high ethical standards in the banking industry, so that banks put their safety and soundness as well as the interests of depositors and customers at the centre stage in the pursuit of commercial interests.*

In further comments offered for inclusion herein, the HKMA cited the first of its "three pillars"—governance—as an example to show that it sees board directors and senior management as "responsible for setting and taking ownership of the culture, values and behavioural standards of banks." As such, the HKMA continued to state that "We

"We have always looked at bank culture reform as an on-going journey that requires sustained effort by the industry. It is encouraging to see the efforts made by banks in promoting a sound culture. The important point here is not how many culture initiatives have been launched. Rather it is important to assess whether the culture initiatives are effective in driving behavioral changes among bank staff. Looking ahead, we will continue to gauge the progress of bank culture reform in Hong Kong and share industry-wide insights and practices with the industry."

Arthur Yuen, Deputy Chief Executive, Hong Kong Monetary Authority

Contributor / South China Morning Post

Supervisory Measure	Key Developments
Self-Assessment	• Commenced in early 2019 covering 30 banks • Reviewing reports by banks to draw insights for sharing with industry
Culture Dialogues	• Arranged with a few banks in 2019 and will continue in 2020 • To discuss effectiveness of culture enhancements, and • To convey supervisory observations on conduct issues
Focused Reviews	• Will conduct, as next steps, deep dives into certain key areas of bank culture

ask banks, among others, to set up a board-level committee, chaired by an independent non-executive director, to advise and assist the board in discharging its responsibilities for the bank's culture-related matters." (See further offered guidance in the March 2017 circular to all AIs issued by Deputy Chief Executive of the HKMA, Arthur Yuen.)[238]

In a December 2018 follow up circular,[239] the HKMA announced several supervisory measures that aim to help it gauge the progress of Bank Culture Reform in Hong Kong.

The HKMA commenced the first phase of this exercise in 2019, by requiring thirty banks to conduct self-assessments on their culture enhancement efforts—including all major retail banks and selected foreign banks with substantial operations in Hong Kong—and to benchmark themselves against the findings of major conduct incidents that had come to prominent public attention outside Hong Kong.

The HKMA has since been reviewing the banks' self-assessment reports, seeking to draw insights from the received submissions with a view to distilling a range of best practices for industry reference, identifying common emerging themes, and informing the HKMA's future work on bank culture supervision.

At the same time, the HKMA commenced culture dialogues with a few banks in 2019, meeting with senior management and/or board members with designated responsibility for bank culture—together with their subordinate teams—in order to conduct in-depth discussions regarding the effectiveness of their culture enhancement efforts. These dialogues also give the HKMA an opportunity to provide supervisory feedback, including feedback regarding observations gathered through the HKMA's ongoing supervision.

The HKMA has established dedicated teams to focus on bank culture and to support frontline supervisors on these issues, combining traditional supervisory activities with new culture supervisory tools—mindful of learnings gathered through various supervisory activities—in order to form a holistic view on a bank's culture. As next steps, the HKMA has planned to conduct focused "deep dive" reviews. As of this writing, it is unclear how the priority of addressing the COVID-19 pandemic might impact the roll-out of this phase in its culture reform efforts.

DIRECTION OF TRAVEL

The HKMA planned to conduct focused reviews on various specific areas of bank culture such as front-office incentive schemes in retail banks. It also intended to continue its culture dialogues (set out in its 2018 Circular[240]). The HKMA is expected to continue to gauge the progress of bank culture reform through various means and to share its observations with the industry broadly.

In a January 2020 keynote address in Hong Kong entitled, "Our Journey Towards Sound Bank Culture – Reflections and Beyond,"[241] HKMA Executive Director (Banking Conduct) Alan Au stated, *"it is encouraging to see that banks generally agree with the need to foster sound bank culture, and have been implementing a range of culture enhancement initiatives."*[242] Mr. Au highlighted that all 30 banks reviewed by the HKMA are actively overseeing culture-related matters and working to set an appropriate tone from the top. He noted that many of the banks had set up 'culture dashboards' but observed that these efforts were at an early stage, with firms still trying to determine which indicators might best inform decision-makers. Mr. Au also noted a few original examples of culture-shaping exercises; for example, monthly employee training videos with a guest—a *Fung Shui* master, celebrity, or a member of senior management—with an aim to communicate culture expectations in a language that can be easily understood by their staff. Other initiatives include the use of peer-recommendation platforms to promote positive behaviors and tailor-made summary sheets outlining corporate behavioral standards for various business functions, which are designed to make culture issues resonate within the context of day-to-day work within the business.

In a cautionary note, Mr. Au also pointed out that stronger links are required by the banks to connect their Hong Kong operations with the culture efforts of their headquarters, or 'upstream' entities, as well as with their 'downstream' operations, as appropriate. Mr. Au suggested that all banks are encouraged to adopt a more sophisticated approach to assessing their culture, by incorporating multiple data sources and a combination of both quantitative and qualitative data in their assessments, in an effort to identify forward-looking indicators.

In a Hong Kong Banking Outlook paper,[243] KPMG Partner Peter Outridge writes of an expectation that regulators will increasingly focus, not just on accountability within banks, but also on the role that culture had played in cases of misconduct. Outridge writes that KPMG thus expects banks will move towards the development of "real-time metrics" of culture and conduct risk, and will prioritize achieving a greater overview of the day-to-day behaviors within a firm with a view to understanding how these can be shaped and influenced in desired directions.[244] Mr. Outridge predicts that the pendulum is swinging towards a "more proactive, front-foot approach" to preventing misconduct and expects that firm leaders will begin to dive deeper into 'why it happened' so as to be better positioned to act before troubles arise, rather than continuing their reliance on after the fact measures.

SUPERVISORY AND REGULATORY TECHNOLOGIES

Hong Kong regulators are generally taking a more data-driven approach to fulfilling their supervisory mandate, with plans to increase the use of data-driven tools that enable real-time risk oversight.[245] This approach has been announced through several regulations from the HKMA, and the Hong Kong Securities and Futures Commission, which require that regulated organizations adopt new data standards and report data in a more granular format. The HKMA is currently undergoing a digital transformation which covers multiple functions, such as banking supervision and anti-money laundering. A new division within the HKMA—the Digitalization Office—will form a long-term strategy for the development of the HKMA's digital capabilities and will work to "promote a culture of technology within the organization."[246]

With the rapid development of fintech (financial technology) in global financial markets and increasing data availability, authorities worldwide have begun to adopt new technologies in an effort to enhance the efficiency and effectiveness of their regulatory and supervisory work. The HKMA has also shared that it is "keen to explore the use of supervisory technology (Suptech) to enhance the effectiveness and forward-looking capability of its supervisory processes through digital transformation and the adoption of new technologies." The HKMA commissioned a consultancy study in early 2019 to derive a possible strategy and roadmap for the development and implementation of Suptech. With the study recently concluded, the HKMA will now turn its attention to implementation. In the coming year, it plans to engage with technology companies in exploring a number of Proof-of-Concepts (PoCs) to gauge the feasibility of new technologies (such as Robotic Process Automation and Speech-to-Text tools) in achieving enhanced supervisory processes.

Besides supervisory technology on the part of the regulator, the HKMA also promotes the use of regtech by the industry. In November 2019, the HKMA hosted an AML/CFT Regtech Forum—the first in a series of events for financial institutions, government agencies, financial regulators, law enforcement agencies, together with global experts and firms in the applications of technology—to discuss and consider ways to address pain points for AML/CFT Regtech adoption in HK.[247]

In his opening remarks, Arthur Yuen commented on the need to continue building on the positive results reported by the Financial Action Task Force (FATF) in its latest evaluation of Hong Kong's AML/CFT regime in part through the promotion of responsible innovation and Regtech adoption.[248] Some of the technologies noted by Yuen as being at the heart of improved tools included the use of robotic process automation, natural language processing, and machine learning in reducing false positives in monitoring and screening.[249]

The HKMA has reached out to the banking industry, technology firms, and consulting firms to understand the latest initiatives and ideas in the Regtech space. The HKMA considered that it would be helpful to share these observations with the banking industry and, thus, launched a newsletter series—the *Regtech Watch*—in November 2019 to share observations about Regtech use cases in various areas with the industry and to further facilitate the use of Regtech by the banking sector. The latest issue of *Regtech Watch* was published in March 2020 to focus on technology application in credit risk management.[250]

> *"We believe that the self-assessment exercise has encouraged and facilitated banks to carry out self-reflection, banks can go forward in their culture journeys with increased self-awareness of their goals and progress, as well as a better idea of how they can foster a sound bank culture that is tailored to their own goals and circumstances."*
>
> **Alan Au**, Executive Director (Banking Conduct), Hong Kong Monetary Authority

Digital transformation is also being encouraged in the industry, particularly through the facilitation of the FinTech and Virtual Bank supervision scheme. Virtual banks are seen as bringing benefits to the market, such as 24/7 services, micro loans, lifestyle banking services, and increased efficiency through the use of new technologies such as Open APIs and cloud computing, all of which may lead to lower costs and improved services for HK consumers. The HKMA has adopted a risk-based and technology-neutral approach to banking supervision and identified a few particular risk areas associated with virtual banks, namely technology risk management, consumer protection, and anti-money laundering and counter-financing of terrorism.[251]

With other leading global regulators, the HKMA has participated actively in a number of international collaborative efforts regarding banking supervision, including work on culture and conduct matters.

Beyond what is listed herein, senior leaders from the HKMA have attended and presented at many conferences, seminars, and events on bank culture. For example, the HKMA has been keeping banking practitioners at all levels updated on regulatory requirements and policy intent through a regular series of Regulator's Dialogue sessions. In 2020, bank culture continues to be covered as one of the topics in the sessions. And the HKMA has hosted conferences exclusively for Independent Non-Executive Directors (INEDs) in order to provide an opportunity for a constructive exchange of views among INEDs with the HKMA on topics of mutual interest. Conferences held for INEDs in the past have focused on bank culture.[252]

In Focus:
The HKMA on Culture, Regtech & Suptech from a Supervisor's Perspective

Since the Hong Kong Monetary Authority (HKMA) initiated its "Bank Culture Reform" programme in March 2017, with a view to cultivating the right culture and values in banks, the HKMA has continued to focus on the promotion of customer-centric culture.

The HKMA's reform effort seeks to develop and promote sound banking culture that supports prudent risk management and contributes towards incentivising proper staff behaviour, that will lead to positive customer outcomes and high ethical standards in the banking industry.

While there is no one-size-fits-all approach when it comes to culture, the HKMA asks banks to adopt a holistic and effective framework for fostering sound culture within their institutions, with a focus on three main pillars:

1. strong governance;
2. appropriate incentive systems; and
3. effective assessment and feedback mechanisms.

The HKMA has always looked at bank culture reform as an on-going journey. It is important for banks to assess whether the culture initiatives are effective in driving behavioral changes among bank staff. Along this line of thinking, the HKMA announced three supervisory measures for bank culture reform in December 2018, namely: self-assessments, focused reviews, and culture dialogues.

As banks map out their own paths towards sound bank culture, they need to have a self-reflective capability to understand what their desired culture might be, and to identify the gap between their current progress and the realisation of the desired culture within the bank. With this in mind, the HKMA first commenced the bank self-assessment exercise in early 2019, by inviting 30 banks (including all major retail banks and selected foreign bank branches with substantial operations in Hong Kong) to conduct self-assessments regarding their culture enhancement efforts. The HKMA has been reviewing the self-assessment reports submitted by the banks subsequently, in order to draw insights from those submissions, with a view to identifying common emerging themes and providing a range of practices for reference by the industry.

While the banks have made good progress in promoting sound bank culture over the past two years, the HKMA identified several common themes in the self-assessments, and it encourages banks to pay more attention to these as they go forward in their culture journey. For instance, the HKMA sees that assessing culture remains a key challenge for many banks. While recognising that there is no single way nor uniform set of indicators for banks to make use of when assessing culture, a more sophisticated culture assessment approach is not to look at individual indicators in isolation, but to combine both quantitative and qualitative data from multiple sources to allow for the different culture indicators to be triangulated.

This is where technology can play a role in assisting banks to address the challenges they face in assessing culture. With the right tools and technology, a potential exists for banks to deliver a "big picture" analysis, with meaningful culture insights, to inform Boards and senior management alike. Such tools would permit banks to assess how close they are to achieving their desired culture, and will help them to understand what enhancements may need to be implemented in order to drive effective cultural change.

Meanwhile, the HKMA recognises the potential offered by Regtech for meeting regulatory requirements.

The HKMA believes the time is right for closer collaboration among the banking industry, the technology community, and the HKMA to further facilitate the adoption of Regtech in Hong Kong.

the HKMA sees that assessing culture remains a key challenge for many banks.

Since 2018, the HKMA has launched a number of Regtech initiatives to facilitate the banking industry's adoption of Regtech. For instance, the HKMA has reached out to the banking industry, technology firms, and consulting firms to develop an understanding of the latest ideas and initiatives in the Regtech space. We have picked up on a diverse range of local and overseas Regtech use cases, including how technology can be adopted to address banking culture and conduct issues. The HKMA believed that it would be helpful to share these observations with the banking industry and, thus, in November 2019 it launched a newsletter series—the Regtech Watch—to share observations regarding Regtech use cases in various areas within the industry and to further facilitate the use of Regtech by the banking sector. And the HKMA also hosted the first Anti-Money Laundering and Counter-Financing of Terrorism (AML/CFT) Regtech Forum in November 2019, to explore the use of Regtech in AML/CFT surveillance.

The HKMA will be developing a Regtech promotion roadmap and will explore a number of Regtech-related initiatives over the next few years. Potential initiatives may include organising Regtech conferences, producing practice guides on Regtech adoption, and nurturing Regtech talent. The ultimate goal is to foster a larger and more diverse Regtech ecosystem in Hong Kong.

The HKMA recognises that technology can also help to enhance the HKMA's supervisory work. Supervisory technology (Suptech) adoption will not only bring transformative changes to the HKMA's banking supervisory processes but should also simultaneously promote Regtech growth.

In early 2019, the HKMA commissioned a consultancy study to derive a possible strategy and roadmap for the development and implementation of Suptech. That study recently came to an end. Now, the HKMA will explore the feasibility of a number of data-science driven Suptech use-cases that resonate with our Regtech themes. As an example, the HKMA will be exploring whether network analytics technology can be used to help identify emerging risks and to raise awareness regarding financial interconnectedness and emerging trends.

Singapore

INDUSTRY & REGULATORY DEVELOPMENTS

The Monetary Authority of Singapore (MAS) has consulted on its proposed set of guidelines to strengthen the individual accountability of senior managers and raise standards of conduct in financial institutions[253]. Under the proposed guidelines, senior managers must be designated as responsible and accountable for the conduct and business operations within their organization, must operate under a clear governance and oversight framework, and be assessed under an "outcomes based approach" rather than a tick-box checklist.[254] Further, to reduce the chances of "rolling bad apples"—or malfeasant individuals moving from one organisation to another—MAS will propose mandatory reference check requirements for financial institutions.

In the course of 2019, we also saw MAS forming a Culture and Conduct Steering Group ▸ P. 79, together with the Association of Banks in Singapore (ABS), with a view to promoting better culture and conduct among banks in the nation. The two organizations released a joint statement[255] stating that the aims of the group would be to identify global best-practices relating to conduct and culture, and to share these with the member banks to facilitate broad adoption. The Group will collaborate with MAS on producing industry codes of conduct, and will serve as a platform to promote relevant dialogue. Participating Group members represent a number of different functions within fourteen banks operating in Singapore (headquartered both domestically and abroad).

The Group is chaired by Shee Tse Koon, Country Head of DBS Bank in Singapore, who notes that, while there has not been significant known misconduct in the Singaporean banking sector, the Group was formed to inculcate a sound industry culture, with ethics and customer service-mindedness at the core. "It is important for us to be proactive in ensuring ongoing customer confidence in our financial ecosystem" he noted.[256] In a separate statement by MAS and the ABS, Mr. Shee said that banking culture was a "nascent area" within which there was clear potential to do more, particularly with a view to driving positive outcomes for consumers.[257]

In addition to this practical function, the Culture & Conduct Steering Group aims to provoke industry-wide dialogue, drawing on the 2018 Group of Thirty's (G30) report on culture and conduct in the banking sector, which has been widely cited for its quality recommendations.[258] (Please see Starling's 2018 Compendium for further detail on the G30 report.)

MAS has established a similar Steering Group for Singapore's insurance sector, with a view to promoting prudent risk-taking and ethical business activity that ensures fair dealing[259] with customers. The Group is chaired by Dr. Khoo Kah Siang, CEO of Manulife Singapore, and includes twelve other insurers in Singapore who have responsibilities in business, distribution, risk management, legal, compliance, operations, and human resources.

The Insurance Group will work to identify emerging issues, and will collaborate with MAS on initiatives such as the development of good practice guides and championing the adoption of best-practices among insurance firms operating in Singapore. For Ms. Ho Hern Shin, MAS Assistant Managing Director of the Banking & Insurance Group, the benefits are twofold; the initiative will help insurers to "do what is right and ethical by their customers," and "build strong business resilience."[260]

INTERNATIONAL INFLUENCE

As an international financial centre, Singapore's activity in the culture and conduct space has been inextricably global in context. For example, the Singapore Institute of Banking and Finance signed a declaration with the City of London Corporation and three UK-based professional bodies to share best practices and to enhance cooperation in raising skills and competencies of banking and finance professionals in areas including ethics and integrity, professional conduct and behavior, cybersecurity, sustainable finance, and operational and conduct risks, among others.[261]

Another example was the launch of a Singapore Center of the newly formed Bank for International Settlements (BIS) Innovation Hub at the 2019 Singapore FinTech Festival.[262] The Hub aims to increase collaboration between central bankers on innovation, enhance understanding of financial technology, and aid the development of innovative solutions to benefit the financial system. The Singapore Center will establish a framework on identity, consent, and data sharing, with a view to encouraging the use of trusted digital identities for individuals and firms. A second project by the Singapore Center is to create a digital platform connecting regulators and supervisors with digital and technology solutions providers, with a view to sourcing community solutions to regulatory problems.[263]

According to Natalie Curtis, partner at Herbert Smith Freehill, MAS is clearly building a supervisory program with a focus on culture, in line with the 2018 FSB Toolkit for Strengthening Governance to Mitigate Misconduct Risk,[264] and is taking into account the recommendations from Australia's Royal Commission into financial services misconduct.

MULTI-AGENCY COLLABORATIONS

In a speech given at the My Money seminar in Singapore titled, "Strengthening Trust In Our Capital Market," Ong Chong Tee, Deputy Managing Director of the Monetary Authority of Singapore, noted the many different collaborations between MAS, other regulators, academic researchers, journalists, analysts, and whistle-blowers, all aimed at building trust in the financial sector. He noted in particular the role of industry groups such as the Singapore Institute of Directors and the Securities Investors' Association in advocating for good governance practices.[265]

MAS will increase its collaboration with the Accounting and Corporate Regulatory Authority of Singapore, as well as with the Commercial Affairs Department of Singapore in its capital markets surveillance and investigation programs.

MAS will also work closely with SGX RegCo, the technology-focused regulatory subsidiary of the Singapore Exchange. RegCo plans to overhaul its enforcement framework in 2020, with a view

"The financial industry in Singapore has made good progress on the culture and conduct front. A number of financial institutions have established board level Ethics and Conduct Committees to provide high-level oversight. Some of them have deployed culture dashboards to help set targets, monitor practices on the ground, and identify emerging areas of concern."

"Both the banking and insurance industries have set up Culture and Conduct Steering Groups, to elevate culture and conduct standards across the industry. These groups are monitoring trends, sharing best practices, and collaborating with MAS on initiatives such as developing good practice guides."

Ravi Menon, Managing Director, Monetary Authority of Singapore

Edgar Su / REUTERS

to strengthening protections against potential misconduct. "The listing rules will be revised to give us more powers to deal with potential misconduct and protect shareholder interest, especially when it comes to interested person transactions," said SGX RegCo chief Tan Boon Gin.[266]

Lastly, MAS has consulted on new guidelines aimed at strengthening individual accountability of senior managers and raising standards of conduct at financial institutions. The guidelines are not meant to be prescriptive but set out supervisory expectations of boards and senior management.

MAS Deputy Managing Director in charge of Financial Supervision, Mr. Ong Chong Tee, said that good conduct and established lines of accountability are central to good governance. "Persistent misconduct and a lack of individual accountability by persons in charge will erode public confidence in our financial institutions. We expect the boards and senior management of financial institutions to instil a strong culture of responsibility and ethical conduct."[267] For MAS, market discipline plays an important role in shaping behavior. In turn, the sound culture and high standards this instills help to maintain public and investor trust in Singapore as a leading financial sector.

REGULATION AND TECHNOLOGY

MAS recognises that technology is at the heart of financial services. According to Vincent Loy, Assistant Managing Director responsible for technology at MAS, "Every decision we make nowadays at MAS, be it an industry decision or a regulatory decision or even an investment decision, involves a technology element… we are also continually asking ourselves how to use technology within MAS to make us a better central bank compared to the rest of the world." In a speech given at the Asian Wealth Management forum, he said that MAS will be increasingly proactive regarding technology and data use and, in doing so, he noted that governance, culture, and ethics will all play key roles. "It is very important that every financial institution spends more time in terms of thinking about the culture within the organisation, and also the incorporation of robust governance, as the organisation transforms in this digital world."[268]

In Focus:
The Association of Banks in Singapore Culture & Conduct Steering Group

The Association of Banks in Singapore (ABS) Culture and Conduct Steering Group for banks (CCSG) was established in May 2019. The CCSG comprises members from 14 banks in Singapore, who have responsibilities in business, risk management, compliance and human resources. MAS is also a member of the CCSG.

The CCSG seeks to promote sound culture and raise conduct standards among banks in Singapore. To achieve this objective, the CCSG serves as a platform for industry participants to:

- Identify best practices in the area of culture and conduct and share them with the wider industry to facilitate adoption;
- Monitor trends and identify emerging conduct and culture issues within the industry; and
- Collaborate with MAS on initiatives to promote strong culture and conduct within the industry, including conducting industry self-assessments or updating industry codes of conduct where necessary.

In 2019, the CCSG discussed the findings of the review of the major overseas misconduct incidents and members shared how their institutions have reflected on these findings. The members also shared the culture and conduct frameworks within their banks and exchanged pointers on good practices in areas such as:

1. Governance structures to enable effective oversight on culture and conduct issues;
2. Mechanisms to monitor culture and measure conduct or behavioural outcomes; and
3. Feedback channels to cultivate psychological safety among employees.

The output from these discussions, in particular the examples of positive practices, will be incorporated within MAS' upcoming Information Paper on Culture and Conduct.

For the coming year, the CCSG will be working on a **Banking Trust Barometer (BTB)**, one of the CCSG's key initiatives. The introduction of a BTB will serve as a standardised means to measure customers' perceptions and trust towards banks in Singapore, and to benchmark across banks. It is also a way to measure the outcome of the industry's culture and conduct initiatives.

The CCSG will look to roll out further initiatives to raise awareness on the importance of sound culture to elevate conduct standards among banks in Singapore.

CCSG Member Banks

- DBS Bank
- United Overseas Bank
- Oversea-Chinese Banking Corporation
- Standard Chartered Bank
- Nomura
- UBS AG
- ICBC
- HSBC
- Wells Fargo
- Northern Trust
- Citibank
- Deutsche Bank AG
- Malayan Banking Berhad
- Bank of China

"For Singapore to continue thriving as a regional financial centre, it is paramount for the banking industry to operate with the highest standards of culture and conduct. While a robust infrastructure, sound legal and regulatory framework and a stable social and political climate have contributed to a healthy banking sector, trust remains a cornerstone. For this reason, I was delighted when ABS, in partnership with the Monetary Authority of Singapore, established the Culture and Conduct Steering Group for banks."

Shee Tse Koon, Country Head of DBS Singapore & Chairman of the ABS Culture and Conduct Steering Group

"Banking is built on the foundation of trust. Banks today are expected to go beyond meeting customers' needs. There is growing emphasis on creating longterm value that is truly sustainable for stakeholders. It would be irresponsible of banks to seek short-term profits, at the expense of customers' trust. Banks must constantly upgrade ourselves to meet the higher ethical standards of integrity, honesty and fair dealing. This journey to strengthen culture and conduct requires a collective effort across departments, banks and the industry. Only then can we sustainably create long-term value for customers and thrive to grow in this era of new social expectation."

Samuel Tsien, Group CEO of OCBC & ABS Chairman

United States

INDUSTRY AND REGULATORY BACKGROUND

Operating at a global scale, US banks are frequently found to suffer problems in other jurisdictions. Bank of America and JPMorgan Chase, for instance, are caught up in Danske Bank's controversial money laundering operation for €200 billion which passed through its Estonian operations between 2007 and 2015.[269] Citigroup received a record penalty of £44 million from the Bank of England in November 2019, for mismanagement of outsourced workers and a "limited understanding and awareness" of the banks' reporting policies.[270] We could list other examples from other jurisdictions but the point is clear: US banks must be concerned with global regulatory and supervisory shifts in priority.

The focus on culture and conduct risk seen among bank regulators in the UK, Australia, Ireland, Hong Kong, Singapore, and elsewhere, has not been quite as evident among US regulators in recent years. While the NY Fed has made regular use of its convening power to drive attention to the importance of culture as a driver of conduct in the financial sector, US regulators and supervisors on the whole have seemed less occupied with seeking to supervise such issues, and the US has not seen the creation of any individual accountability regime such as the SM&CR (UK), BEAR/FAR (Australia), SEAR (Ireland), etc.

Yet perhaps the most pronounced example of individual liability enforcement came from the US in the course of the last 12-months. In the wake of the false accounts scandal and other troubles revealed at Wells Fargo, the US Office of the Comptroller of the Currency (OCC) charged eight former Wells Fargo executives with a cumulative $59 million in personal fines, and former CEO John Stumpf was banned from the industry for life.[271] Mr. Stumpf also saw $70 million of his past remuneration "clawed back," in addition to facing other losses. In explaining its actions, the OCC said that Stumpf had "failed to respond to numerous warning signs," allowing the bank to suffer "catastrophic reputational damage." In an unprecedented move, the US Federal Reserve imposed a cap on the firm's growth, triggering a plunge in share value that left Wells Fargo the worst performing bank in the KBW index.[272] Stumpf's successor, Tim Sloan, did not fare much better: he was forced to resign in April 2019, after deeply critical scrutiny from the House Committee on Financial Services and calls for him to step down.[273] It is too soon to judge the performance of new CEO Charles Scharf but, when he was called to appear before same Committee last month, he was reminded pointedly by its Chairwoman of his predecessors' fate. "I will note that each time a Wells Fargo CEO has testified before this committee he has soon resigned thereafter."

"After the savings-and-loan scandals of the 1980s, 1,100 people were prosecuted, including top executives at many of the largest failed banks," the *New York Times Magazine* observed in a 2014 piece.[274] "In the '90s and early aughts, when the bursting of the Nasdaq bubble revealed widespread corporate accounting scandals, top executives from WorldCom, Enron, Qwest and Tyco, among others, went to prison." A similar degree of personal accountability was not seen after the Financial Crisis, before now. In tracking the frequency of such incidents, a Thomson Reuters observes, "*the pendulum of personal accountability among senior executives in financial services swings over time, and it is now swinging back to holding more individuals accountable*."[275]

However, the COVID-crisis may have stopped the pendulum in mid-swing. In order to ease their ability to respond to the crisis and pump needed dollars into the hands of struggling business and households, federal bank regulators have afforded the banks a significant easing in their supervisory burdens. Yet, as we have observed elsewhere, "the fractured nature of the US regulatory system is such that federal regulators are contemplating how best to ease bank rules even while their key state counterparts are seeking to gain greater control over the firms that operate within their jurisdictions."[276] It is difficult to assess how these tensions will be resolved as we move deeper into 2020, and a general election pending late in the year adds to current uncertainties. An examination of events over the last 12-months may suggest some trends to watch.

"The US Justice Department (DOJ) in recent years has expanded beyond its primary mission—to investigate and prosecute—into a role that's more about explaining what measures companies can take to avoid criminal investigations in the first place," the *Wall Street Journal* observed in December 2019.[277] The piece describes special programs and guidance created by the Department's Criminal Division and purposefully designed to encourage companies to establish risk and compliance systems that work to prevent misconduct. With that, the Division has also begun training prosecutors on how to judge whether a company's program is fit for purpose or mere window-dressing.

Speaking with the *Journal*, the Criminal Division's Deputy Assistant Attorney General, Matt Miner, described the shift in focus as trying to avoid after-the-fact decisions "that a compliance program was *de facto* inadequate because something bad happened," he said. His remarks suggest that Miner sees criminal prosecution as an inappropriate course of action in the case of one-off bad acts. "It can't be that the single worst actor in a corporation that is otherwise 99.9% filled with compliant employees with a compliant culture and a strong program," is the sole basis for a prosecution, Miner said.

Miner went on to emphasize the importance of remediation and self-disclosure when bad acts do occur. Where a firm identifies misconduct, self-discloses such, and takes appropriate remedial steps, Miner suggested, this "would weigh very, very heavily" in a firm's favor during the course of legal decision-making. Miner also pointed to effective remediation efforts as the key to avoiding the appointment of an independent third-party monitor, tasked with overseeing remediation efforts following a settlement with the Department. "If you find something and you invest in remediation based upon what you found—whether you voluntarily self-disclose or we come knocking later—we're likely not going to impose a monitor," he said.

Notably, at the time of Mr. Miner's remarks, it was reported[278] that the DOJ was in discussions with Goldman Sachs aimed at reaching a $2 billion settlement agreement with the firm in the wake of allegations that inadequate risk and compliance controls had permitted firm employees to engage in the misconduct alleged in connection with the Malaysian 1MDB scandal. In addition to the fine, it was reported that the DOJ may also elect to impose a monitor to oversee corrective efforts at the firm.

US TREASURY

The Dodd-Frank Wall Street Reform and Consumer Protection Act brought a number of consumer watchdog agencies under the control of the US Treasury Department. These included those responsible for overseeing credit products and recognizing the particular problems that stemmed from sub-prime lending. While a number of these consumer agencies have made statements and taken action in relation to misconduct within their remit, the US Treasury has not itself published statements in this regard in the past year.

In its strategic plan for 2018-2022,[279] the Treasury sets out five specific goals, one being to achieve operational excellence by fostering a culture of innovation. The outcome of this objective is to have a "sustainable culture of engagement and superior performance" which, in turn, will enable the Treasury to support its own cultural change and improve its organizational performance. At the same time, the Treasury seeks to "Increase access and use of federal financial data to strengthen government-wide decision-making, transparency, and accountability."[280]

In 2019, the US Treasury's Office of Foreign Assets Control (OFAC) published a Framework for OFAC compliance commitments relating to the essential components of a sanctions compliance program.[281] In particular, the new framework states that the senior management of all relevant firms should promote a "culture of compliance" throughout their organizations. This will be measured according to the ability of personnel to report sanctions related misconduct without fear of reprisal, the messages stemming from senior management that aim to discourage misconduct, and the ability of an organizations' sanctions compliance program to produce meaningful oversight over the actions of the entire organization. OFAC Director Andrea M. Gacki stated that "OFAC developed this framework in our continuing effort to strengthen sanctions compliance practices across the board… underlin[ing] our commitment to engage with the private sector to further promote understanding of, and compliance with, sanctions requirements."[282]

The new framework contains an appendix listing the root causes that the US Treasury has found in the course of previous assessments and administrative actions, noting common failures such as the lack of a formal sanctions compliance program, failures to screen financial transactions appropriately, and insufficient due diligence when taking on new customers.[283] In regard to individual liability, the appendix notes that, in several instances, supervisory, managerial, or executive-level positions have played "integral roles in causing or facilitating violations of the regulations," and that, in such circumstances, OFAC will consider using enforcement against individuals as well as violating entities.

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

In a speech to the American Bar Association's Banking Law Committee in January 2020,[284] Vice Chair for Supervision Randal K. Quarles noted the difficulty in balancing the "public interest in agile supervision with the public interest in transparency and accountability." He also commented that, while 20 years ago regulation was interesting and meaningful, supervision was, on the other hand, "both too workaday and too straightforward to merit the commitment of much legal horsepower or personal attention." Today, however, such supervision is a primary way in which the Fed engages with industry to achieve many of its policy objectives. Yet, Quarles notes, supervision is not subject to the same principles of generality, predictability, publicity, and consultation as is the case for regulation. He sees this as, "*a complex and consequential issue that, for decades now, has received far too little attention from practitioners, academics, policymakers and the public*," and stated that, "*Evaluating this question will be a significant focus of mine going forward*."[285]

Reflecting this, Quarles also highlighted the importance of transparency in the Fed's agenda, to prevent arbitrary, capricious and, thus, ineffective regulation.[286] In this regard, he endorsed putting supervisory guidance out for public comment and said that that Fed would increase firms' ability to share Federal Reserve confidential supervisory information with employees, affiliates, service providers, and other government agencies in order to promote greater compliance with laws and to help facilitate effective response to enforcement actions.

In another instance of US regulators asserting individual accountability for misconduct, it is notable that, earlier this year, the Federal Reserve permanently banned former Goldman Sachs banker Andrea Vella from the industry, over his alleged involvement in the 1MDB misconduct scandal.[287]

FEDERAL RESERVE BANK OF NEW YORK

NY Fed Senior Vice President and Deputy General Counsel James P. Bergin, speaking at the 5th Annual Culture and Conduct Forum in London late last year, observed that misconduct harms consumers, counterparties, and competitors, and has "ripple effects that extend far beyond," Bergin said.[288] This sentiment was echoed in remarks made by New York Fed Senior Vice President James Hennessy only some weeks earlier. Hennessy noted that the impact of misconduct could be great, for consumers, investors, and the general public, through its impact on the stability of the financial system.[289]

> *"Too often, when things go wrong, business leaders blame a single 'bad apple' as the cause of the problem. But focusing on an individual bad actor can obscure a culture in which people feel that misconduct in the pursuit of profit is tolerated, or even condoned. The 'bad apple' theory acts as an excuse for not doing the hard work of cultural reform. In this process of blaming bad apples, leaders fail to look at what's happening to the rest of the barrel. What kind of environment has let the rot set in?"*
>
> **John C Williams**, President and CEO, Federal Reserve Bank of New York, June 2019
>
> "Building Cultural Capital in the Financial Services Industry: Emerging Practices, Risks and Opportunities"

Hennessy added, "*Significantly reducing the scale and frequency of misconduct is central to our mission as a supervisor and a central bank. As our understanding of misconduct has grown through our various efforts, we have also become increasingly cognizant of the many elements that influence organizations in developing healthy work cultures*."[290] Hennessy explained that the New York Fed uses three "lenses" through which it views non-financial risk topics: behavioral sciences, technological change, and the composition and dynamics of the workforce. He noted that the Fed will be adding a fourth lens: change management, due to the fact that "*upwards of 70 percent of organizational culture change efforts ultimately fail*." In this regard, Hennessy observed that, while "*change can sometimes occur in an instant, it takes most people's perceptions and feelings a much longer time to adjust and move ahead*."

Hennessy, who leads the New York Fed's culture initiative, concluded that though the journey towards culture reform is long, "*we are optimistic that we can and we will make progress*."[291] The New York Fed sees firm culture as a complex problem and not an area where it "*can simply dictate everything*."[292] But it believes that has an important role to play in driving improved behavioral standards in the industry, summarized under the maxim of "connect," "convene," and "catalyze."[293] It works to advance this agenda by hosting major culture conferences and workshops in which industry leaders are convened to consider how best to address culture and conduct related challenges. Such events bring together interdisciplinary views from industry leaders, industry sectors, psychologists, and philosophers, seeing "*diverse perspectives, professional training, and life experience as critical to challenging assumptions and pointing out uncomfortable truths*."[294]

The NY Fed also promotes the development of industry best practice guides and codes. In 2018, for instance, it announced its commitment to the FX Global Code, which articulates standards of behavior following forex rate manipulation scandals.[295] Mr. Bergin suggested that such guides are essential to filling the gaps where regulations would be too prescriptive and unenforceable—describing the nonbinding nature of such guidance as a "feature not a bug"[296] as it both requires and allows for thinking beyond black letter rules.

With a view to training future generations of financial service industry employees, the NY Fed recently launched an Education and Industry Forum on Financial Services Culture. The Forum is attended by business school deans, professors, and senior representatives from the financial sector to improve the training of the next generation of the financial sector workforce.[297] Through this initiative, the NY Fed looks to collaborate with business schools and employee trainers, and provides them with, for instance, case studies that feature ethical dilemmas which may confront junior employees.[298]

THE FED'S CULTURE INITIATIVE

During a January 2020 Speech delivered at the London School of Economics, NY Fed CEO John Williams observed, "culture is both the hardest and the most important thing to get right. Culture is at the heart of behavior and norms, and the single most important factor driving the decision-making of employees. It's not an exaggeration to say that culture is critical—both when things go right, and when they go wrong."[299]

The aims of the New York Fed's Culture Initiative[300] are to:

- Reduce incidences of misconduct;
- Promote the development of healthier cultures within firms and across the industry; and
- Increase public trust in the financial services sector.

While regulators and enforcement agencies set legal boundaries and "*can, should, and do penalize firms when they cross those boundaries*,"[301] the power of a regulator extends within organizations only to a limited degree. It is both impractical for a regulator to seek to extend its formal reach as regards culture challenges, and as such, would likely also be unsuccessful. Therefore, as Deputy General Counsel Bergin has stated, "organizational culture is an issue that the institutions themselves need to solve."[302] There is a space and need for individuals to exercise ethical judgment and to fill in gaps where they occur. NY Fed Head of Supervision Kevin Stiroh has observed that culture management and supervision is particularly complex, due to the interconnectedness of a large number of factors; among them a constant evolution among "unknown unknowns," the workings of feedback loops, and unpredictable outcomes.[303] These make it essential to attend to "cultural capital" within a firm, which refers to mindsets and norms that shape conduct. "Just like equity capital makes the firm more resilient to credit losses, cultural capital makes the firm more resilient to potential misconduct losses or misconduct events" explained Stiroh.[304]

OFFICE OF THE COMPTROLLER OF THE CURRENCY

Since 2014, the OCC has issued enforceable guidelines for large firms regarding their risk governance frameworks and board oversight activities. These guidelines set out minimum requirements for such frameworks, stipulating that a bank should have a comprehensive written risk appetite statement, for instance, and that management operations relating thereto should be overseen and approved by the board of directors.[305]

In its most recent Annual Report,[306] the OCC restated its commitment to ensuring financial institutions have robust controls against money laundering and terrorist financing. However, addressing the Senate Committee on Banking, Housing, and Urban Affairs in late 2018, OCC Senior Deputy Comptroller for Bank Supervision Policy Grovetta N. Gardineer remarked on the need to update a nearly 50-year old regulatory regime so as to address rapidly evolving risks, and to make better use of technology.[307] An OCC commitment to technology advancement is seen in its close work with fintech firms, through its Innovation Office, now in its third year of operation. The Innovation Office enables the OCC to monitor trends, foster expertise, and enhance collaboration with other regulators in the US and abroad.

Corporate culture issues form part of the OCC's examination process in its Large Bank Supervision program,[308] and also in its examination process for FinTech firms applying for Special Purpose National Bank Charters.[309] The OCC runs workshops in Operational Risk Management for Community Banks, training them in the methods and motives of internal fraud and the role of boards in establishing ethical cultures.[310] Furthermore, it publishes handbooks in retail lending which discuss the role of boards in developing appropriate compensation incentives, making explicit their link with culture, formal and informal organizational structures, and the deliberations of decision-making committees.[311]

It is notable also that, in 2019, the OCC joined the Global Financial Innovation Network (GFIN), signalling an interest in collaborating with global peers. It is not yet clear whether it will prioritize culture and conduct risk related supervision in its GFIN engagements.

CONSUMER FINANCIAL PROTECTION BUREAU

"I am committed to ensuring we have clear rules of the road and fostering a culture of compliance – a key element in preventing consumer harm," stated Consumer Financial Protection Bureau (CFPB) Director Kathleen Kraninger in a recent policy statement.[312] The agency will offer credit in enforcement actions to firms demonstrating responsible conduct such as self-policing, self-reporting, remediation, and cooperation.[313]In March 2020, the CFPB updated its "Responsible Business Conduct" bulletin, which had not been done since 2013.[314] The Bureau will encourage self-assessment and self-reporting of violations by businesses with a focus on "building a culture of compliance among entities, including covered persons and service providers, in order to minimize the likelihood of a violation of Federal consumer financial law, and thereby prevent[ing] harm to consumers."

The CFPB has also proposed to Congress a new whistleblower program, with a view to rewarding those tips that lead to successful prosecutions in sums of either $50,000 or 10% of the total funds collected, capped at $10 million. This development would mirror similar initiatives taking place at the SEC and the Commodity Futures Trading Commission (CFTC).[315]

It is notable also that the CFPB was a 2018 founding member of the Global Financial Innovation Network (GFIN), signalling an interest in collaborating with global peers. It is not yet clear whether it will prioritize culture and conduct risk related supervision in its GFIN engagements.

FEDERAL DEPOSIT INSURANCE CORPORATION

Jelena McWilliams, Chairman of the Federal Deposit Insurance Corporation (FDIC), commented in a recent interview that, "*One of the biggest things that I'm looking to accomplish is a cultural change*"[316] at the FDIC, and noted that she seeks to transform how banks are supervised. "*Cultural change is, at any organization and especially an organization that's been around for 80 plus years, is perhaps one of the biggest challenges that any executive at the helm of an agency or an organization can find themselves in*," McWilliams noted. This requires a greater focus on technology, she believes. In this direction, the FDIC has launched a new innovation lab and is recruiting more technologists. "Thinking differently," the FDIC is looking to establish a new office for financial and technological innovation called FDI Tech, with a remit to review internal processes and how technology is used both by the regulator and banks. For Ms. McWilliams, "*the examiner of the future at the FDIC is going to be more of a data scientist, a person who understands and knows how to deal with algorithms, a person who has an IT background because that's where the banks are going*."[317]

It is notable also that, in 2019, the FCIC joined the Global Financial Innovation Network (GFIN), signalling an interest in collaborating with global peers. It is not yet clear whether it will prioritize culture and conduct risk related supervision in its GFIN engagements.

SECURITIES & EXCHANGES COMMISSION

"The ongoing efforts made by Enforcement to deter misconduct and punish securities law violators are critical to safeguarding millions of investors and instilling confidence in the integrity of our markets," said SEC Chairman Jay Clayton during a September 2019 appearance before the House Committee on Financial Services, describing the priorities and activities of the SEC's Enforcement Division.[318]

The Commission's enforcement actions in recent years have covered a range of matters in investment management, securities offerings, broker-dealer activities, issuer reporting and accounting, and has addressed market manipulation, insider trading, cyber-related misconduct and violations of the Foreign Corrupt Practices Act, among many others.

For instance, in 2018, the SEC brought 821 enforcement actions and obtained judgments and orders for $3.945 billion in penalties and disgorgement, returning $794 million to harmed investors and awarding nearly $50 million in payments to whistleblowers. Through its whistleblowing initiative, the SEC has received 26,000 tips—although "the rates of [employer] retaliation have increased significantly since passage of bounty laws," according to Tom Devine, legal director for the Government Accountability Project.[319]

Through its new Regulation Best Interest, the SEC now requires broker-dealers to act in the best interest of a retail customer when making securities transaction or investment strategy recommendations, in an effort to enhance the broker-dealer conduct standards and to make clear that a broker-dealer may not put its financial interests ahead of the interests of customers.

In its 2020 Examinations Priorities report,[320] the SEC's Office of Compliance Inspections and Examinations (OCIE) observes that, "culture and tone from the top are key," and noted that it looks for this in the tone from the top of an organization, as well as the degree to which it emphasizes a well-resourced and properly empowered compliance function. The report also discusses the SEC's adoption of Regulation Best Interest in 2019 and notes that the relevant standard of conduct "draws from key fiduciary principles and cannot be satisfied through disclosure alone." OCIE notes also that it will run "conduct risk-based examinations" of registered investment advisors (RIAs), focusing on those which have gone without recent scrutiny.

It is notable also that, in 2019, the SEC joined the Global Financial Innovation Network (GFIN), signalling an interest in collaborating with global peers. It is not yet clear whether it will prioritize culture and conduct risk related supervision in its GFIN engagements.

COMMODITY FUTURES TRADING COMMISSION

The CFTC has engaged in high-profile enforcement actions recently: for instance, against Tullett Prebon Americas Inc., for inadequate supervision, lack of action following complaints, and the omissions of material information; and an action against Tower Research

Capital, which agreed to settle allegations that three former traders had engaged in spoofing for $67.4 million—the largest ever penalty for such conduct.[321]

The CFTC has also increased emphasis on its misconduct whistleblower program.[322] Since the program was launched in 2014, it has awarded approximately $100 million to whistleblowers.[323] The Commission recently issued four whistleblower alerts aimed at seeking information in problem areas relating to virtual currency fraud, foreign corrupt practices, insider trading, and violations of the Bank Secrecy Act.[324]

It is notable also that, in 2019, the CFTC joined the Global Financial Innovation Network (GFIN), signalling an interest in collaborating with global peers. It is not yet clear whether it will prioritize culture and conduct risk related supervision in its GFIN engagements.

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In 2018, the Financial Industry Regulatory Authority (FINRA) published a report entitled "Technology Based Innovations for Regulatory Compliance in the Securities Industry,"[325] detailing the areas in which RegTech innovations were being used to the greatest extent. The report also identified key benefits and risks that firms may wish to consider in adopting RegTech tools—including improved efficiency through automation and better risk management, though these must not come at the expense of risking poorer functioning of existing supervisory control systems. Firms will thus have to navigate a tension between maintaining existing tools while seeking to innovate.

In Focus: Culture & Governance Reform Initiatives at the NY Fed

By JAMES HENNESSY, SENIOR VICE PRESIDENT

History of New York Fed Effort

James Hennessy, NY Fed Senior Vice President

The New York Fed began its exploration into the role of culture in financial services in 2013, in response to "evidence of deep-seated cultural and ethical failures" within the industry.[1] In the years since, the persistence of unethical behaviors at financial services firms has only reinforced the organization's commitment to the initiative. As New York Fed President and CEO John Williams recently noted, "culture is both the hardest and the most important thing to get right. Culture is at the heart of behavior and norms, and the single most important factor driving the decision-making of employees. It's not an exaggeration to say that culture is critical—both when things go right, and when they go wrong."[2] The New York Fed will thus continue to train the industry's focus on this topic.

From the start, the long-term goals of the New York Fed's culture initiative have been threefold:

1. Reduce incidences of misconduct;
2. Promote the development of healthier cultures within firms and across the industry; and
3. Help increase public trust in the financial services sector.

The New York Fed has been working on multiple fronts to achieve these goals. It is increasingly clear that the problem of misconduct will not be resolved with one-off statements, discussions, or declarations. Rather, it will take a long-term, multi-disciplinary effort among a variety of stakeholders to achieve these goals. The New York Fed aims to fuel that process by convening the relevant audiences, keeping them informed and focused on the issues, and forging partnerships among disparate groups that share a common interest in the topic.

Convening a Dialogue

In 2014, the New York Fed began hosting its annual culture conference, which is the most prominent among its efforts to address culture in financial services. In the initial years of the conference, speakers primarily included industry leaders, regulators, supervisors, and other government representatives, and the focus was on establishing why culture is so important to financial services outcomes and considering how firms and the official sector could adjust policies and practices to discourage poor behaviors. These first conferences helped to bring together a community of interest, forge connections, and put culture on the radar of financial services firms.

In recent years, the focus has evolved towards treating culture reform as a complex problem. The New York Fed's efforts seek to incorporate perspectives and data from other industries and other disciplines, including behavioral scientists, philosophers, legal scholars, and others. By "expanding the dialogue," the New York Fed aims to introduce new data and grow the number of observations available to help the industry understand how and why norms take root within a group, and to learn about how to influence human behavior to achieve better outcomes. As John Williams stated at the New York Fed's 2019 culture conference, "Looking beyond our own narrow frame of reference to other fields of study… will help us understand how to achieve the progress that's so desperately needed."[3]

Going forward, the New York Fed will continue to expand its audience's exposure to diverse perspectives on how individual and group behaviors form. The 2020 conference will explore how various stakeholders can drive group norms within a firm, and vice-versa. For instance, how does employee activism impact management's ability to influence culture? Do investors care about cultural norms at the organizations they fund, and should they? What role do clients and customers play in demanding cultural change in companies and the industry at large? And what role does the wider public play? How do societal trends influence firms' culture change efforts? The conversation will also continue to look beyond financial services for fresh insight—for instance, what can we learn about drivers of human behavior from neuroscience? How does technology shape behaviors around decision making? What lessons can be learned by other industries, such as aerospace or healthcare?

Partnerships for Change

The problems caused by weak cultures can be larger than any single firm, regulator, or jurisdiction. Behaviors develop over time, and can be addressed at multiple 'entry points.' This is why it's so important to harness the collective wisdom and expertise of a broad swath of disciplines and industries. The New York Fed has focused its efforts not only on providing a venue to hear from various stakeholders; it is also working to forge partnerships among these groups. Three examples of this partnership effort include: the FX Global Code, the Supervisors Roundtable for Governance Effectiveness, and the Education and Industry Forum on Financial Services Culture.

The New York Fed has contributed significantly to developing the FX Global Code, a set of principles to guide conduct and decisions by FX market participants. A principles-based approach, led by central banks and the industry, reflects the truly global nature of the FX market. No single regulator has jurisdiction, so coordination and consent are key to raising standards. The Code was created under the umbrella of the Bank for International Settlements' Markets Committee's FX Working Group and published in final form in 2017. Among the 55 principles within the Code are commitments to increasing transparency and fairness and mitigating risks, including with respect to ethics. Market participants—including central banks—evidence their commitment to the Code by signing statements of commitment and encouraging others to do the same. The New York Fed remains committed to working with US market participants to adopt the Code and, as a sign of its commitment, has made adherence to the Code a condition on its trading relationships.

Through the Supervisors Roundtable for Governance Effectiveness ("the Roundtable"), the New York Fed has built a partnership among members of the international regulatory community who are focused on a common goal of encouraging financial industry culture change. First convened by the New York Fed in 2015, the Roundtable brings together a group of 20 supervisory agencies from 15 jurisdictions to share practices and develop supervisory tools for individual agencies to draw upon in building or refining their own agency approach to the topic.

The New York Fed launched the Education and Industry Forum on Financial Services Culture (EIF) in the Spring of 2019. The EIF brings together leaders from business schools and financial services firms who share an interest in educating and training bank personnel to recognize and address the ethical issues in finance. Its first project is a series of case studies, in which a junior bank employee confronts an ethical dilemma. Each case was written by a senior banker and a business school professor. The cases confront readers with conflicting principles, uncertain expectations, and tight deadlines. They ask readers to use their instincts, intellect, and emotions—not as much to find the "right" answer, as to identify the many factors that should inform a business decision. The cases will be available for free on the New York Fed's public website, for use in the classroom and at banks. The aim of the project is to create common ground for discussions across campuses and the industry. Looking ahead, the EIF plans to host conferences and other forums in which academics and bankers can learn from each other. What can a neurologist, a philosopher, or an evolutionary biologist teach bankers (and other scholars) about human behavior, and vice versa?

Looking Ahead

The New York Fed's efforts have raised and sustained awareness among industry participants of the relevant issues related to culture and behavior in financial services firms and led to broader partnerships supporting better practices. Yet, as long as major instances of misconduct persist, the New York Fed will continue to shine a spotlight on the issues and find ways to fuel greater progress.

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Canada

INDUSTRY DEVELOPMENTS

According to the CanTrust index run by an independent market agency, there was evidence that trust in the Canadian banking sector dropped to 41% in 2019.[326] A number of misconduct-related penalties were issued over the past year: faulty mortgage documents and misrepresentations were found at Home Capital Group,[327] the Royal Bank of Canada and Toronto Dominion Bank settled charges for failures in supervision with the Ontario Securities Commission (OSC) for CAD $22.85 million, and with senior executives found personally liable for non-compliance with Ontario securities laws.[328] According to an analysis by Thomson Reuters, personal liability risk for senior executives of regulated financial institutions and other firms overseen by the OSC is "expected to escalate sharply in the coming years… particularly where intentional misrepresentation or omission is found by the OSC."[329]

THE OFFICE OF THE SUPERINTENDENT OF FINANCIAL INSTITUTIONS (OSFI)

In the spring of 2019, OSFI began an industry culture assessment as part of its research work. The assessment considered culture and conduct risk management frameworks, communication mechanisms, relevant software tools, key performance and risk indicators, and the various initiatives firms may have undertaken so as to better gauge their cultures.[330] The work was done through interviews and questionnaires with senior staff and board members at financial firms. The regulator also took account of internal policies, codes of conduct, conflict of interests, and other metrics. [331]

In November 2019, OSFI shared its observations. It found that, while culture is discussed at board and management levels, it is not as much of a stand-alone of a topic as it ought to be. OSFI acknowledged that culture is a non-traditional risk, difficult to quantify and with unique elements specific to a given financial institution. This makes it challenging to write prescriptive culture rules and procedures.[332]

OSFI revised its Corporate Governance Guidelines in 2018,[333] restating that the board of an institution is responsible for its culture as a fundamental principle,[334] and reinforcing the emphasis on board and senior management accountability for failures in their firm's risk management frameworks.[335] Those responsible for operational risk matters are expected to have appropriate expertise and knowledge of the financial industry to carry out their responsibilities. This revision was part of a move towards a more principles-based rather than prescriptive approach to providing industry guidelines.[336]

Since 2018, OSFI has operated a dedicated Culture & Conduct Risk Division, whose mandate it is to provide expertise on this category of risk and help identify risks at individual institutions, as well as across the Canadian securities sector. In October 2019, OSFI created the Culture External Advisory Committee, comprised of retired senior leaders from the financial sector, academics, and others with strong grounding in risk management culture. The group provides practical guidance to the regulator, which intends to invite behavioural scientists to work together with supervisors. The aim of the group, as well as that of OSFI's Culture & Conduct Risk Division, is to build an assessment framework relating to culture and conduct.[337]

ONTARIO SECURITIES COMMISSION (OSC)

In 2019, the Ontario Securities Commission released a report promising to slash red tape in Ontario's capital markets.[338] The report focused on areas where digitization could save investors and firms resources, and provided dozens of recommendations. The initiative followed the Ford Government's request for the OSC to conduct a cost-benefit analysis regarding reduced regulation in the sector.

The regulator has been active in tackling misconduct. Its whistle-blower program saw the regulator pay $7.5 million in awards to individuals who had disclosed misconduct, describing the information received as "high quality, timely, specific and credible."[339] The programme was launched in July 2016 and generated an average of two tips per week between its launch and June 2018.[340] OSC Chair Maureen Jensen remarked that the whistleblowing programme had been a "game-changer."[341] (Jensen stepped down from her post this month)

FINANCIAL CONSUMER AGENCY OF CANADA (FCAC)

Financial Consumer Agency of Canada

The FCAC published a new Supervision Framework in February 2020 to ensure its responsibilities are carried out in a proactive, accountable, and transparent way.[342] The agency placed emphasis on compliance culture, and a willingness and ability to comply with market conduct obligations when preparing Market Conduct Profiles.[343]

The FCAC also provided a "Code of Conduct for the Credit and Debit Card Industry of Canada," clarifying how these organisations are expected to manage compliance risk.[344] And it published a Code of Conduct for the Delivery of Banking Services to Seniors in 2019 and will monitor banks to ensure they comply with the Code's principles.[345]

Australia

2019–2020 BACKGROUND

The Australian banking sector faced a difficult year of self-scrutiny in 2019, marked by an aggregate total of $4.8 billion in customer remuneration payments in the wake of several misconduct scandals.[346] Although governance, risk, and compliance spending accounted for 40 percent of total investment spending among the country's Big Four banks,[347] those same firms were forced to absorb an additional AUD $1.75 billion in capital penalties assigned by the Australian Prudential Regulation Authority (APRA).[348] To date, the fines associated with the findings of the Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry (the Hayne Commission) amount to an estimated AUD $10 billon.[349]

The Hayne Commission issued a Final Report detailing its extensive investigation into widespread misconduct across the Australian financial sector. The report made 76 recommendations for reform, including 54 for government, 12 for regulators, and 10 for industry.[350] The key question asked by the Commission was how to serve customers more efficiently, honestly, and fairly—a legal duty for providers under Section 912A of the 2001 Corporations Act. Commissioner Hayne gave his own interpretation of the six-part definition of Section 912A within the report, [351] which an Australian Federal Court judgment summarized in one principle—"be fair."[352]

"The most important thing the Hayne Commission did was shine a blinding spotlight on failures of consumer protection in the financial services industry, and that really shook Australians to the bootstraps," commented Bob Austin, former Supreme Court Judge.[353] Industry executives feared that a "regulatory onslaught" similar to that faced by UK peers in the wake of the 2008 Financial Crisis was "seemingly inevitable."[354]

Westpac CEO Brian Hartzer was forced to step down in November 2019, shortly after his firm became embroiled in a money-laundering and child exploitation scandal, stemming from the bank's failure to establish adequate controls and insufficient investment in "appropriate IT systems and automated solutions."[355] Thereafter, mounting board pressure led to the resignation of Mr. Hartzer, the early retirement of Westpac board Chairman Lindsay Maxsted soon followed,[356] and Ewen Crouch, chair of the bank's risk committee, announced that he would not stand for re-election.[357]

Westpac's travails are only the latest in a recent line of scandals to have wracked the sector in recent years, triggered by culture and conduct related risk management failures. A year on from the Hayne Commission hearings, some industry progress towards culture reform has been made, though Reserve Bank of Australia governor Philip Lowe stated that adequate reform will likely take "many, many years."[358] Australian Banking Association Chair, Matt Comyn, who is CEO at the Commonwealth Bank of Australia, sees the industry's reform efforts in the last year driving, "a lot of focus around the customer."[359] This has been advanced by a new Banking Code—a set of enforceable standards that customers can expect of banks—and an independent Banking Code Compliance Committee.[360]

Having passed through an extensive evidence-gathering and capacity-building phase in 2019, the process of corrective reform was expected to begin in earnest this year, with Australian regulators signaling a readiness to bring more aggressive enforcement actions and to turn to the courts as a matter of policy.[361] It is unclear what impact the COVID-crisis may have in this connection.

At the close of 2020, a new Financial Accountability Regime (FAR) was expected to replace the existing Banking Executive Accountability Regime (BEAR), with FAR jointly administered by the Australia Prudential Regulatory Authority (APRA) and Australian Securities and Investment Commission (ASIC).[362] FAR is likely to extend the number of potentially accountable persons within each organization, will introduce a new responsibility for individuals regarding their firm's compliance within their given sphere of influence, and will increase penalties for breaches.[363] In January 2020, the Australian Treasury released a consultation paper[364] proposing the extension of FAR to insurers[365]—a Hayne Commission recommendation. And ASIC Commissioner Danielle Press recently stated that, "ASIC is now firmly in the superannuation conduct space and we are committed to working with industry to lift standards and improve member outcomes."[366] The Australian Treasury is currently working on legislation to clarify the ASIC's role as the primary regulator of superannuation conduct.

Collaboration between Australian regulatory agencies seems set to rise. "*We are working closely with APRA to formalise and enhance information sharing arrangements*," stated ASIC Chairman James Shipton, in a speech given to the Committee for Economic Development of Australia. "*We are updat[ing] our Memorandum of Understanding to reflect our closer working relationship, and... working closer than ever with AUSTRAC, AFCA, the New Zealand Financial Markets Authority and other international and domestic regulators*." The MoU between APRA and ASIC aims to facilitate greater information sharing between the two regulators, more proactive engagement and assistance on matters that affect both agencies, as well as the earlier detection of misconduct and prudential concerns.[367]

These cooperative initiatives will be given the force of law following legislation that implements Hayne Commission recommendations.[368] APRA and ASIC will cooperate on Governance, Culture, Remuneration, and Accountability (GCRA) issues and work with the Treasury to design, implement, and jointly administer the expanded accountability regime for regulated entities.[369] And a new regulatory tool to benchmark and assess trends in risk culture will be introduced across regulated entities, similar in method to the work undertaken by the UK Banking Standards Board.[370] Australian government figures have been vocal of their support for culture reform efforts. Prime Minister Scott Morrison demanded that the Westpac board accept accountability for the firm's regulatory failings, which Morrison sees as having further tarnished the reputation of all Australian banks.[371] And, Treasurer Josh Frydenberg recently stated that, "*many of our financial institutions were acting below community expectations*."[372]

CULTURAL SELF-ASSESSMENTS

In the November 2019 results season, three of Australia's four biggest banks reported significant falls in profit, reduced dividend payouts, and a challenging outlook given low interest rates, tougher regulation, and a weak domestic economy.[373] Investors concerned for these macroeconomic headwinds showed little tolerance for continuing conduct scandals and called for improved nonfinancial risk governance. Louise Davidson, CEO of the Australian Council of Superannuation Investors, argued "*Investors want to see… culture and governance strengthened to avoid a repeat of these issues*."[374] Other investors agreed. "*Our members expect us to engage and vote to protect their interests*," said Cbus superannuation fund Chief Investment Officer Kristian Fok. "*Members understand that poor corporate behaviour destroys the value of their investments over the long term*."[375] Additional industry pressures resulting from the COVID-crisis will likely heighten these concerns for improved risk governance.

Regulators are emphasizing the responsibilities of boards in this connection. In a late 2019 speech on the topic of director and officer oversight of non-financial risk, ASIC's James Shipton commented that "*until now, much of what we know about the corporate governance of our large listed companies has been limited to their own statements. And while these documents do a good job of describing the various frameworks and policies that companies have in place, they don't give us a practical insight into what is actually going on inside the company*."[376] As such, regulators are now requiring that banks conduct and produce governance and culture self-assessments, some of which have been made public.[377] Former National Australian Bank (NAB) CEO Philp Chronican said NAB was committed to changing its culture and that its decision to publish its cultural self-assessment demonstrated this.[378] But Australian National University professor Alessandra Capezio questions whether the bank's self-assessment exercises are truly meaningful, comparing their assessment methodology with, "*hitting a nail with a cucumber*." Capezio criticizes the banks for using, "*faddish… unproven programs peddled by consultants*" and observes, "*Science can't agree on what a risk culture is, and if it can't be properly defined, how can it be measured?*"[379]

REGULATORY DEVELOPMENTS

FEDERAL GOVERNMENT

The Australian Federal Government has taken a number of measures to facilitate culture reform in the financial sector.[380] Shortly after receiving the Hayne Commission Final Report, the government provided a supportive response and committed to implementing all 76 of the Commission's recommendations. Some of those relate to facilitating coordination between ASIC and APRA, obliging them to co-operate with one another to the fullest extent practicable,[381] and to notify one another when a breach of law occurs that relates to either's mandate, formally aligning the two supervisors' activities.[382] Other changes will result in power to issue increased penalties, to intervene in the development or sale of products that may result in consumer detriment, and to otherwise increase investigative and enforcement powers.[383]

Treasurer Josh Frydenberg called the scale and speed of the government's post-Hayne Commission reforms "unprecedented," with more than 50 reform commitments expected either to be implemented or brought before Parliament by mid-2020, in a reform program that represents the "biggest shake-up of the financial sector in three decades."[384] The wide-ranging set of new measures will require an increase in time and resources, with seventy-five percent of the Treasury's (pre-COVID) agenda expected to be taken up by culture-related reforms, representing almost a quarter of the government's entire legislative program. The government will establish a review to assess whether industry practice has reached the desired levels of reform and consumer protection in 2023, and whether further reform will be necessary. In order to ensure fairness to customers with prior complaints, the Financial Complaints Authority will have an extended remit to look back to 2008 so that more consumer complaints may be heard. The government will require a greater number of Chief Executives and members of the Australian Banker's Association to appear before a Parliamentary Standing Committee on Economics, to help increase transparency and public scrutiny in the sector,[385] while ASIC advocates for a "*BEAR for conduct*" individual accountability scheme.[386] Lastly, a Senate Select Committee on FinTech and RegTech aims to ensure that the government's policies provide sufficient space for the development of related beneficial solutions and their adoption by the industry.[387]

Upcoming on the legislative agenda is a potential reform of the rules relating to Corporate Criminal Responsibility. A Government Discussion Paper on the topic describes the proposals as intending to "*harmonise the current law, rather than impose any radical change*."[388] Upon closer review, however, the proposals may be seen as enabling a piercing of the corporate veil by requiring senior officers of firms to ensure that their firms are compliant in the areas "*over which they have influence*," rather than with regard only to their own decisions and actions.[389] Together with an increased regulatory appetite to litigate, the proposed rules have the scope to be interpreted broadly by the courts in relation to what is deemed "*influence*," thereby bringing discussion about culture and conduct into the courtroom.

AUSTRAC

Australia's transaction-monitoring authority, AUSTRAC, has increased surveillance across the 14,000 entities it oversees since 2018[390] after Commonwealth Bank of Australia was found it have failed dramatically in its transaction reporting requirements.[391] The bank suffered an AUD $700 million fine, though it faced a far higher potential penalty. A subsequent scandal at Westpac was deemed more serious still, when the bank was found to conducted transactions that, in some instances, had facilitated child exploitation in Southeast Asia.[392] The firm faced a theoretical maximum penalty of AUD $345 trillion. A Westpac whistleblower blamed the scandal on the bank's culture and insufficient investment in appropriate technical systems.[393] In an example of closer regulatory collaboration, ASIC will investigate whether an AUD $2.5 billion share sale initiated two weeks in advance of the scandal was, in fact, a related event.[394]

ASIC

ASIC'S 2020 STRATEGY

In his keynote address to the Committee for Economic Development of Australia, ASIC chief James Shipton reiterated that the "influence of culture and behavior" was a key strategic priority for the regulator, alongside effectively addressing consumer harm.[395] He stated that ASIC was using "*behavioural insights to better understand what drives certain behaviours and how to influence them for the better*," and that it would be "*applying new technologies such as machine learning and artificial intelligence*" to related supervisory tasks. In addition, the regulator appointed a Chief Data Analytics Officer to lead its data and analytics strategy and to better manage the use of data across the organization, particularly with regard to data generated by an increase in misconduct reports during the 2018 and 2019 financial years.

ASIC Commissioner John Price also indicated that improving governance and accountability, and promoting a culture of ethical decision-making, were key priorities for the regulator. He stated that ASIC aims to accomplish this by being a "strategic as well as forceful regulator," and through promoting the adoption of regulatory technology.[396] Company culture "*shapes its approach to corporate governance and its response to its regulatory obligations, and it drives conduct within the firm*,"[397] Price contends.

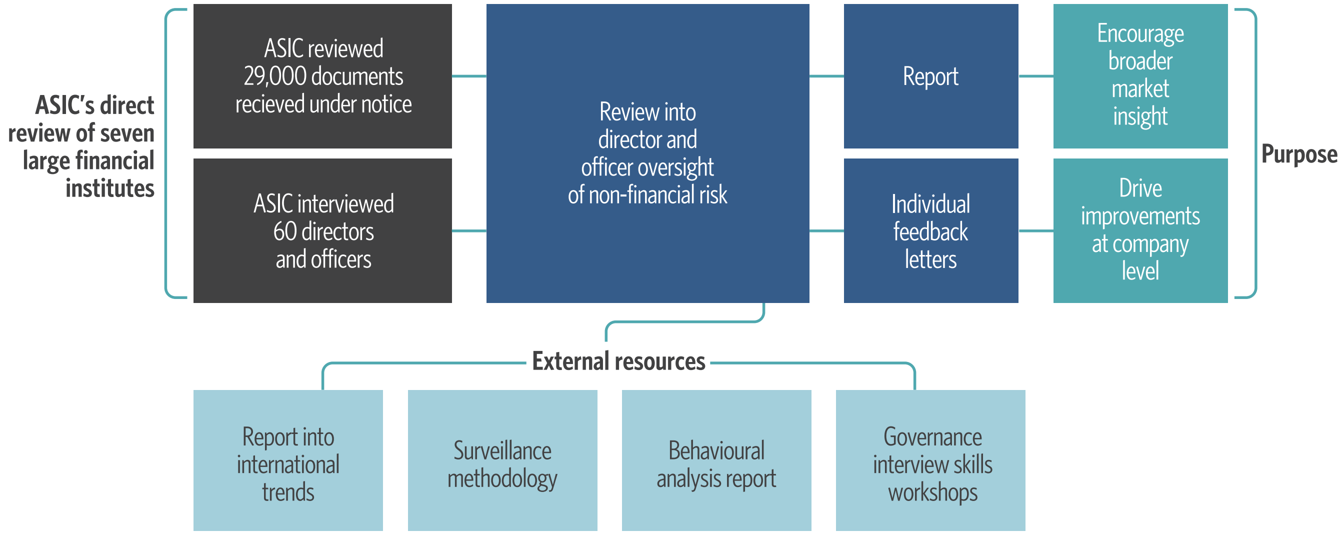
Since the Hayne Commission, ASIC has increased its appetite for litigation, stating that it will prioritize cases with a high deterrence value and where there has been egregious harm, as well as those referred by the Royal Commission.[398] James Shipton described a new policy predilection summed up as, "Why not Litigate?'[399] Elaborating, Shipton explained that ASIC would publicly denounce cases of misconduct.[400]

Between January and June 2019, ASIC reported a 20% increase in enforcement investigations and, by the end of July, it had 46 court actions underway.[401] Significantly, and as an indicator of the regulator's increased appetite to deter wrongdoing, 59 individuals were under investigation and eight of these were the subject of court actions.[402]

ASIC'S CORPORATE GOVERNANCE TASKFORCE

A 2019 Corporate Governance Taskforce completed a review of Australia's largest financial services firms.[403] The taskforce was set up by ASIC in 2018 to better understand how directors and officers of listed firms oversee and manage non-financial risk and related risk drivers. Variable remuneration incentives of key managers were a key focus. ASIC Commissioner John Price commented, "*at the heart of the work of the corporate governance taskforce is a desire to… support changes towards a more ethical culture in business decision-making and so enhance trust in our financial system*." Many of the companies interviewed for ASIC's study acknowledge that non-financial risk is problematic, and that they had been "*operating outside appetite for an extensive period, and that it would take some time to return to within appetite*."[404] There is great incentive to do so—failing to comply with non-financial risk regulations has resulted in hundreds of millions of dollars spent to remedy failures in the treatment of retail customers, besides an increased spending on risk and compliance in the billions of dollars.[405]

Fig. 14



The Corporate Governance Taskforce found that, across the sector:

- Oversight of non-financial risk was immature;
- Risk appetite statements were not used well;
- Reporting to boards was often dense and did not clearly highlight key risks; and
- Board risk committees were under-utilized.[406]

The taskforce concluded that risk committees did not meet regularly enough and devoted insufficient time to oversight of material risks, preferring 'form over substance' in considering "frameworks and processes rather than actual practices."[407] As such, risk events were dealt with as they arose rather than considered "*holistically*."[408] This permitted management to operate outside board-sanctioned risk appetites for months and even years. Where relevant risk issues were discussed, related metrics did not permit for accurate comparison across subsidiaries or against industry peers.[409] And attention was focused on breaches of specific laws and rules, rather than breaches of principal and without concern for underlying causes.

APRA

In 2019, APRA hit both the Commonwealth Bank of Australia and Westpac with billion-dollar capital charges following failures to monitor accounts and transactions which resulted in their use by terrorists, drug traffickers, and pedophiles.[410] The regulator also forced ANZ Bank and NAB to set aside funds following their own negative governance self-assessments.

"Compared to five years ago, APRA now has a much bigger role to play. We will be firmly stepping into our expanded mandate, and acting more forcefully than we have done in the past," commented Wayne Byres, APRA Chair in a Speech to the Australian Risk Management Association.[411] "Our standards and expectations in the future are likely to be more prescriptive and demanding, and our enforcement of them will undoubtedly be firmer and more insistent." Byres continued to comment that governance and culture were not getting the attention they deserved in Australia, while they were being discussed widely in other global fora.[412]

Industry self-assessments of governance, culture and accountability were provided to APRA by nine banks and 27 other financial firms in 2019. APRA was disappointed by the quality of some assessments, warning firms that they would face penalties and capital charges if non-financial risks were addressed inadequately.[413] The word 'culture' is mentioned 76 times in an Information Paper[414] published by APRA on the results of the industry's self-assessments.[415] APRA Deputy Chair John Lonsdale found it "interesting to observe the generally positive assessments boards and senior leadership teams had of their own performance, even when they had identified serious weaknesses in their institutions."[416] The report found further that insurance and superannuation firms' self-assessments were of worse quality than those from banks, that assessments of culture were less comprehensive than other self-assessment components, and that organizations had limited ability to identify the root causes behind misconduct.[417]

APRA'S CORPORATE PLAN

APRA's Corporate Plan[418] for 2019–2023 sets out the measures that the regulator will take to address the challenges of Governance, Culture, Remuneration, and Accountability (GCRA). This will be accomplished through a sharpened focus on regulating non-financial risks, the targeted use of regtech, and increased focus on risk management outcomes. With the roll-out of the new FAR regime that is to replace BEAR, APRA will be increasingly responsible for conduct matters. Under FAR, the list of responsibilities of accountable individuals will be expanded to include activities that were previously at the fringes of the prudential regulators' remit. Possible penalties will also be increased under FAR—although these will remain civil penalties rather than criminal sanctions.

Following the Hayne Commission's report and its own internal self-assessments, APRA will heighten its own risk management, governance, and remuneration standards.[419] APRA's new approach will include reviews of culture, doubling the number of full-time equivalent employees dedicated to culture, snap reviews, as well as culture audit 'deep dives.'[420] APRA's industry reviews will include assessments of risk cultures encountered at different firms and will seek to identify the root causes of deficiencies. Previous suggestions that APRA regulators might attend board meetings were dropped. "Boards should be able to engage in open and robust discussion knowing they are ultimately accountable, without having regulators sitting next to them," commented Senator Frydbenberg.[421]

Additionally, the regulator will be more assertive in holding boards and managers of firms accountable for GCRA standards and will work to increase industry-wide transparency through the encouragement of industry benchmarks and the sharing of best practices.[422] Remuneration standards will also be reviewed by the prudential regulator, with the new draft rules stating that financial metrics should constitute only 50 percent of performance metrics, which should incorporate long-term interests.[423] The regulator published a related Information Paper—"Transforming governance, culture, remuneration and accountability: APRA's approach."[424]

In Focus: Putting Mouths Where the Money Is

By CRIS PARKER, DIRECTOR BFO


Cris Parker, Director BFO

The Australian financial services industry has played a critical role in creating Australia's prosperity. In recent years, however, it has failed to meet community expectations of trustworthiness and, in some cases, financially devastated its customers.

The poor ethical standards in the industry were laid bare in the Royal Commission report on misconduct. While the industry is complex, the Royal Commission revealed that its fundamental purpose has become blurred, and instincts have become about self-interest. Sight lines to the customer have been distorted.

The regulators have been stepping in with accountability regimes, psychologists in board rooms, culture audits, rule-based product and conduct regulation as well as increased enforcement activity. The regulators are driving change because the industry has a chequered history of being able to do so successfully itself. The problem with regulator-driven change, however, is that such change may not be long lasting as other priorities take over.

Logic and observable global examples tell us that industry-agreed standards—where participants hold each other to account—work best to sustain industry wide standards, and the presence of such behaviour usually reflects a mature industry that understands the true benefits of cooperation.

BFO
BANKING + FINANCE OATH
INTEGRITY • TRUST • ETHICS

The Australian Banking & Finance Oath

Trust is the foundation of my profession.

- I will serve all interests in good faith.
- I will compete with honour.
- I will pursue my ends with ethical restraint.
- I will help create a sustainable future.
- I will help create a more just society.
- I will speak out against wrongdoing and support others who do the same.
- I will accept responsibility for my actions.

In these and all other matters;

My word is my bond.

To truly create change in the Australian financial services industry, institutions must design, maintain, review and hold each other accountable in relation to ethical standards and behaviour, and they must do this in collaboration with regulators. Collaboration between the industry and its regulators is not new, but relationships have been strained in the past and, in some cases, even hostile. This has lead to breakdowns in collaborative efforts.

There are examples where the industry has collaborated, agreed and then presented One Voice to the regulators. The following are just three examples of many.

- *Standard Risk Measure (SRM):* This measure, now mandated by ASIC as a disclosure requirement, provides the basis on which a superannuation (pension) fund discloses the likelihood that returns on a particular investment portfolio will be negative in a 20-year period.
- *Life Code of Conduct:* This code provides minimum standards in relation to processing life insurance claims under superannuation. It has been signed up to by the industry on a volunteer basis. The Code provides a clear benefit for consumers and goes beyond the law to ethical conduct.
- *Gateway Governance Body (GGB):* This body was set up by superannuation funds, clearing houses and gateway providers to ensure the transfer of employee/member data was contained in uniform standards and transfer protocols. Agreed data standards used by all providers limit delays and lost moneys. The GGB, which is funded by the industry, oversees the data standards and monitors compliance: enforcement and poor behaviour can be referred to the ATO and ASIC.

Will an industry-driven approach work in relation to ethical standards?

Complexity creates challenges for industry solutions. However, siloed approaches produce siloed outcomes, and treating issues out of context is likely to prove fruitless. Once a solution is placed into its intended environment, it may quickly adapt to suit the status quo.

At the same time, competition around ethics and culture can lead to inaction, perversely, for reasons such as:

- First mover fears of losing market value—leaving the industry hostage to the slowest mover;
- 'There are too many initiatives'—lacking intelligent enquiry as to how the industry may work together for a common good;
- 'It's too complex or too hard'—excusing the inability to make a decision at all;
- 'We have no budget for this'—yet the huge sums already assigned to remediation of customers suggests that surely there is a strong business case for industry investment in ethical standards.

On the other hand, there are encouraging examples in financial services globally, where the importance of good culture and the professional and ethical standards that underpin it, have been acknowledged and pursued by industry and its regulators. Two in particular stand out:

- The Irish Banking Culture Board (IBCB): an industry-driven and funded initiative with the purpose of rebuilding trust through demonstrating a change in behaviour and overall culture underpinned by ethics. **IN FOCUS ▸ P. 51**
- The Monetary Authority of Singapore (MAS) Culture & Conduct Steering Group: a regulator-driven initiative with the purpose of strengthening ethical business practices, developing prudent risk-taking behaviour and supporting banks' safety and soundness. **IN FOCUS ▸ P. 79**

Other sectors are also advancing in this area. Notably, a large proportion of the Australian energy sector has come together impressively under a five-pillar foundation, modelled on fairness principles. The Energy Charter is a voluntary CEO commitment to five high-level principles, co-designed with customers, to put customers at the centre of each signatory business and the energy system. It is designed to embed customer-centric culture and conduct in energy businesses to create tangible improvements for Australians. The Energy Charter fosters authentic discussion at the CEO level across the supply chain (from retailers, to networks, and generators) on long- and short-term decision making and fairness.

Promoting behaviour based on strong ethical foundations has been the raison d'être of The Banking and Finance Oath (BFO), an industry-led initiative enabled by The Ethics Centre and launched online in August 2012. The Oath is a set of simple but powerful tenets, freely entered into by individuals who choose to be accountable to each other for upholding these tenets and to call out behaviour that falls short.

Ethics is the spine, the thread that joins together the system and any systemic change ahead. Laws, regulation, codes and compliance will tell individual players what they can and cannot do but, in a complex environment, there will be challenges when weighing up the interests of different stakeholders in the decision-making processes. It is at this point one must exercise professional judgement, and ethics can inform that judgement. We believe The Banking & Finance Oath could provide the lens through which otherwise fierce competitors can come together to promote strong ethical standards. Such standards are an obvious complement to Financial Services Institute of Australasia's (FINSIA) drive for greater professionalism in the industry.

To achieve true change across financial services in Australia, what is needed is a burning platform, together with a positive commitment by industry as a whole to debate and develop a strong ethical foundation for its daily operations. Surely, the wholesale loss of trust in the industry is the burning platform. The opportunity for the industry to respond and demonstrate collective leadership has never been clearer.

New Zealand

INDUSTRY AND REGULATORY BACKGROUND

Following its neighbors' wide-ranging investigation into misconduct in the financial sector, a reform process has also begun in New Zealand. Adrian Orr, governor of the Reserve Bank of New Zealand (RBNZ) said that regulatory change over the past year had been "extreme"—not only in New Zealand, but globally.[425] For the RBNZ, the focus of change will be on the three pillars of personal, market, and regulatory discipline.[426]

Culture and conduct risk considerations are a relatively new focus area for RBNZ. According to Orr, "*We have an enormous amount of work ahead of us, and the Reserve Bank Act itself has been under review. It's better to first understand what the role of the Reserve Bank is, and we need to be thinking much harder around how we go about regulation*."[427] Geoff Bascand, RBNZ Deputy Governor, warns banks and insurance companies that they should expect the central bank to become more "intrusive" since it "cannot rely solely on self-discipline" driven by the industry itself.[428]

Indeed, 2019 saw considerable enforcement activity, with the theme of misconduct appearing in both civil and criminal litigation, and the subject of 'enforceable undertakings' and public warnings. A particularly prominent enforcement action came in May 2019, when ANZ Bank's accreditation was revoked due to persistent failures in its controls processes. In a separate controversy, ANZ bank's New Zealand CEO was forced to resign over large expense claims about which the board was not made aware, and the sale of a bank property to his wife for a below market price.[429]

INSURANCE INDUSTRY UNDER SCRUTINY

Another prominent case surrounded the liquidation of CBL Insurance, where the court judgment found that management has demonstrated "a lack of commercial probity" and "a lack of candor in dealing with the company's auditors and the regulator."[430] The insurance sector was particularly heavily criticized by regulators, who commented that they were "disappointed by life insurers' response to a conduct and culture review."[431] The findings of the investigation were "dire" according to the RBNZ and the Financial Markets Authority (FMA),[432] with, FMA Director Liam Mason especially concerned over the mis-selling of products such as accidental death or funeral coverage,[433]and citing the Australian Royal Commission Report's opening findings regarding the causes of such misconduct.

CONDUCT AND CULTURE REVIEW

In light of the above, the government of New Zealand now intends to fast-track consumer protection legislation within its Parliamentary agenda,[434] and new legislation to establish a conduct regime recently passed its first reading in the New Zealand Parliament.[435] The new measures will give the FMA greater powers to suspend or vary financial licenses and to enforce requirements that financial institutions remedy misconduct issues. "We are also going to create new enforcement tools so that when these rules aren't met, providers face appropriate consequences,"[436] MP Chris Faafoi remarked, adding that the reforms are aligned with a broader program of work to improve financial regulation in New Zealand and to prioritize customer interests.

In the past year, an FMA and RBNZ review into conduct and culture concluded that customer outcomes were not placed sufficiently close to the core of business priorities among the eleven banks reviewed.[437] The regulators asked banks to improve their governance controls in four key ways; to instill greater board accountability for conduct and culture risks, to prioritize the identification of issues, to invest in frameworks for processes and controls, and to strengthen reporting channels for conduct issues to include those available to whistleblowers. Since the review, Rob Everett, chief executive of the FMA, together with Adrian Orr have stated that all banks have committed to removing sales incentives for both front-office staff and their line managers.[438]

To improve effective communication between the regulator and the banking industry, a Relationship Charter was also established by the Reserve Bank.[439] Mr. Orr commented that a mutual understanding is key for improvements in culture—"This is underpinned by the principle '*te hunga tiaki*', the combined stewardship of an efficient system for the benefit of all," he said, noting, however, that "writing it was the easy part. Operating consistently with the conduct principles is the challenge."

FINANCIAL MARKETS AUTHORITY

"This was a watershed year for the regulator when the Financial Markets Conduct Act was fully implemented and normalized across the financial sectors the FMA regulates,"[440] FMA chief executive Rob Everett stated. On the July 23rd, 2019, the FMA published its Annual Corporate Plan, outlining its work objectives for the coming year. The plan reveals strategic priorities principally related to culture and conduct issues. These included improvements to culture-related systems and controls, deterrence mechanisms for misconduct, and the promotion of trust and confidence in the capital markets. The FMA will implement a new regime for financial advisers and "work closely with the Government to prepare for and implement any changes to the conduct regulation regime for banks and insurers."[441]

MINISTRY OF BUSINESS, INNOVATION AND EMPLOYMENT (MOBIE) REPORT

MoBIE released a report in April 2019,[442] concerning greater regulation in the banking and insurance industries, noting that this might also apply in other financial sectors.[443] The paper suggested 30 options for improved governance and conduct in the development and sale of financial products. It also proposed six principles-based duties that apply "to all aspects of a financial institution's activities." These principles include the requirement to prioritize customer interests, and to have systems and controls in place that support good conduct and address poor conduct, with senior managers to be held responsible for failures. New Zealand had not previously seen a public inquiry into financial sector misconduct.[444] In 2020, however, MoBIE indicated that it may undertake relevant efforts to support the creation of a future culture and conduct regime.

Dubai

DUBAI FINANCIAL SERVICES AUTHORITY

The Dubai Financial Services Authority (DFSA)[445] supervises a range of financial institutions including entities from the banking, insurance, and wealth management sectors. All firms including banks are subject to periodic on-site risk assessments, the frequency of which is determined by the risk profile of the entity. Such inspections will generally include assessment of the following areas:

- Corporate Governance;
- Strategy and Business models;
- Financial and Operational risks;
- Conduct of Business risks to clients and markets; and
- Financial Crime risks

The DFSA has an express mandate to regulate culture and conduct risks for entities providing financial services in or from the Dubai International Financial Centre (DIFC), and conduct risk is one of the three key regulatory priorities set out for 2020 and beyond in the DFSA's 2019-2020 Business Plan.[446]

In discharging its regulatory mandate, the DFSA has a statutory obligation to foster and maintain fairness, transparency, and efficiency in the financial services industry. It is also entrusted with fostering and maintaining confidence, financial stability, and reducing systemic risk. The regulator seeks to prevent, detect, and restrain conduct that may cause damage to consumers, or to the reputation of the DIFC or the local financial services sector, including through the imposition of punitive sanctions. To enforce its mandate, the DFSA has taken and will continue to take regulatory action against senior managers and other individuals in relation to their misconduct or management failures.

For example, in the DFSA's 2018 Annual Report, DFSA Chief Executive Bryan Stirewalt stated:

> *"During the year, our supervision and enforcement teams devoted considerable time and effort to investigating the conduct of the affairs of the private equity firm, Abraaj Capital Limited, and its related parties. This investigation is highly complex, on a wide scale and is being pursued vigorously. We are focusing our attention on senior management responsible for the conduct of the affairs of the relevant companies and funds, and persons who may have failed in their responsibilities to identify or report irregularities. We will use all of our powers to deal with those who are found to be culpable."*[447]

In implementing its mandate, the DFSA issues "Dear SEO" letters which further expand upon its supervisory priorities. Some ongoing business conduct priorities include the safeguarding of client assets, appropriate brokerage business models, and the adequacy of market abuse prevention systems, among others.

Through various regulatory communications, such as Outreach Sessions and DFSA in Action publications,[448] the DFSA sets out its supervisory priorities and other matters requiring regulatory attention. These provide an opportunity for financial institutions to conduct their own internal reviews and to engage with any helpful third-party consultants before DFSA assessments or inspections are conducted.

Previous Outreach Sessions have been themed specifically on Conduct of Business risks. DFSA staff also participate in a number of conferences and events that cover conduct and culture risks that are held in the UAE and other countries, such as the MENA Regulatory Summit organised by Thomson Reuters—an event that the DFSA has previously hosted.

To monitor developments, the DFSA has a dedicated Conduct of Business team in its Supervision Division. This team is responsible for overseeing conduct of business risks across all financial institutions operating in or from the DIFC.

Following a risk assessment or regulatory event, the DFSA may, in specified circumstances, require financial institutions to appoint an independent third-party to conduct a review and provide a report to the DFSA (similar to a Skilled Persons report in the UK context).

At present, the DFSA has not introduced any additional regulations to its framework similar to the UK's Senior Managers and Certification Regime and similar such accountability schemes adopted by regulatory authorities in countries such as Ireland and Australia, among others. However, relevant individuals, including Senior Management, members of the

Governing Body, and other Authorized Individuals, are subject to various regulatory requirements including regulations surrounding their fitness and propriety.

Senior members of the DFSA Executive team participate with the Basel Committee on Banking Supervision (BCBS), the International Association of Insurance Supervisors (IAIS), the International Organization of Securities Commissions (IOSCO), the Islamic Financial Services Board, and the International Forum of Independent Audit Regulators. In so doing, the DFSA hopes to contribute to the work of international standard-setters on a range of matters, to include the supervision of conduct and culture related risks.

DFSA supervisory staff also participate in "supervisory colleges" held by a number of global financial institutions, where conduct and culture related matters form part of the agenda. Such events include participating in the FINRA Business Conduct Roundtable. This annual event brings together senior colleagues from a dozen or more regulators, inviting them to discuss current and emerging conduct and culture issues.

Finally, in regard to FinTech and RegTech, the DFSA engages with regional and international regulators and are also members of the Global Financial Innovation Network (GFIN). The DFSA has also engaged in a number of RegTech and SupTech initiatives.[449]

The DFSA is using a mix of in-house and third-party capabilities to develop its SupTech program and is using in-house capabilities to develop regulatory intelligence monitoring tools. The regulator is also looking to third-party applications in the areas of payments transaction monitoring and compliance monitoring, including prospectus, regulatory business plans, legal documentation reviews, and chatbot development.

South Africa

FINANCIAL SECTOR CONDUCT AUTHORITY (FSCA)

The FSCA received an explicit mandate to regulate culture and conduct under the Financial Sector Regulation Act of 2018 and under a 2019 statement supporting a new draft of Conduct Standards.[450] The FSCA had identified that, over the past decade, a "clear gap in the regulation of market conduct"[451] of retail banks had become apparent. Under the new standards, in part driven given by recommendations from a 2017 World Bank diagnostic report,[452] banks will be expected to demonstrate the design and use of governance arrangements which ensure that fair treatment of customers is central to the firm's culture, and that customers receive consistently delivered outcomes.[453]

The FSCA's approach aims to pre-empt the emerging risks within a bank and those which may exist at an industry level. Such risks will be relayed to the FSCA through a new reporting framework, permitting supervisors to gather and analyze information that reveals conduct risks and trends at any particular bank. This framework may develop into a more comprehensive market conduct framework over time.

The core of the new conduct standard is a set of 'Treating Customers Fairly' outcomes. These outcomes have been put forward to commentators for industry feedback, and in turn, the FSCA has requested review with a view to identifying any risks and benefits, as well as to comment on the potential costs of implementation of the new standards.

Conclusion: What's Next

The Basel Committee's 2011 *Principles for the Sound Management of Operational Risk* points to the importance of people, processes, and systems.[454] At most firms, the emphasis appears to be on processes and systems run by risk and compliance teams, while 'people concerns' are typically relegated to Human Resource departments where they are likely to receive less significant budget commitments and C-suite bandwidth. Behavioral risks can fall through the cracks between these functions, getting lost at the seams of a firm's risk management framework.

The Operational Risk Exchange (ORX), we noted in the Conclusion to our report last year, has estimated that the financial industry paid over $600 *billion* in punitive fines and customer remediation costs since the Financial Crisis. This is in addition to the billions spent annually on governance, risk, and compliance. Such expense is both unsustainable and insufficiently productive of desired outcomes.

In the year since we made those observations, Australia's Westpac suffered from a money-laundering scandal involving transactions that facilitated child sex abuse.[455] The CEO of Japan Post was forced to resign in disgrace after a mis-selling scandal involving abuse of the country's elderly.[456] In the UK, HSBC reported that whistleblower complaints had jumped for the third consecutive year and reported that three-quarters of closed cases had related to conduct complaints.[457] A US Congressional committee issued a report on "The Real Wells Fargo: Board & Management Failures, Consumer Abuses, and Ineffective Regulatory Oversight."[458] Long-serving board members and CEO Tim Sloan were forced to resign, while past executives were assessed *personal* fines in the millions.[459] Former-CEO John Stumpf was banned from the industry for life.[460]

At the time of the mis-selling activity that led to the firm's travails, new-CEO Charles Scharf had recent occasion to explain to Congress, "the company did not have in place the appropriate people, structure, processes, controls, or culture to prevent the inappropriate conduct."[461]

THERE'S SOMETHING HAPPENING HERE...

In the US, 2019 was a record year for CEO turnover.[462] Across several industries, over 1600 CEOs left their roles – driven, in some 35 instances, by allegations of misconduct. This builds on a trend observed in 2018, when 17.5 percent of CEOs among the world's top 2500 firms chose or were forced to step down.[463] For the first time, PwC affiliate Strategy& then reported, "more CEOs were dismissed for ethical lapses than for financial performance or board struggles."

Culture and conduct management challenges feature in many industries, of course. In recent months alone, McDonald's was beset by legal claims stemming from alleged, "sexual harassment and the company culture that enables it."[464] Boeing posted its first full year loss since 1997 after deadly crashes of its 737 MAX aircraft.[465] Preliminary findings from a US Congressional committee indicate that the safety failures resulted from a "culture of concealment" that worked to hide safety problems.[466] Boeing's European rival, Airbus, saw €3.6 billion in fines and penalties levied by regulators in France, the UK and the US after a bribery scheme came to light.[467] In Australia, the Interim Report of a Royal Commission into Aged Care Quality and Safety detailed appalling cases of elder-abuse.[468] A "culture of apathy" was blamed.[469] And the UK's accountancy industry was rocked after investigative journalists reported on a "culture of fear" that prohibited employees of the 'Big Four' from speaking out about rampant abusive behavior.[470] It would be gratuitously easy to add to this list.

As Buffalo Springfield might have styled it, *there's something happening here*. Heightened sensitivity to perceived misbehavior may now be leading to increased complaints of such.[471] But bigger problems often result when employees elect *not* to speak up after ethical or misconduct concerns arise.[472] A 2020 Top-10 Risks list from Protiviti features the risk that a firm's culture "may not sufficiently encourage timely identification and escalation of risk issues."[473] Bank regulators have thus begun looking for evidence of a "speak-up" culture within firms.[474] The UK's FCA has encouraged them to work towards a culture that promotes greater "psychological safety" so that leadership may learn of problems more readily.[475]

And conduct risk takes the #2 slot on the 2020 OpRisk Top-5 List from ORX—the industry association for top operational risk leaders in the financial sector.[476] Yet, in a recently reported study[477] based on ORX data—featuring 700,000 operational loss events recorded among 74 global banks from 2002 until end-2017—the Bank for International Settlements (BIS) found that banks take an average of 251 days to discover that an operational loss event took place. Moreover, the BIS reports, "Internal fraud events and failures as a result of negligence or improper business practices are less likely to be discovered than other events." Indeed, the BIS finds that it takes an average of 448 days before internal fraud events are recognized and responded to as such, and 827 days in the case of improper business practices.

At many firms, the HR toolkit for 'culture management' relies on staples such as personality testing, which critics have likened to "office astrology,"[478] or the ubiquitous staff 'engagement survey,' which some see as the metaphorical equivalent of an organizational "mood-ring."[479] Such instruments have proven inadequate to the task of managing culture and conduct risk in the banking sector. Consider: the most recent annual survey from the UK's Banking Standards Board (BSB) finds that employees feel unheard when they try to speak up about workplace culture and conduct problems. Thus, the BSB reports that only two-thirds of employees even bother trying to report concerns. And, of those, less than half feel they are listened to seriously.[480]

Estimates are that financial firms spend hundreds of millions of dollars on these HR-fielded tools annually, in the global aggregate. But they spent $181 *billion* on financial crime compliance alone last year, a survey from LexisNexis finds. A majority of respondents pointed to "minimizing reputational risk" as a key cost driver.[481] But it is not clear that the spend achieves the goal, and regulators are no longer prepared to accept swollen GRC budgets as a proxy for efficacy. They are "no longer satisfied with frameworks, documentation, and audit validation alone; they want tangible evidence," Deloitte argues.[482] "Institutions will need to cast a net wide enough to detect potential risks that have not yet occurred and will need a real-time view based on internal and external indicators," McKinsey contends.[483] In short, regulators want firms to evidence some ability to anticipate and ameliorate conduct risks before they cascade into crises—and especially now.

"There is concern that conduct exposure may be created by the new business environment adopted in response to the pandemic," ORX recently reported. "The potential for lasting reputational damage due to firms' response to the pandemic is apparent," ORX concludes.[484] We make this same argument in the **Our View ▸ p. 38** insert appearing alongside these concluding remarks. Conduct risk governance is all the more critical against the backdrop of the COVID-crisis, and the economic damage and relief efforts that it has triggered.[485]

ABSENCE OF EVIDENCE IS NOT EVIDENCE OF ABSENCE

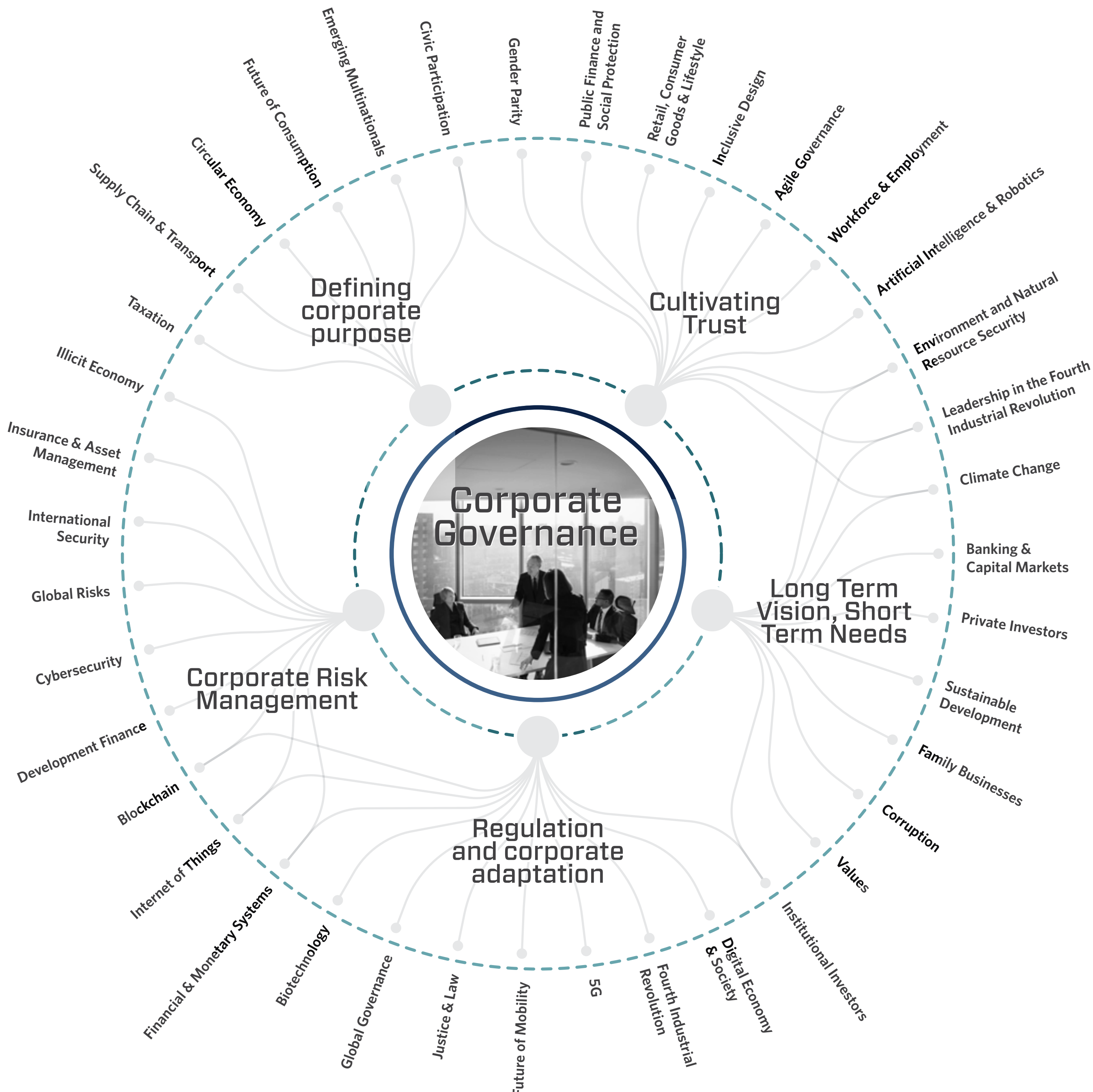
"Five years ago, the prevailing reaction to a suggestion that regulators and supervisors should pay attention to culture was, in essence, 'seriously?'," write New York Fed attorneys Michael Held and Thomas Noone.[486] This has changed: culture has become a recognized corporate governance concern and has moved away from the issues that typically occupy HR departments and into the remit of risk and compliance teams.[487] "A financial firm's culture is the key driver of their conduct and more general risk management," Reserve Bank of New Zealand Governor Adrian Orr argued in a recent speech.[488]

Boards take note: Bank of America estimates that Environmental, Social, and Governance (ESG) issues erased $500 billion from the value of US companies over the past five years.[489] ESG concerns are thus rightly considered 'material',[490] and it is unsurprising that the need for a common set of metrics by which to gauge such concerns was a prominent theme in Davos this year, with numerous related initiatives announced.[491] **SEE FIGURE 15 BELOW** Corporate culture is seen as a core part of the 'governance' aspect of ESG considerations, and we may expect increased attention to it as such in the year ahead.

This takes place at a time when ESG funds have seen a significant increase in demand from retail investors.[492] Moreover, the COVID-crisis appears to have led to a heightened interest in ESG themes among institutional investors—particularly with regard to social and governance matters.[493] And they seem unreceptive to excuses from firms that might wish to argue that the COVID-crisis has made it too difficult for them to address such 'soft' concerns. Global head of BlackRock's investment stewardship team Michelle Edkins, for instance, has said the asset manager wants to see progress from companies on these issues regardless of the coronavirus outbreak. "We are looking at these [issues] long term. These are not new issues," she said. "Companies can still demonstrate that they have effective leadership. In times of crisis that becomes more apparent, not less apparent."[494]

An absence of evidence regarding culture or conduct concerns will not be viewed as evidence of their absence. Regulators and others seem to feel that the time has come for reliable culture metrics that serve as leading indicators of culture challenges and the

15. The WEF Portrays an Extended Corporate Governance Universe



Source: World Economic Forum. Interactive Graphic Available at: https://intelligence.weforum.org/topics/a1G0X000005JLTqUAO

conduct-concerns they represent. The Institute of Internal Auditors (IIA) recently published a guide, for instance, called "Auditing Culture,"[495] in which it gives directions on how culture and subcultures within a firm are best evaluated with a view to auditing and managing the risks associated with such.[496] IIA CEO Richard Chambers observed that, when he began his career, "*there was great debate as to whether internal audit could develop the requisite qualitative and quantitative skills to audit culture. I believe it is safe to say we are well on our way to answering that question with a resounding 'yes'*."[497] Accordingly, a 2019 IIA

Corporate Governance Index includes among its eight core principles: "*The board should ensure that the culture of the company is healthy, regularly monitor and evaluate the company's core culture and values, assess the integrity and ethics of senior management, and, as needed, intervene to correct misaligned corporate objectives and culture*."[498]

IF YOU CAN'T MEASURE IT...

Here, as noted in our report last year, we see a growing confluence in the concern for culture and conduct risk among regulators, with an interest in the management and audit thereof within firms, and with a related insistence among investors who regard effective governance in this context as a safeguard of firm value. All three constituencies—firms, their regulators, and their investors—have a common interest in superior risk metrics by which to gauge the 'soft risks' that a firm's cultural propensities may represent. Neither the HR manager's toolkit nor the processes and systems deployed by risk and compliance teams have thus far permitted for the development of adequate leading indicators of culture and conduct risk.

In the US banking sector, pressure for change in this regard may now become caught up in deliberations regarding reform of the so-called 'CAMELS' rating system. The acronym refers to the six components of a bank's condition assessed by the Fed, OCC, and FDIC: Capital adequacy, Asset quality, Management capability, Earnings, Liquidity, and Sensitivity to market risk. Each factor is rated on a scale of 1 to 5 (with 1 being best) and the overall condition of a firm is found by some weighted blending of those six scores. Ratings of three and below are of supervisory concern, indicating an assessment of firm performance ranging from poor to critically deficient and requiring immediate remedial actions. Developed in 1979, the CAMELS rating system is today an internationally known regulatory point of reference.

In October last year, the Fed and FDIC solicited public comments as to whether application of the ratings system may warrant revision.[499] CAMELS ratings are not released to the public. Rather, intent is that the rating is used by management of a given firm to better understand and mitigate possible risks. The precise means by which a particular bank examiner makes its ratings decisions is not shared publicly and firms are not permitted to share their ratings with one another. Indeed, as the OCC warned last year,[500] unauthorized disclosure of a firm's CAMELS rating may result in criminal penalties. Critics such as the American Bankers Association argue that the system requires greater transparency, particularly as regards the management component, which it claims to be "viewed by banks of all sizes as an arbitrary, highly subjective, catch-all category."[501]

Banks are adept at managing their financial performance metrics and have become more analytically sound in that regard since the Financial Crisis. As this has occurred, "examiners have shifted their emphasis to the one entirely subjective component: management," The Clearinghouse argues.[502] "And not management as viewed through the lens of maintaining sound financial condition, but rather through the lens of 'compliance' – not just with laws, but with examiner guidance and criticisms too."

Gary Cohn, former President and COO of Goldman Sachs and Director of the US National Economic Council, offered us the following remarks regarding such frustrations:

> *For decades we've relied upon a ratings system—CAMELS—that has been inconsistently applied by bank examiners, against a backdrop of secrecy and subjectivity regarding how they reach their ratings decisions. This approach may have been understandable in the past, but it would seem that new data technologies might permit for a better and more objective approach today.*

Most troublesome is the "M" rating, which stands for "Management Capability." Because the CAMELS rating is an aggregate score, across all of its constituent elements, regulators can really torpedo a firm by assigning it a poor M-score, and thus dragging down a firm's total score. Yet we have very poor visibility into how the critical M-score is developed.

Surprisingly, different supervisors appear to use different methodologies in this regard—as do different examiners within a single regulatory body. This disadvantages the industry, of course, but it also works against key regulatory and policy interests: setting consistent standards and conducting horizontal reviews on an apples-to-apples basis.

The management component of CAMELS may involve a number of factors, but there can be little question that a concern for the management of misconduct and other non-financial risks is a key element. To the extent that regulators and firms can agree to some set of standardized metrics for such operational concerns, this would be helpful in the CAMELS context.

My own experience in dealing with such matters suggests that we would benefit by the development of industry standard, data-driven metrics for culture and conduct 'soft risks'—which have proven to be deeply intractable across the financial sector. This would facilitate better supervision and more proactive internal risk governance alike.

THE ERA OF 'PRECISION MANAGEMENT'

If we could go back a year, knowing what we now know about the COVID-19 pandemic, what would we do differently to prepare for what we know is to come? Surely, we would do something to better prepare. The time is right for the banking sector to consider the lessons of the recent past and to *anticipate* what is to come once we get past our current trials. Examples of such forecasting abound in the biological sciences.

Consider the parallels between managing conduct risk and kidney failure. One of the most common causes of death in hospital patients is the sudden loss of kidney function: the Centre for Disease Control reports that acute kidney failure struck more than four million Americans in 2014, leading directly to death for hundreds of thousands. Survivors were often left dependent upon expensive dialysis for months or even years. And, frighteningly, kidney failure often occurs swiftly, with little warning, triggered by multiple causes that are hard to detect in advance. By the time clear warning signs do emerge, it is usually too late.

But a study[503] appearing in the journal *Nature* reports that researchers at Google's DeepMind Health have developed algorithms that can identify various factors – '*conditions*' – that point to risk of renal failure. With data from the US Department of Veteran Affairs, Google trained its models on 600,000 different 'health indicators' and identified some 4,000 that proved to be of high predictive value. The subsequently trained AI models were seen to be 90% accurate in cases that were severe enough to later require dialysis, successfully predicting renal failure 48 hours before it actually occurred and thus promising to give doctors ample time to take corrective steps that may save lives, avoid injury, and reduce all the attendant suffering – and costs.

There are many other such examples. For instance, it is current practice for doctors to prescribe depressed patients whichever antidepressant they may prefer, and then they have to wait six to eight weeks to know whether it is working. If not, another six to eight weeks is devoted to trialing another drug. Meanwhile, patients may be at risk for suicide or too depressed to function well. But now, scientists have found a means of reading a patient's 'brain-waves' in order test a drug for its likelihood of efficacy.[504] One firm, Scipher

Medicine, observing that 90 percent of patients prescribed leading drugs will not respond to therapy, is using network science to analyze patient genetics in a manner that allows for accurate prediction of drug response.[505]

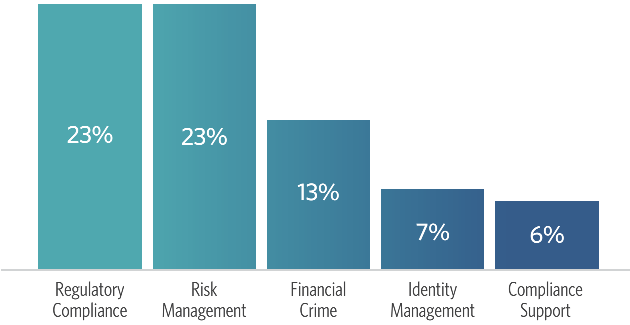
The list of examples goes on, but in nearly all instances, these practitioners of "precision medicine" are making use of powerful machine learning technologies paired with massive amounts of training data. Could something similar work in the organizational context to permit for "precision management" of non-financial risks? Research in the emerging field of computational social science demonstrates that this is indeed possible but, as leading network scientist Duncan Watts warns, in the context of behavioral risk forecasting, "computational social science works well only when powerful computation is matched with careful social science."[506]

A number of new firms in the regtech space have begun to test the viability of applying such AI tools to the challenges of risk and compliance in the banking sector. **FIGURE 16** Machine learning tools are assessed to have particularly strong potential impact, according to a global study of the RegTech sector conducted by the University of Cambridge.[507] While every significant financial institution uses surveillance and monitoring tools to look for 'anomalies' in internal data systems that may indicate that problematic behavior has taken place, relatively few are applying a behavioral lens in this context. **FIGURE 17** However, a 2019 survey[508] finds that firms are placing increasing emphasis on conduct risk controls. **FIGURE 18** Regtech may have an important role to play in this regard, as many regulators are beginning to encourage. "The HKMA believes the time is right for closer collaboration among the banking industry, technology community and the HKMA to further facilitate the adoption of Regtech in Hong Kong," the HKMA reports in its contributed remarks herein. **IN FOCUS ▸ P. 74**

A convergence of RegTech and SupTech, Deloitte observes, is prompting financial institutions to experiment with a "digitized risk management strategy."[509] An effective such program, "can position leaders and team members to respond to potential threats in a timely and proactive manner," it argues. "It also has the potential to enhance an institution's supervisory standing with regulatory authorities by demonstrating improvements in risk management practices." A recent report from Juniper research suggests that spending on regtech platforms may exceed $127 billion by 2024, up from $25 billion in 2018.[510] As we write, the Saudi G20 Presidency and the BIS Innovation Hub have announced the launch of the "G20 TechSprint Initiative," which aims to explore and promote the potential for new technologies that address compliance (RegTech) and supervision (SupTech) challenges.[511]

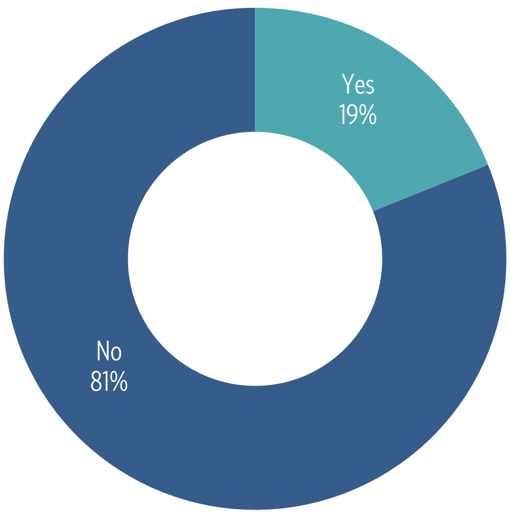
A late 2019 report from BCG touts the advantages of "algorithmic forecasting" in the context of "steering" a firm's financial performance. "Algorithmically derived forecasts allow the focus to shift from periodically reporting results to accurately forecasting the development of KPIs—faster and with less effort," BCG argues. "Armed with foresight into how conditions will change, companies can take action to preempt unfavorable outcomes." Perhaps we might apply a similar mindset to "steering" operational risk management frameworks, bringing a set of new tools to the governance of culture and conduct risk?

16. Growth in the Number of Firms in Each Regtech Segment, 2010-2018



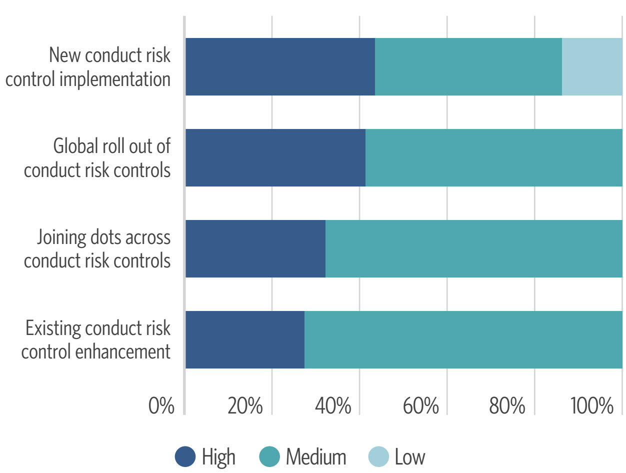
source: https://www.businessinsider.com/regtech-revisited-report-2018-4

17. Do you use behavioral profiling to filter your communications surveillance monitoring alerts?



Source: The 1LoD Global Benchmarking Survey & Annual Report 2020

18. Over the next 12 months, what priority do you think the following control implementations will have?



Source: The 1LoD Global Benchmarking Survey & Annual Report 2019

CONCLUSION: WHAT'S NEXT

Pool / REUTERS

Mark Carney

The British Academy has called for the application of data and the 'hard sciences' in seeking solutions to a wide range of social challenges. But, it cautions, this must include a complementary application of the humanities and social sciences.[512] Former Bank of England Governor Mark Carney might agree. In a piece appearing in the *Economist* this month,[513] Carney quotes philosopher Michael Sandel, who has argued that, "in recent decades, subtly but relentlessly, we have been moving from a market economy to a market society." As a consequence, "The price of everything is becoming the value of everything." Carney argues that this will change in the post-COVID world, and that it will have to. Value will be shaped by "new vectors," he maintains, pointing to those of the economic and financial as well as psychological and societal sorts. Businesses must give thought to this now, while grappling with the current health and economic crisis, Carney cautions. "When it's over, companies will be judged by 'what they did during the war'."

Ruben Sprich / REUTERS

Paul Polman

"Our political leaders, financial institutions and global governance structures are being severely tested," former Unilever CEO Paul Polman said in a recently reported interview.[514] "Their job is made harder by low levels of public trust and broken social contracts in many parts of the world." Polman reminds that, in recent years, we have seen that "employees and consumers increasingly reward businesses that use their powers for good." As companies struggle to respond to the challenges represented by the COVID-crisis, there will be little tolerance for what

Polman calls "false virtuousness." Rather, he urges us to recognize that, "Business leaders who back moral statements with practical action will stand out."

This will be especially true, we believe, in the banking sector. As the *Wall Street Journal* put it so aptly, "Banks can't do social distancing."[515] Across the globe, banks have been called upon to play a critical social function, serving as intermediaries between the public, and the public purse. This is testing their own resilience but,[516] in our duress, they simply must rise to the challenge and show that they really can "do God's work," as the *Financial Times* quipped,[517] in a backhanded reference to what some regarded as "tone-deaf" remarks made by bankers after the Financial Crisis.

Thus far in our current crisis, the banks have served us as we've asked—and with little thanks. Perhaps the public will withhold any gratitude that may be due to the banks until we get past the COVID-crisis and have time to conduct a thorough look-back. With trillions flowing from national treasuries through the banks to succor ailing businesses and households, many bank staffs are working from home, and largely outside the purview of standard office surveillance and monitoring protocols. A history of misconduct scandals following the Financial Crisis provides a cynical public with cause to question whether we will discover more of the same when we look back to see 'what they did during the war.' We expect that regulatory priorities regarding culture and conduct risk in the coming year will reflect such concern.

It is in the nature of emergencies, Yuval Noah Harari suggests, that they fast-forward historical processes. "Normally, trust that has been eroded for years cannot be rebuilt overnight, he writes, "But these are not normal times. In a moment of crisis, minds too can change quickly."[518] Perhaps current efforts in the banking industry will provide cause for doubters to change their minds about the industry's general trustworthiness.

As we close this year's report and look ahead, it is our hope that Bank of England Chief Economist Andy Haldane is correct in his recent observations: the COVID-crisis has revealed marked amounts of social capital. "We see this daily on our doorsteps through small acts of neighbourly kindness. We see it in the activities of community groups, charities and philanthropic movements," Haldane writes, "And we see it too in the vastly increased numbers of people volunteering to help."[519] Such capital, Haldane suggests, might permit us to do the work of "reweaving the social fabric" of our societies after the current crisis is past. The post-COVID public will surely look to see that the banking sector played its own critical part in this, and played it well.

Davies / Stringer

In Focus:
Further On up the Road

by GARY COHN, TOM CURRY, & MARTIN WHEATLEY

Those old enough to recall the collapse of the Soviet Union will remember how time seemed to accelerate, as established truths toppled like dominoes. Addressing Congress in February 1990,[1] Václav Havel captured the moment: "The human face of the world is changing so rapidly that none of the familiar political speedometers are adequate," he said, describing a breathless disorientation when he added, "we have literally no time even to be astonished."

History sometimes lurches away from the deeply familiar into an ill-formed "new normal." But it also has a way of *lingering*, leaving elements of What-had-Been deeply interred—in the earth and the national psyche—to be rediscovered in the course of the Yet-to-Come.

Consider the 1940 image above, warning of an unexploded German bomb found lying beneath London's Fleet Street. Then consider this story[2] of WWII-era bombs found in Dortmund—reported on January 12th *of this year*. Or this story,[3] from February 2nd, when another bomb was found in Venice. Or this one,[4] appearing just a day later, when yet another bomb was found under Dean Street in London's Soho. History lurches, true, yet it also *lingers*...

We are again living through a time of lurching, when "political speedometers" are insufficiently well calibrated to the pace of change.

In the face of the current pandemic, and the economic dislocation it has occasioned, we must throw as much money as possible, as quickly as possible, at floundering businesses, entrepreneurs and sole proprietorships, gig economy workers and households in order to create conditions for a swift recovery. To do so, we will be forced to rely on the banking sector to play its critical intermediary role[5] as perhaps never before.

In support, bank regulators worldwide are putting a hold on the introduction of new regulations and delaying normal supervisory and oversight activities: the Basel Committee has pushed the deadline for implementing Basel III standards out by a year; the US Federal Reserve Bank is working to ease rules;[6] the UK's Prudential Regulatory Authority has cancelled its 2020 stress tests;[7] the Australian Prudential Regulation Authority has suspended much of its regulatory work through September[8] and the Australian Securities and Investments Commission has suspended its "close and continuous monitoring" program.

In Asia, banks and regulators have benefitted by their experience confronting SARS in the early 2000s, and they have had longer to adjust to the pandemic. Today, banks across the region appear to be in a competition of sorts, aiming to burnish their credentials and social standing.

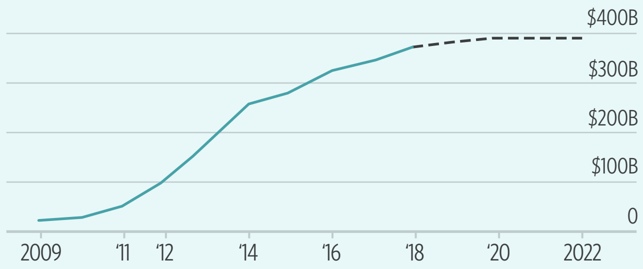
Others must follow their example. Over a decade after the Financial Crisis, Banco Santander chair Ana Botín reminds, bankers remain distrusted[9] around the world, contributing to current political populism. The 2008 Financial Crisis originated in the banking sector—it was the banks that needed saving. But the subsequent "bailouts" bred a lingering resentment,[10] and many still feel that banks first caused the crisis and then benefited at the taxpayer's expense.

Today's trials reverse that dynamic: the current pandemic positions banks to *reciprocate* and to extend themselves on behalf of the taxpayers. But optimism here is unfortunately wanting.

The years since the Financial Crisis have witnessed countless misconduct scandals, among banks in every major market across the globe. Despite enormous investment in governance, risk and compliance systems, processes and personnel, efforts to manage culture and conduct related risks in the financial sector in the last decade have proven demonstrably inadequate. Throwing more resources at past failed approaches is senseless—perhaps even irresponsible.

Once our present crisis is past, we fear that we will learn of yet more industrywide misconduct, this time taking place as trillions of dollars were steered through the global banking system in order to support taxpayers. Assuredly, some firms will seize

19. Bank Misconduct Fines Top $372 Billion
Fines and settlements have been slowing in recent years



Sources for the period through 2018, BCG analysis of the top 50 firms in europe and the U.S.
Projection for the coming years compiled by Bloomberg Intelligence

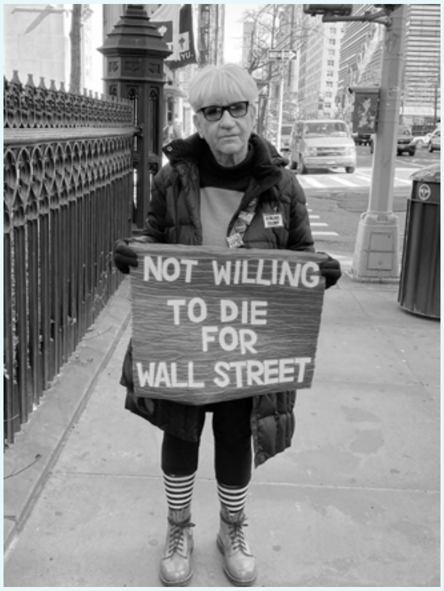
upon our current circumstances as a much-needed "redemption moment"[11] for the industry. But this will not insulate good actors from the inevitable social blowback that will result from the bad acts of even a relative few.

"What struck me when the manipulation was made public was how much it angered people," one of us observed[12] a few years after the Financial Crisis, when the LIBOR rate-rigging scandal broke into public view. "It said something about the culture of financial services, but also led people to question what they can rely on."

In this time of lurching, we must pause to consider what may linger well into the future.

Though supervisory scrutiny by regulators may be suspended, rather than viewing this as a "compliance holiday" of sorts, we believe that a doubling down on nonfinancial risk management should be an industry-wide priority. We cannot afford to allow a public health and economic crisis to become a moral crisis as well.

History lingers. "If this epidemic results in greater disunity and mistrust among humans," warns Yuval Noah Harari,[13] "it will be the virus's greatest victory."



@ianbremmer March 26, 2020

If we fail to address the financial sector's Achilles' Heel[14]—misconduct risk—in the course of what Mohamed El-Erian has termed a race between economics and COVID-19,[15] a spate of scandals will almost inevitably follow our current heroic efforts. This will rob the financial industry of what little public trust[16] remains to it, likely deepening an already worryingly broad discontent with capitalism—and perhaps even with democracy itself.

Policymakers, regulators, supervisors, boards and bank leadership and risk officers should consider this closely if they wish to avoid a future crisis, as pandemic-era bombs explode further on up the road.

A version of this article was published by Thomson Reuters Regulator Intelligence on April 1st, 2020 and again, on April 13th, Here.[17]

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13 Yuval Noah Harari, " In the Battle Against Coronavirus, Humanity Lacks Leadership," *Time*, Mar. 15, 2020.

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APPENDIX
The Starling Bookshelf

We speak a fair bit on the topics herein, at events where the organizers and audience are interested in learning how behavioral science, organizational network analytics, and machine-learning techniques come together in the context of culture and conduct risk management (and supervision). Nearly always someone asks, "What can I read to learn more about this stuff?"

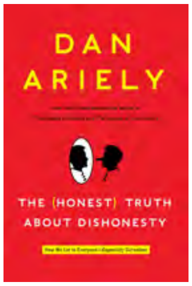
So we thought we'd complement this year's *Compendium* with a glance at some of what sits dog-eared on our bookshelves—yellow highlighter marks competing with coffee stains and notes in the margins. We hope that some of our readers will be inspired to give one or two of these terrific books a glance—and most particularly those by our academic advisors, noted below with an arrow icon.

Connected:
The Surprising Power of Our Social Networks and How They Shape Our Lives—How Your Friends' Friends' Friends Affect Everything You Feel, Think, and Do

Nicholas Christakis & James Fowler

"Germs are not the only things that spread from person to person. Behaviors also spread."

"Interconnections between people give rise to phenomena that are not present in individuals or reducible to their solitary desires and actions. Indeed, culture is one such phenomenon."

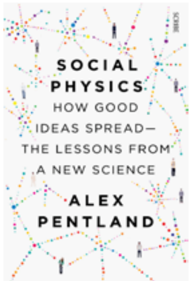


The Honest Truth About Dishonesty:
How We Lie to Everyone—Especially Ourselves

Dan Ariely

"Passed from peron to person, dishonesty has a slow, creeping, socially erosive effect. As the 'virus' mutates and spreads from one person to another, a new, less ethical code of conduct develops."

"The idea that dishonesty can be transmitted from person to person via social contagion suggests that we need to take a different approach to curbing dishonesty."

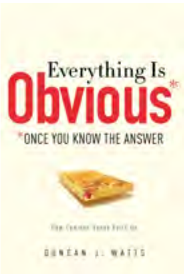


Social Physics:
How Good Ideas Spread—the Lessons from a New Science

Alex Pentland

"The effects of exposure to peer behaviors are roughly the same size as the influence of genes on behavior or IQ on academic performance."

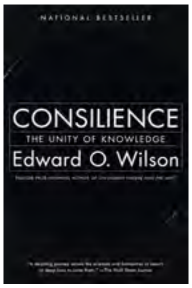
"By combining the influence model with a measure of exposure to peers' behaviors, or a measure of social strength tie, we can produce useful predictions of the likelihood that an individual will adopt a particular behavior."



Everything is Obvious:
How Common Sense Fails Us

Duncan Watts

"[O]ur impressive ability to make sense of behavior we have observed does not imply a corresponding ability to predict it... It is this diffrence between making sense of behavior and predicting it that is responsible for many of the failures of commonsense reasoning. And if this difference poses difficulties for dealing with individual behavior, the problem only gets more pronounced when dealing with the behavior of groups."

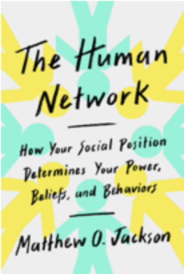


Consilience:
The Unity of Knowledge

Edward O. Wilson

"In economics and in the remainder of the social sciences as well, the translation from individual to aggregate behavior is the key analytical problem. Yet in these disiplines the exact nature and sources of individual behavior are rarely considered."

"People expect from the social sciences... the knowledge to understand their lives and control their future. They want the power to predict."

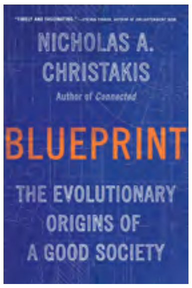


The Human Network:
How Your Social Position Determines Your Power, Beliefs and Behaviors

Matthew O. Jackson

"[T]here is a chasm between our scientific knowledge of networks as drivers of human behavior and what the general public and policymakers know."

"First, a few primary features of networks yield enormous insight into why humans behave the way they do. Second, these features are simple, intuitive, and quantifiable. Third, human activity exhibits regularities..."

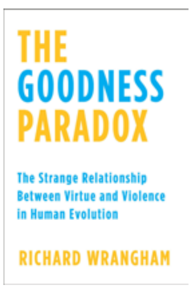


Blueprint:
The Evolutionary Origins of a Good Society

Nicholas A. Christakis

"We have not evolved simply to live in undifferentiated groups like herds of cattle; we have evolved to live in networks in which we have specific connections to other individuals whom we come to know, love, and like."

"[W]hen it comes to our way of living socially, we are more similar than different."



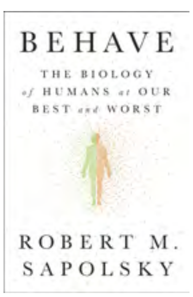
The Goodness Paradox:
The Strange Relationship Between Virtue and Violence in Human Evolution

Richard Wrangham

"History and evolutionary anthropology tell the same sad story."

"[C]apital punishment emerged with language in the mid-Pleistocene. Afterward, an individual who challenged the dominant culture could be in mortal danger."

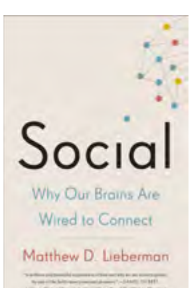
"When the risk of being a nonconformist is that you will be executed, it is easy to imagine intense selection in favor of moral sensibilities that maintain you as part of the in-group."



Behave:
The Biology of Humans at Our Best and Worst

Robert M. Sapolsky

"Like so many other animals, we have an often-frantic need to conform, belong, and obey. Such conformity can be markedly maladaptive... When we discover we are out of step with everyone else, our amygdalae spasm with anxiety, our memories are revised, and our sensory-processing regions are even pressured to experience what is not true. All to fit in."

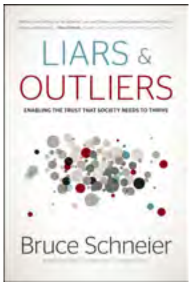


Social:
Why Our Brains Are Wired to Connect

Matthew D. Lieberman

"Our brains evolved to experience threats to our social connections in much the same way as they experience physical pain."

"Whether employees realize it or not, they have been wired to be motivated by being accepted and valued by the groups they are socially connected with."



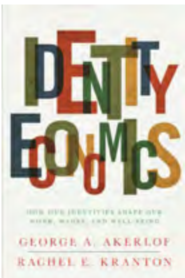
Liars & Outliers:

Enabling the Trust that Society Needs to Thrive

Bruce Schneier

"Many people associate morals with the responsibilities arising from ... group membership."

"While morals are part of the reason we cooperate with each other, the preponderance of the evidence—both observational and experimental—supports the hypothesis that we cooperate primarily because we crave reward (engagement) and fear punishment (exclusion) from other members of our group."



Identity Economics:

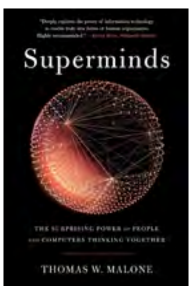
How Our Identities Shape Our Work, Wages, and Well-Being

George A. Akerlof & Rachel E. Kranton

"In every social context, people have a notion of who they are, which is associated with beliefs about how they and others are supposed to behave."

"Effective management encourages workers to be insiders, who identify with the goals of the firm."

"But many studies have found that workers typically identify with their immediate workgroup rather than with the organization as a whole."



Superminds:

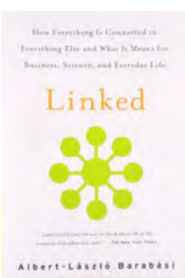
The Surprising Power of People and Computers Thinking Together

Thomas W. Malone

"We can define a community as a supermind where decisions are made by informal consensus or according to shared norms, both of which are enforced through reputations and access to resources."

"It turns out that groups have scientifically measureable properties, just as individual humans do."

"[N]ew information technologies are changing the political calculus of how to organize large groups."



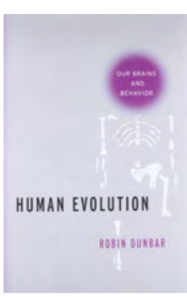
Linked:

How Everything Is Connected to Everything Else and What It Means for Business, Science, and Everyday Life

Albert-László Barabási

"While our individual choices are highly unpredictable, as a group we follow strict patterns."

"While noticing similarities between natural systems and human designs has a long history, it has always been difficult to move beyond the metaphors to quantify these analogies. Lately, networks have become the X-ray machines of our connectedness..."



Human Evolution:

Our Brains and Behavior

Robin Dunbar

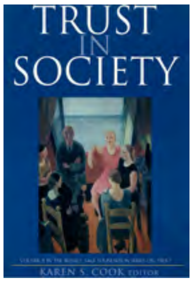
"We each have a distinctive signature, rather like a fingerprint, in how we distribute our social capital (time and emotional effort) across the individuals in our extended social networks—so much so that this pattern is preserved even when there is considerable turnover in network membership..."

In The Company of Strangers:
A Natural History of Economic Life - Revised Edition

Paul Seabright

"[N]o country can hope to live peacefully and prosperously unless it finds ways to reconcile its citizens to mutual trust."

"Only if we are alive to the way in which trust is taken and given in the various arenas that make up modern society will we be able to use the institutions in which trust remains healthy to cure the deficiency of the institutions in which trust has decayed."



Trust in Society
(Russell Sage Foundation Series on Trust, Vol. 2)

Karen S. Cook, Editor

"In the absence of trust, what are often fairly complex systems must be put in place to protect against exploitation and opportunism and to produce close monitoring and effective sanctioning. Even the law is a blunt instrument that cannot efficiently produce the kind of social order that comes from the existence of trusting relations in a group or society."

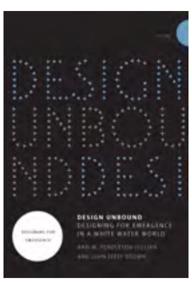
How Behavior Spreads:
The Science of Complex Contagions

Damon Centola

"Once organizational networks can be measured, they can be controlled."

"[B]y understanding the network structure of a population, we can discover new ways to control the flow of behaviors across it."

"The most important implication here is that managers can design organizational networks to provide a structural foundation for accelerating the dynamics of change."

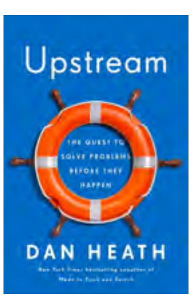


Design Unbound:
Designing for Emergence in a White Water World

Ann M. Pendleton-Jullian & John Seely Brown

"[I]n philosophy, in the sciences, in art, and specifically within complexity theory, emergence now refers to a very specific process: one in which simple interactions among individual parts or agents form complex behaviors and patterns at the system level."

"Designing for emergence is about understanding the propensities of the context and designing with and for those propensities."



Upstream:
The Quest to Solve Problems Before They Happen

Dan Heath

"Upstream work is about reducing the probability that problems will happen, and for that reason, the work must culminate in systems change. Because systems are the source of those probabilities. To change the system is to change the rules that govern us or the culture that influences us."

APPENDIX

2020 Survey

1. If your regulatory agency has a mandate to regulate culture and conduct, is the mandate express or implied?

2. Has your regulatory agency made culture and conduct a regulatory priority? Do you intend to continue or initiate that priority in 2020?

3. Do you have a dedicated culture or conduct supervisory or risk assessment team?

4. Does your agency require senior managers to be held accountable for their organisation's culture and/or any conduct related risk management failures?

5. In your examination efforts or other supervisory engagement with banks, is culture and conduct specifically assessed or discussed? If so, do you discuss only with senior management or do you also engage mid-level managers?

6. Has your regulatory agency organized or participated in any conferences or events that are focused on culture or conduct risk management and supervision?

7. Do you engage in any international regulatory collaborations relating to culture and conduct, or do you expect to engage in any during 2020?

8. Are any financial institutions within your jurisdiction conducting culture and/or conduct risk audits, whether following from or in anticipation of supervisory action?

9. If your regulatory agency is trialling new approaches, please provide more detail in the answer text below:

10. Has your government enacted any legislation that specifically aims to address culture or conduct related risks at financial institutions? Is any such legislative activity anticipated in 2020?

11. Has your regulatory agency issued any new rules or mandates to address culture or misconduct? Are any contemplated for 2020? If so, can you provide any information?

12. Has your government (or any government-sponsored commission) conducted any hearings or inquiries into culture or misconduct at financial institutions? If so, what involvement did your agency have? Are any such hearings or inquiries planned for 2020?

13. Has your regulatory agency engaged in any significant supervisory actions or assessed fines for perceived cultural issues or instances of misconduct that have shaped forward-looking views around culture and conduct risk supervision?

14. Have you engaged with any RegTech or SupTech companies with a view to developing the use of these technologies in your regulatory agency?

15. What other questions should we have asked in this survey? Can you suggest any other information that might be relevant to this study?

APPENDIX
Abbreviations

Acronynm	Organization	Country
APRA	Australian Prudential Regulation Authority	Australia
ASIC	Australian Securities and Investments Commission	Australia
AUSTRAC	Australian Transaction Reports and Analysis Centre	Australia
BaFin	Federal Financial Supervisory Authority	Germany
BOE PRA	Prudential Regulatory Authority of the Bank of England	United Kingdom
BoF	Bank of France	France
BoS	Bank of Spain	Spain
CBI	Central Bank of Ireland	Ireland
CFPB	Consumer Financial Protection Bureau	United States
CFTC	Commodity Futures Trading Commission	United States
DFSA	Dubai Financial Services Authority	Dubai
DNB	De Nederlandsche Bank	Netherlands
ECB	European Central Bank	European Union
FCA	Financial Conduct Authority	United Kingdom
FCAC	Financial Consumer Agency of Canada	Canada
FDIC	Federal Deposit Insurance Corporation	United States
FINRA	Financial Industry Regulatory Authority	United States
FMA	Financial Markets Authority	New Zealand
FSCA	Financial Sector Conduct Authority	South Africa
HKMA	Hong Kong Monetary Authority	Hong Kong
MAS	Monetary Authority of Singapore	Singapore
OCC	Office of the Comptroller of the Currency	United States
OSC	Ontario Securities Commission	Canada
OSFI	Office of the Superintendent of Financial Institutions	Canada
SEC	Securities and Exchange Commission	United States
US Fed Reserve	Board of Governors of the Federal Reserve System or Federal Reserve Board	United States

APPENDIX

Culture and Conduct Risk Regulatory Landscape

Our Methodology

In 2020, Starling introduces this new feature to our *Compendium*, motivated by a desire to capture and plot an evolution in approaches to culture and conduct supervision worldwide.

In this chart, we have sought to distill the various culture and conduct-related strategies and initiatives pursued by leading global regulators and supervisors into some framework that permits for a trend-line comparison. The intent is to provide and broadly objective means by which to summarize approaches that regulators and supervisors have taken across their respective jurisdictions.

Inputs for this analysis were drawn from public as well as non-public sources. In early 2020, for instance, Starling collected responses to a survey it had sent to global regulators, supervisors, standard setters, industry associations, and other relevant organizations. Survey responses were complemented by the detailed submissions we received from many regulatory authorities that went into the production of this report, as well as by policy papers, interviews and other public commentary collated by our staff in the past year. This data was then used to generate scores for each regulator on over a dozen factors.

We are grateful to the many supporters that offered input into this process. These are dynamic times and we fully expect to see a number of changes to this chart going forward, as regulators continue to evolve their approaches to addressing the challenge of culture and conduct risk supervision. As the industry evolves in its own approaches, and as new data becomes available, we will of course make changes to this chart in the coming year. We welcome reactions at compendium@starlingtrust.com

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