APRIL 2018

Culture & Conduct Risk in the Banking Sector

Why it matters and what regulators are doing to address it

starling

ABOUT STARLING

Starling is an applied behavioral sciences company. Its predictive behavioral analytics platform allows managers to anticipate, and to shape, the behavior of employees and teams. Combining machine learning and network analytics, Starling reveals how relational trust dynamics within organizations impact critical business KPIs — predictably. Starling's proprietary algorithms generate actionable insights, displayed through intuitive and customizable dashboards, that allow leaders to optimize performance and to identify and mitigate culture and conduct related risks before they cascade into crises. Starling positions its customers to create, to preserve, and to restore value.

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And special thanks to Joe Brunk, a graduate student at George Mason University who has been a great help with research, as well as to Taylor Griffin and Steve Leacock.

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Starling is privileged to be advised by a highly-esteemed board of former regulators, including **Rick Ketchum**, former CEO of the US Financial Industry Regulatory Authority (FINRA), whose career has featured senior leadership roles with the SEC, NASD, Nasdaq, and the NYSE; **Mirea Raaijmakers**, former lead for the supervision of culture and conduct at the Dutch National Bank; and **Martin Wheatley**, former CEO of the UK Financial Conduct Authority and the Hong Kong Securities & Futures Commission.

It is our hope that this **Compendium** will help to prompt further informed discussion, among banking industry executives and their regulators, regarding the role that culture plays in shaping employee conduct and misconduct risks. Starling expects to produce an annual update to this inaugural report, and welcomes any questions, comments, and criticisms. Please reach us at info@starlingtrust.com.

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Executive Summary

In the aftermath of the global financial crisis, the culture prevalent in the financial sector has received widespread attention. Bank executives and boards, regulators, academics, and the general public have begun to argue for the importance of firm culture, seeing it both to reflect, and to shape, the (mis-) behavior of employees. By extension, one cannot identify, mitigate, or supervise "conduct risk" effectively without paying close attention to the culture of an institution. Such arguments culminate in calls for "culture assessments" and "conduct risk audits."

During the past few years, regulatory officials across all key banking centers, globally, have proffered a now substantial array of speeches, studies, and recommendations regarding the culture of banks and other financial firms. Collectively, these public resources provide the backbone of this report. While the available information on the "why, what and how" of bank culture reform is prolific, this material exists in a dispersed and unconsolidated fashion.

This "Compendium" aims to provide those working on, or otherwise interested in, this topic with a one-stop resource that highlights recent developments in the financial sector on the culture and conduct issue. The goal is to provide a comprehensive summary of the substantive work underway regarding the nexus between firm culture, employee behavior, business performance outcomes, and social consequences.

This Compendium begins by introducing "culture" – why it matters to banks, regulators and to society, and then moves to a summary of the various approaches for assessing and supervising culture today. It will then recount how regulators around the world are seeking to address these matters through a variety of new approaches that are either being implemented currently, or are under close consideration, each with different emphases and enforcement imperatives.

A separate report, to be published at a later date, will describe what firms are doing to measure and manage culture and conduct risk, out of their own self-interest, as well as in response to the increased regulatory attention and actions outlined herein.

Chapter 1 clarifies widely used concepts such as "culture" and "conduct risk." More broadly, it explains how cultural issues at banks have had costly and far-reaching effects on the industry and the wider economy. Since the global financial crisis, regulators have assessed conduct-related punitive fines in excess of $320 billion and banks have been forced to spend hundreds of billions more on vastly expanded governance, risk and compliance functions.

Despite what now approaches a trillion dollars being put towards conduct troubles in the last decade, behavior-driven scandals among banks persist, leaving many to conclude that the industry itself is characterized by a "toxic culture." Chapter 1 therefore also explores the breakdown of trust between banks and their customers, and how misconduct within banks is now seen as posing a problem not with "a few bad apples" but, rather, with the "barrel" itself.

Chapter 2 provides an overview of the available diagnostic tools used to address questions of culture and conduct. In so doing, it primarily uses the indicators developed by the Financial Stability Board (FSB), the global organization created in 2009 by the G-20 heads of state to promote financial stability and to help reform international financial regulation.

The indicators discussed here will include the tone from the top, the "tone in the middle," effective communication, accountability and readiness to challenge, as well as compensation and incentive schemes.

- Many point to tone from the top as the most important shaper of organizational culture. While important, experience and behavioral science strongly suggests that the "tone in the middle" and the "echo from the bottom" are of primary concern.

- If it is to be meaningful, "accountability" must involve clear ownership of risk, practical and reliable escalation mechanisms, and consequences for policy violations.

- Consideration of "effective communication" encompasses the degree of openness to challenge and critical feedback that characterizes a firm's operational norms.

- Lastly, when considering the role of incentive schemes and compensation in shaping firm culture and employee conduct, it is critical to attend to *informal* incentives, since these are often the largest driver of behavior and, therefore, of perceived firm culture.

Chapter 3 presents a summary of the different regulators' approaches to supervising culture and conduct at banks. Some highlights:

- The UK has taken an assertive approach by establishing personal accountability under its "Senior Managers & Certification Regime." British regulators have asked the industry to map out clear responsibilities for covered individuals in order to enhance accountability. Culture oversight has been specifically named as a prescribed responsibility. And Mark Carney, at the Bank of England, recently suggested that firms that fail to demonstrate adequate oversight of culture and conduct risk may be subject to additional capital charges.

- In the US, regulators have emphasized the importance of culture and conduct risk during increased interactions with bank boards and senior leaders, both during formal supervisory actions and at industry workshops. The New York Fed has been particularly active in this area. The Office of the Comptroller of the Currency has focused on risk culture through its "heightened expectations" framework and has launched enhanced supervisory standards that seek to foster greater regulatory involvement and large-bank accountability. The SEC and FINRA have also prioritized firms' culture in their examinations.

- In the wake of persistent conduct challenges blamed on firm culture, a “consent order” between the Federal Reserve Board and Wells Fargo now prohibits that bank from growing its balance sheet until it can demonstrate improved means of mitigating culture and conduct related risks. While this gives the culture topic greater perceived teeth, it bears noting that the Trump Administration has appointed a new slate of regulators, including a new Chairman of the Federal Reserve Board, and it remains unclear whether, or how, they may continue to prioritize these issues. Meanwhile, NY Fed President Bill Dudley, who has persistently led calls for greater attention to culture, will retire in June 2018.

- In Europe, Dutch regulators have been especially innovative in their supervision of culture at banks through forward-looking and non-conventional approaches that emphasize behavioral science. The Dutch National Bank has studied the drivers of firm conduct up-close, attending board meetings to gauge interaction dynamics, and conducting interviews to understand the potential impact of “group-think” on decision making. Further, the Dutch regulators have adopted a Bankers’ Oath and established stricter bonus caps than seen elsewhere in Europe.

- Irish regulators, among others in Europe, are deeply influenced by the example of their Dutch peers. They have begun in-depth inspections on governance arrangements and have taken a cue from the Netherlands in examining culture through applied behavioral science. While there is some conduct supervision at the pan-European level (through the European Central Bank), there is not complete harmonization across all EU jurisdictions. However, the Single Supervisory Mechanism provides for the dissemination of cross-jurisdictional best practices, which is likely to lead towards greater consistency of conduct supervision.

- In Asia as well, regulators have made significant progress towards supervisory frameworks regarding culture and conduct. In Hong Kong, the Securities and Futures Commission has enacted its own “Managers in Charge” regime, requiring its licensed firms to set out individual responsibilities for those in core functions. And the Hong Kong Monetary Authority has actively engaged its regulated banks on culture reform initiatives and issued a “three pillars” framework for promoting sound bank culture.

- Singapore has also paid greater supervisory attention to conduct issues, with the Monetary Authority of Singapore intensifying efforts to promote a “positive culture” through greater focus on management quality, incentives, “tone at the top” and “echo from the bottom.”

- Australian regulators have pushed forward on culture reform through a series of supervisory actions. The Australian Prudential Regulatory Authority is in the process of establishing a “Banking Executive Accountability Regime,” slated to take effect in July 2018, and has stood up a team with expertise in the behavioral sciences to develop risk culture assessments. The Australian Securities and Investments Commission has intensified its own supervision of culture through the use of questionnaires listing specific “culture indicators.” And, in the wake of numerous conduct-related issues among its largest banks, in late 2017, the Australian Prime Minister established a Royal Commission to study misconduct in the financial services industry.

- The China Banking Regulatory Commission has been particularly vociferous of late regarding its intent to focus on the integrity of its financial sector and the governance of banks.

Our View:

This Compendium offers our attempt to trace the evolving landscape of culture reform efforts in the financial sector and to take the pulse of what is to come. We do not seek to offer judgments or to make normative claims outside these separate text-boxes.

The journey taken by the financial industry and its regulators towards improved ability to examine how firm culture produces employee behavior – and consequent outcomes for firms and their stakeholders – need not take a generation. In the course of compiling this review, we have seen many positive initiatives that are likely to produce lasting change.

While some of this is driven by regulatory impetus, still more is motivated by a desire among bank boards and leadership to manage culture and conduct risks in a manner that is more timely, effective, efficient – and less costly.

Moreover, cooperation and knowledge-sharing among regulators around the world has led to a greater consensus that an international and industry-wide culture and conduct risk management and supervision framework may be warranted.

If efforts to generate virtuous cycles of behavior within the financial sector are to succeed, they must begin with clear and consistent definitions of the terms of debate, and the development of sound metrics regarding "soft" notions such as culture and conduct risk.

Ideally, such metrics might permit for industry-wide benchmarking and for the greater ability of firms to demonstrate success to concerned stakeholders. A call for consistent metrics does not imply a call for prescribed firm cultures. But such metrics may well facilitate improved management of culture and conduct, reduced exposure to punitive fines, and more targeted, efficient, and reduced governance, risk and compliance costs.

If this is to be realized, it will necessitate greater collaboration between regulators and the industry. We hope that this Compendium will be supportive of such efforts.

CHAPTER ONE: Why Culture Matters

Discussion of firm culture is no longer limited to academic circles and gatherings of behavioral scientists. In the decade since the financial crisis, such conversations have entered the financial industry's mainstream dialogue, are debated in the corner offices of senior bankers, considered in bank boardrooms, and included in the supervisory assessments of regulators.

There is an increasingly shared recognition that firm culture effects employee conduct which, in turn, shapes stakeholder outcomes. With this, it is important to have some consensus around the defining aspects of culture and corresponding conduct risk.

What is culture?

The academic literature here is robust and copious. While there is no one accepted definition of culture adopted by the financial services industry, most descriptions tend to boil it down to the set of behavioral norms, often unspoken, that drive concrete actions, consciously or not.

In driving concrete actions among employees, culture consequently drives outcomes for firms, management, and stakeholders. Reflecting this, the Group of Thirty (G30), an international body of leading financiers and academics, defines culture as, "The mechanism that delivers the values and behaviors that shape conduct and contribute to creating trust in banks and a positive reputation for banks among key stakeholders, both internal and external."[1]

William Dudley, President of the Federal Reserve Bank of New York (NY Fed), describes culture as the "implicit norms that guide behavior in the absence of regulations or compliance rules – and sometimes despite those explicit restraints."[2]

William Dudley **REUTERS / Jonathan Ernst - stock.adobe.com**

Culture, Dudley explains, "reflects the prevailing attitudes and behaviors within a firm. It is how people react not only to black and white, but to all of the shades of grey. Like a gentle breeze, culture may be hard to see, but you can feel it. Culture relates to what 'should' I do, and not to what 'can' I do."[3]

Greg Medcraft, the then Chairman of Australia's Securities & Investments Commission (ASIC), echoed Dudley: "Culture is a set of shared values and assumptions within an organisation. It reflects the underlying 'mindset of an organisation', the 'unwritten rules' for how things really work... Culture matters to ASIC because poor culture can be a driver of poor conduct – and we regulate conduct."[4]

Last year, at a conference hosted by the Hong Kong Monetary Authority, Andrew Bailey, head of the UK's Financial Conduct Authority (FCA), emphasized the elusive quality of culture in a speech titled, "Culture in financial institutions: it's everywhere and nowhere."[5]

Clive Adamson, former director of supervision at the FCA, offers, "Culture is like DNA. It shapes judgment, ethics and behaviours displayed at those key moments, big or small, that matter to the performance and reputation of firms and the service that it provides to customers and clients."[6]

There is recognition that culture is difficult to measure. Thomas Curry, former head of the US Office of the Comptroller of the Currency (OCC) noted, "Culture is a bit more amorphous and more difficult to quantify than other standards, such as capital and liquidity. But it's just as important, and in some ways more important."[7]

Moreover, organizations are not monolithic; different organizational subcultures exist – among different teams, departments, geographies, business lines, etc. – and these must be examined to see whether they are consistent with desired firm culture. For instance, The Salz Review, an independent study of Barclay's business practices after the LIBOR rigging scandal, found that the various subcultures present at the bank had greater influence on the actions of its employees than did the group's overall culture.[8]

One critical distinction to note here involves "risk culture." In its Comptroller's Handbook, the OCC makes clear that such is best seen as a subset of corporate culture. "Risk culture is the shared values, attitudes, competencies, and behaviors throughout the bank that shape and influence governance practices and risk decisions. *As a subset of corporate culture*, risk culture pertains to the bank's risk approach and is critical to a sound risk governance framework."[9]

Andrew Bailey **REUTERS / HANNAH MCKAY - stock.adobe.com**

Sarah Dahlgren, former head of supervision at the New York Fed, observes that while corporate culture and risk culture are related, there is a clear difference. "I want to stress that 'culture' is very different from 'risk culture.' You can have a strong risk culture within your firm, but still have culture issues."[10] Dahlgren emphasizes that firms cannot be satisfied with a narrow, sterile or legalistic focus. Rather, boards and management must fully apprehend and address both the overall culture of the bank, as well as its many subcultural units.

Linking culture to conduct risk

Corporate culture, explains the Financial Stability Board (FSB), is an important determinant for the occurrence of misconduct. A 2017 Thomson Reuters survey finds that this sentiment is echoed by the industry, where almost half of surveyed firms, "consider culture and conduct risk to be intrinsically linked, with culture as a critical factor in managing conduct risk."[11]

As with the term "culture," there is no consensus definition of "conduct risk." The FSB notes that there is "neither a homogeneous definition nor a predetermined taxonomy."[12] In the Thomson Reuters survey, only 21% of firms were found to have a working definition of conduct risk.

And while some use the terms "conduct risk" and "misconduct risk" interchangeably, others see conduct risk as the broader term, encompassing both good and bad conduct. It can refer, for instance, to both the risk of failing to achieve desired behavior and failing to stem behaviors that are undesired or unlawful.

The FSB Working Group on Governance Frameworks, established in 2016, defines misconduct as, "Conduct that falls short of expected standards, including legal, professional and ethical standards."[13] The European Systemic Risk Board echoes that definition, focusing on the term "misconduct risk" and noting that it is linked to "willful or intentional disregard of laws, ethics or internal governance and controls."[14]

That said, a common set of elements does seem to feature in most definitions of conduct (or misconduct) risk, with a focus on how behavior on display within firms – both good and bad – may impact customers, counterparties and investors. The European Systemic Risk Board, for instance, argues: "Broadly put, conduct risk refers to risks attached to the way in which a firm and its staff conduct themselves, and to how customers and investors are treated."[15]

Largely missing from such definitions and discussions is a consensus view as to *how* culture and conduct relate. What are the mechanisms? There is an inconsistent and often circular dialogue in which some argue that culture is shaped by observed behaviors, while others argue that behaviors are shaped by perceived culture. The academic literature emphasizes that both views are correct, and that culture and conduct exist in a mutual feedback loop.

"Culture is contagious," argues NY Fed General Counsel Michael Held. "In my experience, junior bankers typically don't consult 'the law' for guidance on a day-to-day basis. They take their cues from their peers and immediate supervisors... More often than not, it's an organization's culture — the shared norms conveyed through conduct — that provides instruction."[16]

Much social science suggests that culture and behavior should indeed be seen as operating in a contagion-like manner, much like a virus. With this view, the task for supervisors and risk managers becomes one of determining where, and when, "inoculation efforts" may be most necessary.

This task is especially difficult, given that shared norms are often conveyed non-explicitly, thereby establishing the "unwritten rules" of an organization.

"When you violate one of our unwritten rules you'll know it by the unspoken censure."

As the NY Fed's Bill Dudley observes, "If we want to improve culture and conduct, we need to start by being realists about human behavior."[17]

A crisis of "ethic proportions" at banks – how did we get here?

In a 2009 report, bank supervisors pointed to widespread failures in corporate governance and inherent conflicts within firms' compensation structures as lead culprits of the financial crisis.[18] In its broader aftermath, however, others argued that a severe crisis of culture existed in the industry. John C. Bogle, founder of Vanguard Group, termed it a "crisis of ethic proportions."[19]

A perceived erosion in banks' ethical standards was held to have underpinned many systemic factors that led to the crisis, such as easy "sub-prime" credit, high leverage ratios, weakened capital levels, inadequate risk management, and a pervasive "I'll be gone, you'll be gone" mindset among many bankers and traders brazenly unconcerned for personal accountability.

Reacting to continuing scandals since the crisis, the FCA's Andrew Bailey observed, "There has not been a case of a major prudential or conduct failing in a firm which did not have among its root causes a failure of culture as manifested in governance, remuneration, risk management or tone at the top."[20]

And as Bill Dudley just remarked, "regulation and supervision are necessary but not sufficient—they must be supplemented by bank cultures that encourage ethical behavior, the early identification of problems, and a willingness to address those problems proactively."[21]

Such views were little heard before the crisis. Errant behaviors among bankers and traders did not register as systemic concerns, and prudential regulation was not focused on such matters. "Culture" and "conduct risk" were not terms featured within the pre-crisis lexicon.

In the wake of the crisis, many bank leaders cited outside pressures to justify their actions. Chuck Prince, then-CEO of Citigroup, symbolized this approach when he proclaimed, at the height of the subprime crisis, "As long as the music is playing, you've got to get up and dance... We're still dancing."[22] Few were eager to shoulder blame when the music stopped. Instead, most pointed to a "perfect storm" of unforeseeable conditions that led to the near-collapse of the financial system. During a visit to the London School of Economics to discuss the origins of the financial crisis, even Queen Elizabeth II reportedly demanded of the experts, "Why did nobody notice it?"[23]

Gradually, the public narrative around troubles in the financial sector moved on from the complaint that the banks were "too big to fail," to the complaint heard more regularly today: that they're simply "too big to manage."

Progress report since the global financial crisis

Lending credence to this view, in the years since the crisis, the industry has been plagued by a series of high-profile conduct scandals, despite dramatically increased budgets for governance, risk and compliance personnel and vastly expanded surveillance and monitoring systems.

The uncovering of the LIBOR-rigging scandal in 2012 shook regulators and policymakers, and reinforced the perception that banks had not learned the lessons of the financial crisis. Then, on the heels of

Mark Carney **REUTERS / POOL - stock.adobe.com**

LIBOR, came the foreign exchange rigging scandal. That bank leadership had failed to halt such market manipulation, even following the penalties meted out in the wake of the LIBOR scandal, enflamed regulators further. "The LIBOR and FX events made clear that serious ethical and behavioral problems had persisted in the industry," said Dudley at the NY Fed. "I was particularly struck by how the manipulation of foreign exchange rates occurred even after the LIBOR fixing was widely known."[24]

No region has been spared such scandals: the opening of false customer accounts in the US, persistent money laundering and tax evasion alleged among German banks, price-fixing in South Africa's forex market, and corrupt money movements sweeping from Malaysia to Zurich.

Fallout has been dramatic: punitive fines of over $320 billion (and climbing); costly legislative and regulatory investigations, class-action lawsuits; reputational and brand damage; increased regulatory burden; and swollen governance, risk and compliance costs that now account for an estimated 15-20% of the fixed cost-base at most firms, savaging ROE for many.

The ECB has estimated that between 2008 and 2016, provisions for legal costs by banks were equal to almost half of their entire net income over the same period.[25] And the Bank of England's Mark Carney has estimated that these additional costs, if retained as bank capital, would have supported about $5 trillion of lending to households and businesses.[26]

Restoring trust and renewing banks' "social license"

In 2009, Stephen Green, then-Chairman of HSBC, penned his early reflections on the unfolding cataclysm that only later came to be called the global financial crisis. "There has been a massive breakdown of trust: trust in the financial system, trust in bankers, trust in business, trust in business leaders, trust in politicians, trust in the media, trust in the whole process of globalization – all have been severely damaged, in rich countries and in poor countries alike."[27]

The financial crisis intensified an already steep decline of public trust in the financial industry. Among the general public, there was a clear sense that bank profit-taking had come at the expense of shareholders and society. This sentiment was reinforced by the fact that, while the destructive force of the financial crisis had rippled through the real economy, there were virtually no financial or public leaders jailed or held personally accountable for the crisis while taxpayers footed the bill for bankers' perceived transgressions. A decade on from the events, there remains a widespread belief that bankers played – and continue to play – a game of "heads I win, tails everyone else loses."

Andrew Bailey of the UK's FCA has observed, "Today, the public perception of banking, and some other areas of finance, remains too much towards the exploitative 'greed is good' end of the spectrum. Major changes have occurred since the crisis which have improved behaviour in firms, but public opinion broadly does not recognise these developments and tends to think that nothing has changed. Culture is an important part of demonstrating that change."[28]

Mark Carney recognized the trend of declining trust in the industry, warning, "In a system where trust is fundamental it ought to be of grave concern that only 20% of UK citizens now think that banks are well-run, down from 90% in the late 1980s."[29]

While a slight recovery in confidence has emerged in most recent years, the financial sector still counts among the least trusted industries. According to the 2017 Edelman Trust Barometer, this low level of trust in the industry is seen at a time when there has been an "implosion of trust" in almost all mainstream institutions.[30] With this trust crisis has come debate regarding banks' overall purpose in society.

As Baroness Onora O'Neill of the UK Banking Standards Board observes, "you need only look to the volume of banking regulation compared to the regulation of other industries... Banking is regulated on a par with the food we eat, the air we breathe, and taxes. There is no doubt of the public importance of banking and of the existence of its public purposes."[31]

Christine Lagarde, Managing Director of the International Monetary Fund, points out the financial industry has responsibilities residing outside its own interests. "After all," she argues, "the goal of the financial sector must be not only to maximize the wealth of its shareholders, but to enrich society by supporting economic activity and creating value and jobs – to ultimately improve the well-being of

Christine Lagarde ***REUTERS / JORGE ADORNO - stock.adobe.com*** people."[32] Only by aligning what Lagarde refers to as the "telos" of the financial sector – its purpose – with a "new ethos," or "culture," will the industry regain its social license to operate. And this social license should be seen as going well beyond factors that feed into a bank's regulatory license or compliance duties.

Mark Carney of the Bank of England concludes, "markets need to retain the consent of society – a social license – to be allowed to operate, innovate and grow. Repeated episodes of misconduct have called that social license into question."[33]

Blackrock CEO Larry Fink recently echoed this view. "To prosper over time, every company must not only deliver financial performance, but also show how it makes a positive contribution to society… Without a sense of purpose, no company, either public or private, can achieve its full potential. It will ultimately lose the license to operate from key stakeholders."[34]

Industry-wide culture problems requiring long-term solutions

Continued scandals at banks have led many to conclude that conduct and culture problems are not an issue of just errant individuals – "rogue employees" – nor are they idiosyncratic to any single bank. Rather, there is a growing consensus that the industry is beset by a systemic problem: this concern is not "a few bad apples" but a problem with the "barrels" themselves.[35]

Mark Carney is one of many regulators who have picked up on that metaphor: "the succession of scandals means it is simply untenable now to argue that the problem is one of a few bad apples. The issue is with the barrels in which they are stored."[36]

A study conducted by researchers at the University of Zurich supports the notion that we are confronted by a barrel-level challenge. As part of a coin-tossing

Ravi Menon **REUTERS / Edgar Su - stock.adobe.com**

experiment, participants were asked to pick heads or tails and then, after flipping the coin, to self-report whether they had guessed the outcome of the coin-toss correctly. Researchers were able to confirm the honesty of such self-reports.

Just prior to playing the coin-toss game again, participants were tasked with a quick reading exercise that served to call to mind their professional identities. Researchers found bankers participating in the study to be influenced by such "identity priming" to engage in dramatically increased levels of cheating. Notably, no other industry profession saw similar such influence, suggesting that identification as a banker alone was sufficient to induce greater misbehavior. The authors concluded, *"the prevailing business culture in the banking industry weakens and undermines the honesty norm."*[37]

There are no quick solutions. A sobering report by the *Economist* observed that changing culture is a slow process, possibly taking decades.[38] Bill Dudley offers a similar prognosis: "…unethical and illegal behavior may take a much longer period of time – measured in many years – to surface and to be fully resolved."[39] Banks and regulators seem to have recognized the long-term nature of the challenge, as noted by a NY Fed conference summary that culture change is more of "a lifestyle choice than a New Year's resolution."[40]

"As a working definition, an unhealthy culture is one with heightened risk of employee misconduct," explain NY Fed officials in a 2017 whitepaper.[41] Coauthor and head of banking supervision Kevin Stiroh explained in a speech accompanying the release of the paper that supervisors can help mitigate misconduct risk and make the financial industry stronger by "draw[ing] from the growing literature about the root causes of misconduct and the underlying factors that drive unhealthy cultures."[42]

This long-term and barrel-level challenge has resulted in increased regulatory collaboration across jurisdictions and the sharing of learnings around root-causes. "No amount of regulatory reforms or supervision can assure a stable financial system if the culture and conduct of firms and individuals are flawed," Deputy Managing Director Ong Chong Tee of the Monetary Authority of Singapore recently observed. "MAS will be stepping up our supervisory reviews on various aspects of risk governance and culture in financial institutions... We are sharing our supervisory experiences with other regulators to learn from one another."[43]

CHAPTER TWO:
Diagnosing Culture Challenges in Banks

"A good culture aims for what is right, not what is merely legal."

BARONESS ONORA O'NEILL

Chair of the UK Banking Standard Board,

Speech at the NY Federal Reserve, November 9, 2016.

As Onora O'Neill has noted, effective culture change among banks – and particularly among those firms that have suffered from highly-visible misconduct challenges – is the first step towards rebuilding the financial industry's reputation and to revitalizing a socially responsible and trustworthy profession.[44]

In the effort to identify the root causes of misconduct issues, the FSB has developed a number of indicators that reflect the gaps between the bank's current culture and its desired culture: (1) tone at the top; (2) accountability; (3) effective communication and challenge; and (4) incentives.[45] Regulators in the UK and the US have readily adopted the FSB's risk culture framework. For example, when he held the senior supervisory position at the Bank of England, Andrew Bailey (now at the FCA) outlined the culture indicators assessed by the UK regulator:

> *"We seek to ensure that firms have robust governance, which includes appropriate challenge from all levels of the organisation; and promote the acceptance that not all news can be good and the willingness to act on and respond promptly to bad news. We insist that remuneration is structured to ensure that individuals have skin in the game, namely that a meaningful amount of past remuneration is retained or deferred and for senior people is at risk should problems then emerge. We require that risk management and internal audit in firms are effective and act to root out poor incentives and weak controls."*[46]

The broadness of such indicators reflects a desire among many regulators to steer clear of a "one-size-fits-all" prescriptive approach to bank culture. They recognize that different firms may have legitimate interest in inculcating different cultures. And they note, further, that firms will have multiple sub-cultures, existing within different business lines, departments, and teams.

The Salz Review, for instance, observed that rapid growth at Barclays resulted in a firm that "became complex to manage, tending to develop silos with different values and cultures."[47] David Walker, ex-chairman of Barclays, remarked, "the whole group did not function as a whole group; it was a set of these separate business silos."[48]

Such "loose federations of money making franchises," as the Parliamentary Commission on Banking Standards styled it, cause additional management and supervisory complexity and challenges.[49] It is essential, therefore, that any use of diagnostic tools aims at identifying and observing siloed subcultures within the organization, *in vivo*, and then applying those same tools in a manner that presents an aggregated view of how these subcultures roll-up to form an overall firm culture.

"Tone at the top"

> *"The tone has to come from the CEO – he is responsible for the delivery globally of a culture that values high standards of conduct. It's about personal leadership and being very visible."*

STUART GULLIVER

former Chief Executive, HSBC, "Corporate Culture and the Role of Boards," Financial Reporting Council, July 2016

The Basel Committee on Banking Supervision: Guidelines on "Tone at the Top"

BIS

A fundamental component of good governance is a corporate culture of reinforcing appropriate norms for responsible and ethical behavior. These norms are especially critical in terms of a bank's risk awareness, risk-taking behavior and risk management (i.e., the bank's "risk culture").

In order to promote a sound corporate culture, the board should reinforce the "tone at the top" by:

- Setting and adhering to corporate values that create expectations that all business should be conducted in a legal and ethical manner, and overseeing the adherence to such values by senior management and other employees;
- Promoting risk awareness within a strong risk culture, conveying the board's expectation that it does not support excessive risk-taking and that all employees are responsible for helping the bank operate within the established risk appetite and risk limits;
- Confirming that appropriate steps have been or are being taken to communicate throughout the bank the corporate values, professional standards or codes of conduct it sets, together with supporting policies; and
- Confirming that employees, including senior management, are aware that appropriate disciplinary or other actions will follow unacceptable behaviours and transgressions.

Regulators and bankers agree that establishing a good firm culture starts with the values and attitudes displayed by those in leadership. In a 2017 analysis, the FSB found that around half of banks surveyed reported that the "tone at the top" was viewed as one of three principal means of preventing misconduct.[50] Similarly, E&Y and the Institute of International Finance found that 90 percent of risk executives at global banks believed enhancing message and tone from the top was essential for strengthening culture and behavior.[51]

In 2014, at a NY Fed conference on culture and conduct, Bill Dudley argued that the tone at the top influences more than individual behavior of employees: it shapes the conduct of the institution overall. "The tone at the top and the example that senior leaders set is critical to an institution's culture – it largely determines the quality of the barrel."[52]

The UK has also emphasized that the board and senior management are responsible for setting an exemplary tone at the top. After leading a 2009 UK government inquiry into the financial services sector, David Walker noted that a board-level "attention deficit" to both financial and conduct risk was "probably the most significant explanatory variable" for the financial crisis.[53] He added that board members who permit an "atmosphere of tolerance," for even minor conduct offences, set the wrong tone – one that "could be taken to imply tolerance for and thus accommodate more serious failures."

At the international level, bank standard-setting bodies have committed to strengthening the "global language of corporate governance." In 2015, the G20 and the OECD revised their joint corporate governance principles, specifically asserting the importance of an "ethical tone." They noted that "the board has a key role in setting the ethical tone of a company, not only by its own actions, but also in appointing and overseeing key executives and consequently the management in general."[54]

Since then, these high-level principles have been adopted and expanded upon by the World Bank, the Financial Stability Board and the Basel Committee on Banking Supervision.

The FSB has also conducted peer reviews into how different jurisdictions have implemented these principles. The latest results, published in 2017, summarized that while "tone at the top" has found resonance with banks' boards, and though most jurisdictions have now assigned specific responsibility for setting the tone of the firm to the board, there was still a lack of conclusive information on actual implementation and its practical implications.

There have been concrete implications of this focus on tone at the top. Regulators increasingly consider senior leadership's attitudes and example in their enforcement actions. For instance, in February 2017, the Fraud Section of the US Department of Justice's

Conduct at the Top

US Department of Justice

- How have senior leaders, through their words and actions, encouraged or discouraged the type of misconduct in question?
- What concrete actions have they taken to demonstrate leadership in the company's compliance and remediation efforts?
- How does the company monitor its senior leadership's behavior?
- How has senior leadership modelled proper behavior to subordinates?

Criminal Division issued guidance for a "culture of compliance." Their indicators include evaluation of "conduct at the top," underscoring the importance of setting the right tone and modelling proper behavior for rank and file employees.[55] Some firms have since begun to tie tone at the top to compensation, using it as a qualitative point considered by the board when setting CEO pay.[56]

"Echo from the Bottom" and Barrier in the Middle

Most regulators recognize that "tone from the top" is essential but insufficient. The MAS recently emphasized that, while it is concerned with tone from the top, it is the "echo from the bottom" that is often the more important consideration. And while not included among its four core indicators, the FSB also asserts that lasting change will not take place without the right tone and behavior "in the middle" of the organization.[57]

As Bill Dudley has noted, "the middle layer of an organization is critical to the reform of culture." He goes on to explain, "Middle managers are immediate role models for the majority of a firm's employees and provide a gloss on any message from senior management about the firm's values. Any program seeking sustainable cultural change should involve all of a firm's managers."[58]

Former FCA Chief Executive Martin Wheatley has called middle management a regulatory "blind spot" that should be elevated in importance. He commented, "So, while we've quite rightly and properly seen significant attention focused on the most senior leaders, there's been far too little debate around the many thousands of decision makers beneath them."[59]

"Tuning into" tone in the middle of an organization is much more difficult than at the top. Some have described middle levels of management as the "permafrost layer" – a frozen sub-layer unresponsive to change initiatives. As a consequence, there is often a disconnect between the message that leadership believes itself to have articulated successfully and the message that middle managers are in fact receiving.[60]

In the E&Y/IIF risk survey mentioned above, over half of surveyed respondents believed that the understanding of desired behavior varies widely across their companies. And, in a different survey from PwC, only 16 percent of bankers indicated that their CEO is the ethics champion of their organization.[61] Such surveys point to the need to focus on the middle, and to find a way to gauge whether desired cultural messages are actually permeating the entire organization and are heard as a steady "echo from the bottom."

Accountability

> *"I blame the management teams and ... no one else."*

JAMIE DIMON

CEO of JP Morgan,

Testimony to the Financial Crisis Inquiry Commission, January 13, 2010

There is broad agreement that accountability starts with a well-defined identification and clear ownership of roles and responsibilities within corporate functions and business units. The FSB describes its approach to accountability as follows:

> *"Relevant employees at all levels understand the core values of the institution and its approach to risk, are capable of performing their prescribed roles, and are aware that they are held accountable for their actions in relation to the institution's risk-taking behaviour. Staff acceptance of risk-related goals and related values is essential."*[62]

Martin Wheatley ***REUTERS / Andrew Winning - stock.adobe.com***

In its report, the UK Parliamentary Commission on Banking Standards concluded that a lack of specificity and clarity regarding risk roles and ownership contributed directly to the financial crisis. "Those who should have been exercising supervisory or leadership roles benefited from an accountability firewall between themselves and individual misconduct, and demonstrated poor, perhaps deliberately poor, understanding of the front line."[63]

However, it appears genuinely difficult to implement desired accountability in practice, as is seen in the struggle, prominent at most firms, in establishing a fully functioning "three lines of defense," (3LoD) – the risk management model used across the industry globally.

Described in a London School of Economics and Political Science report: the first line of defense is the "business unit [itself] with its own supervisory capacity to manage risks. The second line is broadly the central risk management function in a policy setting and advisory role, and the third line is the internal audit."[64] The report notes that tensions often arise when there is an overlap or gap in matrix accountability structures.

Under the 3LoD model, the risk management function is forced to strive for a delicate balance as it alternates between its competing roles of advocate, critic and policeman. At most firms, imbalances here result in mismatched expectations among risk owners and other employees.

The heart of the issue, the LSE report concludes, "is the authority of risk personnel, and the degree of friction and/or respect between front-office and risk management teams… Role tensions and ambiguities at the interface between the first and second line seem to be inherent in all the risk culture change programmes we encountered."[65]

Communication and Readiness to Challenge

> *"What we need is a culture of values, not just compliance."*
>
> **CHRISTINE LAGARDE**
>
> *IMF Managing Director, Speech at the International Bar Association conference, September 18, 2016.*

In retrospect, a key takeaway from the financial crisis is that those who escalated issues and took on whistleblower roles were most often ignored, seldom rewarded, and were frequently ostracized by peers and even faced promotional and financial repercussions for their actions. Critical opportunities to identify and stem systemic risks were thus missed.

Given this experience, regulators now look for clear and open channels of communication and a ready ability to escalate concerns as another key indicator of a healthy firm culture. In its 2015 culture conference, the NY Fed underscored the need to support employees who highlight problems. "The flipside of accountability is recognition. Firms should identify good conduct and support employees who put the long-term interests of the firm ahead of short-term financial gain."[66]

In a 2017 speech, NY Fed General Counsel Michael Held emphasized that the ways in which a firm treats employees who escalate issues of concern is a primary focus for the regulator. In his words, it is "mission-critical that employees feel comfortable escalating potential problems and challenging accepted points of view."[67]

The FSB has made clear that "transparency and open dialogue across and between the board and senior management and senior management and staff" is a precondition of a strong risk culture.[68] The OCC's Heightened Standards Guidelines echoes the FSB, stating that "Evidence of a sound risk culture includes, but is not limited to ... open dialogue and transparent sharing of information between front line units, independent risk management, and internal audit."[69]

Perceiving not all firms to be successful in creating cultures that promote internal challenge and open communication, and with interest in encouraging employees to speak up regarding perceived improprieties, regulators have strengthened whistleblower protections at banks.

In the UK, regulators now require that banks appoint a senior manager to take on the role of "whistleblowers' champion." Whistleblowing processes and protections are to be specified, and legal language is required that gives employees the unambiguous right to disclose wrongdoing.

In the US, the SEC has established a whistleblower program that rewards those who bring actionable information and meaningful cooperation to the Commission. The Dutch Central Bank established whistleblowing regulations and has also recently created a Whistleblowing Desk for bank employees to report information directly to the regulator instead of their firm.[70]

There is, however, a clear tension between regulatory energies aimed at prompting employees to challenge misdeeds *internally* and to report such *externally*.

Firms will clearly want to learn first when employees perceive something problematic and are sufficiently uncomfortable with this that they feel the need to speak up. Regulators will want to act so that such employees may come to them when firm culture inadequately supports raising an internal challenge.

This tension highlights the importance of firm culture dynamics and puts the onus on bank leaders to establish effective internal communication and challenge norms. In fact, the Banking Standard Board's most recent annual review, released in March 2018, highlights this issue. One key finding was that "a culture of fear and blame" leaves many employees unwilling to speak up when they witness illegal or unethical behavior. Equally important, though, was a perception that nothing would be done to address their concerns.[71]

Compensation and Incentives

> *"We are focused on 'three lines of defense,' talent management, performance management, and compensation"*
>
> **MOLLY SCHERF**
>
> *Deputy Comptroller at the OCC,*
> *Remarks at The Clearing House conference, November 2015.*

There is widespread agreement that compensation and incentives are significant drivers of behavior. Looking back at the financial crisis, 98 percent of industry respondents to an IIF survey agreed that "compensation structures were a factor underlying the crisis."[72]

Sheila Blair, FDIC chairwoman at the time, explained, "The crisis has shown that most financial institution compensation systems were not properly linked to risk management. Formula-driven compensation allows high short-term profits to be translated into generous bonus payments, without regard to any longer-term risks."[73]

Even at the time, many bankers recognized the problem, but went along anyway. As former Citigroup CEO Sandy Weill explained to the US Financial Crisis Inquiry Commission (FCIC), "I think if you look at the results of what happened on Wall Street, it became, 'Well, this one's doing it, so how can I not do it, if I don't do it, then the people are going to leave my place and go someplace else.'"[74]

One area of focus has been the aggregate compensation. According to the FCIC, investment banks were paying about half of their revenues in compensation before the financial crisis. As seen in the accompanying chart, overall compensation levels in the banking industry had also soared well beyond other industries, a reality that certainly impacted behavior of employees and management.

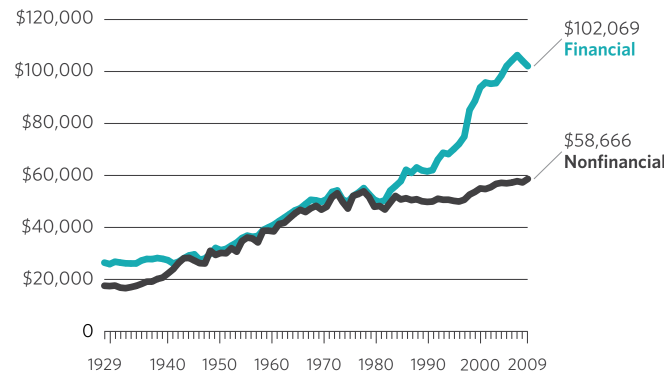
Besides the amount of compensation, there is increasing attention on the structure of the package. As the IMF has noted, "how you pay matters more than how much you pay."[75]

The Squam Lake Report, written by influential economists and policymakers, recommends that regulatory policies seek to address the structure of compensation rather than attempt to limit levels thereof.[76] By understanding and, if necessary, altering such structures – e.g., what is paid out and what can be clawed back, when and how is compensation paid, etc. – firms can influence employee behaviors and modify their culture. Major jurisdictions have proposed or implemented a number of compensation-related rules in this direction.[77]

Compensation in Financial and Nonfinancial Sectors

Compensation in the financial sector outstripped pay elsewhere, a pattern not seen since the years before the Great Depression.

ANNUAL AVERAGE, IN 2009 DOLLARS



NOTE: Average compensation includes wages, salaries, commissions, tips, bonuses, and payments for government insurance and pension programs. Ninfinancial sector is all domestic employeees except those in finance and insurance.
SOURCES: Bureau of Economic Analysis, Bureau of Labor Statistics, CPI-Urban, FCIC calculations

Others acknowledge the importance of compensation but emphasize that other factors are also in play. Molly Scherf, deputy comptroller for large banks at the OCC, has argued that too much attention is paid to compensation and not enough to performance management. She observes that, "who gets promoted up in an organization…says a lot about that institution."[78]

One way in which banks and regulators are addressing this issue is to include non-financial metrics in performance assessments. The Group of Thirty, for example, recommends a 50/50 treatment of financial performance and behavior in banks' performance reviews. Promotion patterns that lead employees to conclude that getting ahead means bending the rules will surely incentivize misconduct.

It is therefore concerning that the 2016-17 Annual Review conducted by the UK Banking Standards Board (BSB) found that one in eight bankers still believes that it is difficult to progress in their careers without "flexing ethical standards."[79]

The NY Fed's Bill Dudley, makes a concise point in this connection. "To put it very simply, incentives drive behavior, and behavior establishes the social norms that drive culture. If the incentives are wrong and accountability is weak, we will get bad behavior and cultures."[80]

It is clear that bad apples and bad barrels tend to reinforce one another. For instance, a 2017 study examining misconduct among US financial advisors found that firms that hire advisers with previous misconduct records are more likely themselves to have engaged in misconduct.[81]

In effect, there is an association – or a "matching on misconduct" – between firms and employees with past conduct issues. The paper estimates that over a third of advisers with misconduct charges on their record are repeat offenders, and yet 44 percent of advisers who lost their job after misconduct find employment in the industry within a year. This issue of "rolling bad apples" is receiving increased regulatory attention and regulators are working to achieve cross-jurisdiction information sharing schemes to better confront this challenge.

At the NY Fed, General Counsel Michael Held has noted that former employers often do not share information about misconduct with their prospective employers and Bill Dudley has suggested the need for a centralized database that banks could use to investigate misconduct. We expect to hear greater calls for such centralized and shared "data lakes" among regulators.

Our View:

As various remarks from prominent regulators make clear, there is some consensus that witnessed behaviors shape employee perception of company behavioral norms or culture, yet other remarks seem to argue the other way around – that established cultural norms shape witnessed behaviors. It is less frequently recognized that *both* formulations are correct, and interact in a feed-back loop mechanism, or “fly-wheel.”

At this nexus between culture and conduct, one must consider the role of incentives, as is noted in this chapter. We would add that consideration should also go to *disincentives*, such as punitive mechanisms. And we’d argue further that the actual *workings* of both incentives and disincentives needs to be reconsidered.

Despite the rapid advance of behavioral economics, management theory remains largely in thrall to the “rational actor” model. Bank leaders and regulators alike thus argue that, with the right *formal* incentives in place, and with complementary *formal* sanctions to suppress misconduct, rational employees will elect to behave in a manner that achieves reward and avoids punishment. Behaviors aimed at such “utility maximization” (as the traditional economist would term it) are then witnessed, helping to fix perception of company values and norms, which in turn shapes the behavior of others. Job done.

But countless studies from behavioral economics suggest that we are *not* rational actors – or at least not purely so. Rather, as some style it, we are in fact “predictably irrational.”

In addition to individual, psychological idiosyncrasies that fly in the face of the rationality bias, behavioral science has shown repeatedly that behavior is as much a *social* construct as it is a psychological one, if not more so. As such, to understand the behavior of the individual, one must study the behavioral tendencies promoted by the *group* in which individuals are embedded.

When the FCA’s Andrew Bailey argues that culture is “everywhere and nowhere,” it is this sociological complexity that comes to the fore. Group dynamics work to establish a set of *informal* incentives and disincentives that operate to shape individual and group behavior observably. Such *informal* pressures may support, or conflict with, formal schemes.

When formal and informal organizational norms are in conflict, we witness a disconnect between the “tone from the top” and the “echo from the bottom.” Achieving alignment here will require regulators and bank leaders alike to reconsider fundamental beliefs regarding how behaviors are formed, take root, and perpetuate across an organization.

Informal behavioral norms and incentives can – and demonstrably do – often override personal moral codes and rational inclination towards ethical conduct. In a world where individuals are joined in fluid social networks, Fredrick Winslow Taylor’s mechanistic view of the firm is largely outmoded, and management science is in need of a reboot. Perhaps nowhere is this more critical – and difficult – than in the field of risk management.

CHAPTER THREE:
A Compendium of Regulatory Priorities Aimed at Culture and Conduct Challenges

> *"The incidence of financial sector misconduct has risen to a level that has the potential to create systemic risks by undermining trust in both financial institutions and markets."*
>
> **MARK CARNEY**
>
> *Open letter to the G20, August 30, 2016*

The financial crisis caused regulators to re-think their approach to culture and conduct risk. This is no longer a "backseat issue" but, rather, an increasingly prominent priority, and we expect 2018 to mark a significant increase in attention to and action concerning this agenda.

The volume of speeches by regulators cited herein attests to the growing awareness of the pressing need to "fix" culture at banks, particularly given the systemic risk it is seen to pose to financial stability. There also seems to be a view among regulators that if they fail to review firm culture in a structured and rigorous manner, banks will have less incentive to focus their own attention to such matters.[82]

Regulators in different jurisdictions are taking different approaches to prompting corrective steps among the banks they oversee. While distinct, these approaches are substantially similar and reflect an emerging consensus view as to how culture and conduct concerns are to be considered. Directly conflicting regulatory emphases are very infrequently encountered.

While most regulators agree that more needs to be done to address cultural deficiencies at banks, and the conduct risks that ensue, they have taken distinct paths towards enhanced supervision, black-letter regulation, and broader policy prescription. Bank leadership is thus left to address different culture and conduct regimes from jurisdiction to jurisdiction, and a cross-jurisdictional guide has not been available to help shape a consistent response.

To this end, this section of our report seeks to illuminate the major regulatory approaches, policy priorities, and supervisory tools that have been employed to monitor and measure banks' progress in addressing their culture issues in all the major financial centers globally.

It should be noted at the outset, however, that regulators are working to stich their disparate efforts together into something of a common quilt-work.

In February 2015, Financial Stability Board Chairman, Mark Carney, informed G20 Finance Ministers and Central Bank Governors that the FSB would coordinate their various efforts to address the vulnerabilities caused by misconduct risks. In May 2017, the FSB released a summary report on the use of governance frameworks to mitigate such risks.[83]

The summary, which relied primarily on survey results, identified three focus areas for future work, with an eye towards a culture and conduct risk "toolkit" for firms and supervisors. The three focus areas, discussed later in this chapter, are: (1) dealing with employees with a history of misconduct; (2) mapping out specific responsibility and accountability for misconduct within the organization; and (3) understanding how cultural norms might undermine governance and encourage misconduct.[84] The various regimes outlined below will be seen to reflect these aims.

United Kingdom

The UK has been at the forefront of regulatory efforts to address culture at banks. Both the Bank of England (BOE) and the Financial Conduct Authority (FCA) have emphasized culture and conduct issues as a top priority in their supervisory oversight.

In 2013, the UK split its previous financial services regulator, the Financial Services Authority, into two separate entities. The Prudential Regulation Authority (PRA), which is part of the Bank of England, is responsible for the prudential regulation of about 1,700 banks, credit unions, insurers, and major investment firms. Its chief executive is the Deputy Governor of the Bank of England, currently Jon Cunliffe.

The second entity, the Financial Conduct Authority (FCA), acts as the conduct regulator for 56,000 financial services firms. In its mission statement, the FCA notes that its goal is "to serve the public interest by improving the way financial markets work and how firms conduct their business." Its inaugural chief executive was Martin Wheatley, and the position is now held by Andrew Bailey.

In November 2017, Bank of England Governor Mark Carney publicly linked bank culture to other prudential requirements. He warned banks that repeated cultural failings could cause supervisors to raise a bank's capital reserve requirements. Carney also noted that the Senior Manager's and Certification Regime has provided regulators with greater ability to measure culture at banks.[85]

SENIOR MANAGERS & CERTIFICATION REGIME

Underpinning the UK regulators' approach to supervising culture at banks is the Senior Managers and Certification Regime (SMR). Pursuant to legislation passed by Parliament in 2013, the PRA and FCA began applying the SMR to the banking sector in 2016. Since then, Parliament has extended its scope and, beginning in 2018, the SMR will apply to tens of thousands of asset managers, hedge funds, investment firms, and insurance companies.

The SMR framework was largely based on the recommendations put forth by the 2013 Parliamentary Commission on Banking Standards' report titled, "Changing Banking for Good." The report charged regulators with ensuring that important responsibilities be assigned to specific senior individuals "so they can be held fully accountable for their decisions."[86]

The UK's Treasury Committee explained the impetus to legislative action: "We were discovering that the people at the top of our banks did not know where the risks really lay and how responsibility for them was distributed among their own most senior management. They thought they did, but once detailed questions started to be asked, they discovered that they did not. It is rather like a firm trying to manufacture something that did not really know who was really responsible for putting in which widget, as for cars being made on a production line. That was quite an extraordinary discovery that we made. It is with that in mind that we are trying to put this right."[87]

The SMR significantly overhauled predecessor legislation, the UK Approved Persons regime, in assigning responsibility for a firm's culture to specific senior-level individuals and requiring that certain pre-defined responsibilities be identified and mapped.[88]

In general, the SMR requires that:

> *Each Senior Manager produce a "Statement of Responsibilities" setting out the areas for which they are personally accountable and the prescribed responsibilities that are allocated to the senior manager ("senior management functions"). Senior Managers must be pre-approved by the regulators before carrying out these roles.*
>
> *A "Firm Responsibilities Map" must knit together the Statement of Responsibilities with detail regarding the firm's organizational structure, reporting lines, and descriptions of its management/governance arrangements.*[89]

Demonstrating the importance of culture, the SMR for the first time prescribed responsibilities for developing and embedding a firm's culture. This is typically assigned to the Chairman and CEO. Two prescribed responsibilities relating to culture include: (a) overseeing the adoption of the firm's culture in the day-to-day management of the firm and; (b) leading the development of the firm's culture by the governing body as a whole.

The SMR's approach of placing responsibility on certain individuals is a significant departure from the old regulatory framework of generically prescribing conduct rules to a more general group of individuals. Mark Steward, head of enforcement at the FCA, marks this distinction: "While the FCA's Handbook included conduct rules for individuals in authorised firms, *the key difference* under the Senior Manager's Regime is that specific senior management responsibilities have now been mapped to identify individuals within firms, with statements of responsibility which make it clear what each senior manager, in fact, has responsibility for."[90]

Additionally, UK regulators have implemented a certification regime that applies more broadly to staff in roles that have the potential to cause "significant harm," including material risk-takers.

These individuals must be identified and assessed as "fit and proper."[91] Firms must undergo fitness and properness certification of this wider range of staff on an annual basis.

By shifting responsibility from the institution to the individual, the SMR creates the predicate for enforcement cases to be brought against individuals. This aims to remedy what regulators view as a lack of individual accountability in the aftermath of the global financial crisis. As Andrew Bailey candidly commented in the PRA's 2015 annual report, "One of the most depressing aspects of the experience of the financial crisis was the lack of a clear sense of who was responsible."[92]

Indeed, while large fines were levied on firms, regulators were keenly aware that "individuals have got away relatively scot-free."[93] With the SMR in place, Carney has declared, "It's vital that we – public authorities and private market participants – work together to reverse the tide of ethical drift... The Age of Irresponsibility is over."[94]

The SMR further makes clear that covered individuals cannot avoid liability by not taking any action. Through the "duty of responsibility" requirement, regulators can take enforcement action against covered individuals by showing that they "did not take such steps as a person in their position could reasonably be expected to take to avoid the contravention occurring or continuing."[95]

It is worth noting that, even with the SMR, regulators have emphasized that firms as a whole will still be held accountable. As Mark Steward of the FCA vigorously stated, "There is no free pass for firms and so the Senior Managers Regime does not mean there will be an end to action against firms, including heavy financial penalties."[96]

Regulators are heartened by what they have seen since the SMR came into force. Speaking in late 2017, Mark Carney commented, "We are already seeing encouraging signs that it is making a difference. For firms, it's clarified [the need for] improving governance, accountability and decision-making processes. Senior managers are increasingly focused on building cultures of risk awareness, openness and ethical behaviour. In the words of one chair, 'Responsibility for culture has now moved to the top of my agenda.' I'm not sure where it was before that."[97]

GOVERNANCE, REMUNERATION AND INCENTIVES

Another area in which UK regulators have focused considerable attention is on governance, remuneration and incentives.

Andrew Bailey sums up this approach by explaining that, rather than "trying to tackle the culture" head-on, regulators are looking for banks to "act on the many things that determine [culture], of which governance and remuneration are important."[98]

For its largest banks, the PRA has conducted a series of corporate governance reviews, focused on "both the design and, even more importantly, the effectiveness of the firm's arrangements, including how firm culture is created, embedded and overseen."[99] Mark Carney has stated that he "regard[s] the discussions we have with boards of firms on our supervisory priorities as among the most important things that we do."[100]

Significantly for banks' bottom lines, the PRA has indicated that, when it observes deficient corporate governance, "We have the ability to apply additional capital to cover the financial risks generated by that weakness."[101]

The PRA and the FCA both have sought to discourage short-term compensation incentives.[102] For instance, the PRA has issued rules that defer at least 40 percent of variable remuneration for up to seven years and instituted claw-back rules that can "bite for up to ten years from the date of award."[103] These rules

Minouche Shafik **REUTERS / Suzanne Plunkett - stock.adobe.com**

also require that 'buy-outs' of an employee's existing contract from a previous employer be subject to claw-back provisions as well. According to one analysis, these remuneration rules have led to a halving of banks' bonus pools since the financial crisis.[104]

Mark Carney has noted that regulators increasingly prefer to use enhanced governance and tougher conduct rules to deal with misconduct. "We all can sense that ... an approach to misconduct which is entirely *ex-post* punishment of institutions and their shareholders at that time is not the best way to manage that situation."[105]

But there is a call for carrots as well as sticks. Minouche Shafik, former deputy director of the Bank of England has emphasized that fines and penalties did not stop the "ethical drift" that left bad behaviors unchecked prior to the financial crisis.[106] Mark Carney has called on banks to transmute such ethical drift" into an "ethical lift," and raise the bar on behaviors through positive performance management.[107]

FCA'S REVIEW OF CULTURE

An early perception that regulators might seek to prescribe a standardized culture for all banks caused notable controversy in the UK. At the end of 2015, the FCA announced that it was changing course and was no longer going to publish a thematic review of banking culture that was viewed by many as indicative of this desire to prescribe a fit and proper firm culture.

Instead, the FCA announced that it would pursue culture reviews on an individual firm level. In addition, the FCA stated that "current practices at banks are new and [the] FCA may not be in a position to endorse specific practices without evidence of long-term effectiveness."[108] While this posture met with relief among firms, some among the public viewed this change of tenor as indicating that the government had been pressured in to "backing off" from the banks.

Even without producing a public listing of good or bad cultural practices at banks, it is clear that the FCA aims to continue its review of culture and conduct risk practices through its regular supervisory processes. A few years ago, the FCA developed five questions to assess banks' governance and culture.[109]

Moreover, the FCA is going to continue to highlight the importance of culture. In March 2018, the FCA released a discussion paper on transforming culture – describing what a good culture may look like, and the role for regulation and regulators.[110]

In summarizing the series of essays in the paper, Jonathan Davidson, FCA Executive Director of Supervision - Retail and Authorisations, commented, "Culture may not be easily measurable, but it is manageable. So firms can and should take responsibility for ensuring their culture is healthy for both their employees and customers, which can complement and support their business strategy."[111]

Davidson added, "We as a regulator have long gone beyond having the mindset that simply complying with rules is enough. However we don't believe a one size fits all culture is the right way to go. So we want to promote a discussion and consensus on the essential features of a healthy culture and how firms, regulators, employees and customers can help deliver that culture."[112]

FCA Questions to Assess Governance and Culture

What proactive steps do you take as a firm to identify the conduct risks inherent within your business?

How do you encourage the individuals who work in front, middle, back office, control and support functions to feel and be responsible for managing the conduct of their business?

What support (broadly defined) does the firm put in place to enable those who work for it to improve the conduct of their business or function?

How does the Board and ExCo (or appropriate senior management) gain oversight of the conduct of business within their organisation and, equally importantly, how does the Board or ExCo consider the conduct implications of the strategic decisions that they make?

Has the firm assessed whether there are any other activities that it undertakes that could undermine strategies put in place to improve conduct?

United States

In the US, cultural change initiatives have been primarily driven by the Federal Reserve and the Office of the Comptroller of the Currency, although the SEC, FINRA, the NY State Superintendent of Financial Services, and other regulatory agencies have also weighed in on the culture challenge in the financial services sector.

US regulators have voiced strong concerns over the culture issues facing banks, with one even going so far as to warn banks that cultural failings may push regulators to break up the banks.[113]

While rhetoric has been robust, the US has not adopted a personal accountability regime akin to that of their UK counterparts. Instead, they have pressed firms to reform culture through industry-led initiatives primarily focused on corporate governance and incentive changes.

Moreover, the Trump Administration has appointed a new set of economic officials and financial regulators since taking power in January 2017, and it is still too early to conclude how they will view and whether (and how) they will act on the issue of culture within financial institutions.

As a general matter, the new administration has focused on reducing regulatory burdens, announcing seven “core principles” that will guide its activities, which include fostering economic growth through more rigorous regulatory impact analysis and making regulation efficient, effective, and appropriately tailored.

During 2017, the Treasury Department released three separate reports regarding financial regulation: a June 2017 report on banks and credit unions, an October 2017 report on capital markets, and another October 2017 report on insurance and asset management. While these reports included recommendations on their particular focus areas, none offered a view of banking culture or the administration's regulatory approach to that issue.

FEDERAL RESERVE

Within the Federal Reserve system, the Federal Reserve Bank of New York ("New York Fed") has been the most vocal in calling for banks to build a stronger ethical culture. William Dudley, President of the New York Fed since 2009, has emphasized that he has "personally delivered a strong message that the culture of Wall Street is unacceptable."[114] In late 2017, Dudley announced that he would retire. He will be replaced by John Williams, the current President of the San Francisco Federal Reserve Bank, in June 2018.

Since the last Presidential election, the composition of the Federal Reserve Board has also changed, with a new Chairman, Jerome Powell, and a new Vice-Chairman of Bank Supervision, Randy Quarles.

Quarles, a former US Treasury official, took the position created by the Dodd Frank legislation in 2010, but which was never formally filled by President Obama. Instead, Fed Governor Daniel Tarullo (who resigned in April 2017) had informally handled the role. Generally known as an aggressive regulator, Tarullo pushed for tighter capital and liquidity requirements and helped to design and implement the annual banking "stress tests." In his public comments, Tarullo did not often focus on banking culture, nor did he push for any specific supervisory or regulatory requirements targeted at banking culture.

> "In the end a bank is only as trustworthy as the people who work within it."

At this point, it is unclear how the Federal Reserve approach to these issues may change under the leadership of Powell, Quarles and Williams in New York. In her final act as Fed Chair, Janet Yellen required Wells Fargo to enter into a "consent order" which prohibits that bank from growing its balance sheet until such time as the Fed deems that bank leadership has better management of conduct risk in operation.

Since taking over from Yellen, Chairman Powell has expressed no inclination to modify or lift that consent order. Moreover, it is worth noting that Williams told the *Wall Street Journal* last year, "Supervision is not just, again, about stress tests and capital, but it's also about the management, the governance, and culture."[115]

IMPORTANCE OF CULTURE

Under Dudley's leadership, and beginning in 2014, the New York Fed has convened three high-profile culture workshops aimed at taking inventory of best practices and industry-led solutions regarding culture reform and conduct risk management. With a mix of regulators, senior bank leadership, board members, and others, these workshops have focused on exploring how firms are deploying resources to manage and measure behavioral risk.

Dudley's 2014 Congressional testimony provided a good summary of his approach He noted that the New York Fed has devoted "significant resources and attention to the form of bank culture and conduct," and went on to say that the public's loss of trust in the financial industry "is so severe that it has become a financial stability concern."[116]

This direct linkage to systemic financial stability was a significant development, as the Federal Reserve had traditionally paid less attention to conduct risks, instead concentrating its supervisory focus on prudential matters such as capital, liquidity, resolution and recovery planning. Dudley explained that, while "increased capital and liquidity are important tools to promote financial stability…in the end a bank is only as trustworthy as the people who work within it."[117]

In its December 2017 whitepaper, New York Fed officials made an explicit connection between firm culture and employee misconduct, and then linked such misconduct to prudential risk for both individual firms and for the overall market.[118]

> *The impact of employee misconduct extends beyond the individual and can impact the firm as a whole and the economy and financial markets more broadly. Employee misconduct can make a firm less resilient, for example, by diverting management attention, harming a firm's reputation in a way that impedes its business, driving change in the composition of the workforce, and depleting its capital. For the broader economy and financial markets, misconduct can inflict harm directly on consumers and employees. Over time, market participants may lose confidence in the financial sector as a whole and adversely impact its critical role in financial intermediation.*[119]

The paper also introduces the term "cultural capital" as a type of asset that impacts how a firm operates. Recognizing it is an intangible asset, the authors nevertheless argue that cultural capital can be "measured, assessed, and ultimately influenced."

The authors note that in organizations with high levels of cultural capital, misconduct risk is low, and processes, incentives and outcomes are consistent with the firm's stated values promoting ethical conduct. Moreover, "unspoken patterns of behavior reinforce this alignment."

Conversely, in an organization with low cultural capital, formal policies do not reflect the "way things are really done" and the stated values of senior leaders are not reflected in the behaviors and actions of the organization's members.[120]

Endorsing the concepts in the whitepaper, Kevin Stiroh, Executive Vice President and current head of the supervision group at the NY Fed, emphasized the importance of these issues for bank supervision. "Root cause analyses of many recent cases of misconduct in the financial sector suggest that misconduct is not just the product of a few individuals or bad processes, but rather the result of wider organizational breakdowns, enabled by a firm's culture," he commented in a December 2017 speech.[121]

"From both a prudential perspective and a financial stability perspective," Stiroh concluded, "misconduct risk threatens our core supervisory objective to sustain the efficient provision of financial services to the economy. This suggests that supervisors have an obligation to promote strong internal practices and behaviors that mitigate misconduct risk and create a healthy culture."[122]

GOVERNANCE

Sarah Dahlgren

During the last few years, the Federal Reserve has reoriented its supervisory approach to focus attention on corporate governance and culture issues. One prime example is an "enhanced engagement" program, in which regulators have closer and more frequent dialogue with banks' directors and senior management.[123] In describing their interactions with board directors, Sarah Dahlgren, who previously headed the NY Fed's supervision group, has said that their direct engagement was met with "an initial wariness" and noted that "directors were often accompanied by a compliance or regulatory relations liaison."[124]

However, over time, Dahlgren commented, "we are seeing boards being more active in asking questions, providing oversight of management and engaging with supervisors. We, in turn, have deeper insight into decision making dynamics at the board and c-suite level, including the how and why of decision making on key strategic issues."[125]

William Dudley President, New York Federal Reserve Bank

Why culture is in your firm's economic best interest

- Good culture means fewer incidents of misconduct, which leads to lower internal monitoring costs.
- Good culture means that employees speak up so that problems get early attention and tend to stay small. Smaller problems lead to less reputational harm and damage to franchise value. And, habits of speaking up lead to better exchanges of ideas—a hallmark of successful organizations.
- Good culture means greater credibility with prosecutors and regulators—and fewer and lower fines.
- Good culture helps to attract and retain good talent. This creates a virtuous circle of higher performance and greater innovation, and less pressure to cut ethical corners to generate the returns necessary to stay in business.
- Good culture builds a strong organizational story that is a source of pride and that can be passed along through generations of employees. It is also attractive to clients.
- Good culture helps to rebuild public trust in finance, which could, in turn, lead to a lower burden imposed by regulation over time. Regulation and compliance are expensive substitutes for good stewardship.

- Remarks at the Banking Standards Board, London, March 21, 2017

In order to assess what former NY Fed General Counsel Thomas Baxter has termed "character at the top,"[126] the Fed has developed a set of questions.

- Do the directors/CEO set the right tone for behavior at the organization?
- Is there effective challenge and debate at the board meetings/committee meetings?
- Do personalities interfere/get too big within the company for effective risk management?
- What's the dialogue like between supervisors and the firm? [127]

These questions are often asked by the Fed's Senior Supervisory Officers (SSOs) who oversee the supervisory program for the firm and meet regularly with the firm's CEO and board of directors.[128] SSOs have been given extensive training to focus on "corporate governance and relationship-building with boards, key directors and senior managers."

The corporate governance dialogue that occurs between senior regulators and firm leadership has allowed regulators to have a more comprehensive understanding of the underlying culture issues facing banks. This, in turn, has allowed the Fed's senior supervisors to take a "higher-level and more encompassing view of the potential problems that a firm might encounter and, when necessary, deliver clearer and timelier supervisory messages and guidance to the firm."[129]

This was also echoed in the report delivered by the IMF's financial sector assessment program. The report acknowledged that the New York Fed's corporate governance supervision is a very hands-on process: "Group level governance is a key focus of on-site supervisory work by the FRB... Supervisory teams review documentation, interview directors and management and sit in as observers at board and management meetings. FRB supervisors provide feedback observations and can and do require remedial action."[130]

While the Fed has not yet taken personal accountability as far as its UK counterparts, it has nevertheless issued supervisory policies stipulating that responsibility for culture, risk appetite and incentives should rest squarely in the hands of senior managers.

Pursuant to a Fed Supervisory Letter issued in 2012, the bank's board and its committees should "assign senior managers with the responsibility for ensuring that investments across business lines and operations align with corporate strategies and that compensation arrangements and other incentives are consistent with the corporate culture and institutional risk appetite."[131]

There has also been a strong push by the Federal Reserve for banks to demonstrate that they are not just carrying out compliance to meet the regulator's rules, but that they are going above and beyond "mere compliance" to what is considered "good compliance."

A few weeks ago, Bill Dudley told the US Chamber of Commerce, "As I see it, an organization's culture gets into trouble when it equates "what is right" with what is legally permissible... A proliferation of rules—followed by the gaming of these rules—can be ultimately self-defeating."[132]

Daniel Tarullo, former governor of the Federal Reserve, had also cautioned the industry to dispense with a "check the box" compliance mentality and to think of compliance as not merely a legal constraint, but one that addresses the underlying needs of the organization, such as its reputation.

Indeed, reputational risk is an area on which the Federal Reserve is increasingly focusing its supervisory attention.[133] Dudley has argued that firms that pay attention early-on to culture issues are able to catch the problems when they are small. "Smaller problems," he concludes "lead to less reputational harm and damage to franchise value."[134]

COMPENSATION

The Fed has also placed greater emphasis on the incentive compensation frameworks at its largest banks. Bill Dudley has repeatedly highlighted the need for an alignment of incentives with intended behavior, arguing that "incentives shape behavior, and behavior drives culture. If you want a culture that will support your long-term business strategy, you need to align incentives with the behaviors that will sustain your business over the long haul."[135]

In focusing on incentive structure, the Fed has suggested that banks consider shifting the mix of incentives to include deferred debt. Dudley notes that unethical behavior is often revealed over many years. Deferred debt compensation structures would act as "performance bonds" that would be depleted first in the event of unethical activities or negative events.

To further strengthen compensation practices, and to implement the Dodd-Frank prohibition on incentive-based compensation schemes that have been found to encourage inappropriate risks at a financial institution, in 2016, the Federal Reserve and five other US regulatory agencies re-proposed a joint rule. That rule would continue to prohibit incentive-based compensation schemes that provide excessive compensation and require that a risk / reward calculus be factored into compensation plans, with a view to effective risk management and governance.

Most notably, the rule would require that banks defer a certain percentage of incentive-based compensation (in the range of 40-60 percent) paid to significant risk-takers or senior executive officers for a period of one to four years, and be subject to a seven-year claw-back period. With the new administration, it is unclear what will happen to the proposed rule.

OFFICE OF THE COMPTROLLER OF THE CURRENCY

The OCC is the primary federal supervisor of many large US banks. After the financial crisis, Comptroller Thomas Curry heightened supervisory focus on the culture of firms. “Addressing the risk culture within the banking system was an early priority of mine as Comptroller, and I continue to make it a theme of conversation with bankers, examiners, and other regulators.”[136]

He also explained why he was focused on culture. “At the end of the day, however, regulations only go so far, and systems of internal control are no stronger than the culture that surrounds them. We can’t write rules to cover every conceivable situation that might come up, and risk officers are only as effective as the support they receive from top management, which is another way of saying that they can only be as effective as their bank’s culture will permit.”[137]

In 2010, the OCC introduced a set of high-level supervisory guidelines aimed at its largest and most complex banks. However, the agency soon realized that these “heightened expectations” – which were not readily enforceable – failed to have the intended effect and that progress in meeting them was “too slow.” In 2014, therefore, the OCC finalized a set of “heightened *standards*,” which included possible enforcement action when standards were unmet.[138]

These heightened standards focus on banks’ risk governance framework and the responsibility of the board of directors to provide effective oversight. A key aspect is a “risk appetite” statement, which is supposed to describe a safe and sound “risk culture” and articulate the core values of the organization.

The requirement of a risk appetite statement helps the OCC to understand more clearly how risks are assessed and accepted within the broader context of what a bank may seek to define as its culture and values. “The strength of an organization’s risk culture is not easy for regulators to measure. It’s not like credit quality or earnings strength. But it’s important because it has an incredibly powerful influence on the risk decisions and behaviors at all levels of an organization,” Curry explained in 2014. “We at the OCC are looking to boards of directors and the senior management of our large banks to set the tone at the top that leads to a healthy organizational culture that abhors improper practices and excessive risk taking.”[139]

The heightened standards guidelines also delineate the roles and responsibilities of the board and senior management around risk culture. According to the guidelines, “evidence of a sound risk culture,” include qualitative measures like open dialogue and transparent information sharing, consideration of risk management and internal audit’s views, as well as compensation and performance management programs that both reward for good conduct and “hold accountable those who do not conduct themselves in a manner consistent with [the banks’] articulated standards.”[140]

In July 2016, the OCC updated its “Directors Book,” a lengthy document outlining directors’ roles, and noted that one of the important responsibilities of directors (and senior management) is to establish an appropriate corporate culture.[141]

In its annual supervisory reviews, the OCC also considers reputational risk which, it notes, “should take into account the bank’s culture” as a primary criterion. Curry summarized, "Our approach to prudential supervision today includes an assessment of organizational values."[142]

In November 2017, a new Comptroller, Joseph Otting, took office. At this time, he has not made any public comments about his views of banking culture.

SECURITIES AND EXCHANGE COMMISSION

In recent years, the SEC has articulated a "top down" approach to compliance, emphasizing the status of the function within the institution and advocating for a "culture of compliance." In a 2015 speech, then director of enforcement Andrew Ceresney commented, "the state of a firm's compliance function says a lot about the firm's likelihood of engaging in misconduct and facing sanctions."[143] He called upon firms to ensure that compliance personnel receive the resources, cooperation, and transparency that they need to do their jobs.

But at the same time, the SEC made it clear that it will hold chief compliance officers (CCOs) at investment advisory firms personally liable for compliance rule breaches. Even while noting the small number of enforcement cases brought against compliance officers, Ceresney stressed in his 2015 speech that the SEC will not hesitate to act when the CCO engages in misconduct, has demonstrated a wholesale failure to carry out his or her responsibilities, or has misled the government.

In its examinations, the SEC's Office of Compliance Inspections and Examinations has included assessments of CCOs and other senior officers. The examinations also focus on the "tone at the top and culture of compliance."[144]

The new SEC chairman, Jay Clayton, and new co-directors of enforcement, Stephanie Avakian and Steven Peiken, have yet to make comments about how their approach may differ from the SEC's previous efforts.

FINRA

FINRA has also focused extensively on the issue of culture at firms. Under the leadership of then-CEO Rick Ketchum, their 2016 Regulatory and Examination Priorities Letter indicated that FINRA would formalize its assessment of firm culture, which it defined as "the set of explicit and implicit norms, practices and expected behaviors that influence how employees make and carry out decisions in the course of conducting the firm's business."[145] The regulator commented that it wasn't trying to dictate a company's culture, but rather to understand how it affects compliance and risk management practices at firms.

In February 2016, FINRA followed up with a more targeted exam letter titled, "Establishing, Communicating, and Implementing Cultural Values."[146] Noting that they were planning to meet with executives to evaluate whether cultural values were guiding business conduct, in advance thereof, FINRA asked firms to provide it with at least eight specific categories of information.

Former FINRA CEO Richard Ketchum **REUTERS / Brendan McDermid - stock.adobe.com**

This information included: a summary of the policies and processes used to establish firm culture, as well as specific implementation measures taken in the last two years; information concerning involvement by the board of directors in this regard; specific steps taken by senior management to shape culture; information regarding efforts to determine how “tone from the top” filters down to middle management; and internal research aimed to discovering how compensation and other personnel practices reinforce intended firm culture. FINRA also asked how the firm assesses its culture, how any breaches are addressed, and how it looks to identify and evaluate any subcultures within the firm.

Since FINRA issued this letter in early 2016, the organization has not released any public information about its ongoing assessment nor has it issued any new regulatory guidance that addresses culture.

European Union

In the wake of the global financial crisis, European Union (EU) regulators advocated for a harmonized approach and application of a uniform set of prudential regulatory standards across the Union. In 2014, the EU adopted a pan-European supervisory regime for its banks, giving the European Central Bank (ECB) direct supervision over its member countries’ financial institutions. Under the Single Supervisory Mechanism (SSM), the ECB is tasked with directly supervising “significant” financial firms regarding prudential requirements. The hope is that this will ensure early detection of weaknesses and better preservation of financial stability.

The SSM framework allows national authorities to share in the supervisory role with the ECB under a mechanism called “joint supervisory teams.” National banking regulators of member-state countries remain in charge of all supervisory tasks falling outside the scope of the SSM.

Conduct supervision in the EU has yet to be harmonized, nor is it routine in all jurisdictions. In fact, only about half of EU member authorities now include conduct risk in their supervisory examination programs. Still less, about one quarter of member countries, have established dedicated teams or units on conduct risk.[147]

The European Banking Authority (EBA), was created in 2011 to increase transparency in the banking sector and to assess capital requirements at European banks. In developing what it calls a “Single Rulebook” of common prudential rules throughout the EU, the EBA has begun to look at conduct risk. It has performed qualitative surveys and, in 2016, it began to require that all of its supervised European banks separately report and calculate misconduct risk losses in its stress testing exercises, given that misconduct risk has been found to comprise the largest portion of operational risk losses.[148]

Between the ECB and the EBA, there appears to be greater awareness and focus at the EU-wide level to enlarge the boundaries of prudential supervision to include areas such as governance and remuneration. These topics are now being met with a more ‘intense and intrusive” examination approach.

Netherlands

Financial regulators in the Netherlands have been especially forward-leaning in their efforts to address misconduct at its banks. The Dutch Central Bank (DNB) has been on the cutting-edge regarding the supervision of culture and conduct and has developed a supervisory framework for banks around behavior and culture that is, by design, “intrusive and decisive” in nature.[149]

The DNB's supervisory approach is predicated on the belief that "capital and liquidity – the traditional indicators of financial institutions' health – are primarily backward looking: they reflect the risks in the past." Supervision of behavior and culture, along with governance and integrity, and a financial institution's business models and strategies, provides a more forward-looking model.

The DNB has stated that the purpose of behavior and culture supervision is to answer two broad sets of questions:

- Which – positive or negative – influence do individual actions and group dynamics have on the financial performance, integrity and reputation of an institution? And which facilitating or restraining role does the institution's prevailing culture play?

- Which measures are necessary to mitigate the risks related to human behavior as much as possible?

Since 2011, the DNB has often sought "non-traditional" means of analyzing culture, by utilizing an array of experts, psychologists, social workers and organizational behaviorists to understand and identify behavioral issues within financial institutions. Along those lines, it has taken an up-close look at boardroom dynamics, sometimes taking a seat at the table during board meetings or observing internal meetings with senior management. It has also interviewed board directors individually.

The DNB has also closely examined group dynamics of banks, citing patterns of "group think," or consensus at the expense of individuals expressing dissenting opinions. It has reviewed the capability of banks to change cultural and behavioral predilections and has conducted over 50 examinations touching on these areas.

Some of these examinations have been jointly performed with the Authority for Financial Markets (AFM). According to the AFM's Chairman Merel van Vroohoven, "By this close combination of risk and conduct supervision, we are able to influence the attitudes, culture and ethical stance of banks."[150]

The Dutch regulators have also put in place a strict 20 percent bonus cap of bankers' annual salaries.[151] Elsewhere in Europe, per the EU's Capital Requirements Directive IV, the bonus cap is substantially higher at 100 percent of annual income. According to former Dutch Finance Minister Jeroen Dijseelbloem, "This law will put an end to golden handshakes of more than a year's pay and guarantee bonuses in the financial sector."

The Dutch have also taken the unique step of adopting a Bankers' Oath. In 2015, the Dutch Banking Code was revised to require about 90,000 Dutch bank employees to swear an Oath and adhere to an accompanying code of conduct or face disciplinary measures. Largely modelled and inspired after the Dutch Oath for Civil Servants,[152] the Oath reads as follows:

Dutch Banking Oath:

"I swear/promise that within the limits of the position I hold at any time in the banking industry:

I will execute my function ethically and with care; I will draw a careful balance between the interests of all parties associated with the business, being the customers, shareholders, employers and the society in which the business operates; when drawing the balance, I will make customers' interests central; I will comply with the laws, regulations and codes of conduct that apply to me; I will keep confidential that which has been entrusted to me; I will not abuse my knowledge; I will act openly and accountably and I know my responsibility to society; I will make every effort to retain and improve trust in the financial sector.

So help me God / This I declare and promise.

The Oath has been somewhat controversial, with some questioning its effectiveness. One study concluded that it did not increase trust in the financial sector But that same study also pointed out the dichotomy between consumer and bankers' views of the Oath: "Consumers were fairly positive about the Oath having an effect on the behavior of bank employees, while the majority of bank employees did not have such high hopes."[153]

In any event, the requirement of the Oath certainly brought attention to the banking sector and government efforts to address its culture. Wim Mijs, Chief Executive of the European Banking Federation, and former CEO of the Dutch Banking Association, promoted the Oath as a means for promoting active discussion, commenting, "The most important element the oath has introduced is the prolonged dialogue between society and the banker's community."[154]

Ireland

Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

The Central Bank of Ireland has also made meaningful headway in its supervisory approach to culture and conduct issues. It has focused primarily on governance issues. "Responsibility for driving the right culture," Central Bank Deputy Governor and Director of Credit Institutions Ed Sibley has said, "resides, first and foremost, with a bank's board." In terms of the tone from the top, the Central Bank has asked firms to "own it, commit to it, and deliver on it."[155]

The Irish supervisor, in tandem with other SSM countries, has deployed subject matter experts to "drill down further into the practices within individual banks" on governance structures and their governance and control arrangements.[156] Ed Sibley comments that it is the regulator's job to "challenge and assess governance arrangements" and has acknowledged that, through their intensified supervision of governance, they have spotted "many serious issues in both governance arrangements themselves and also in critical business areas."[157]

Sibley explains that amongst a host of governance issues, the Central Bank has seen "strategies not being appropriately challenged," and, "risk appetites and frameworks not being embedded or reflecting underlying risks being run in the banks." Sibley notes that it is unsurprising that deepened engagement implies that the regulator will see more issues. What *has* surprised is the "materiality and pervasiveness of these issues – particularly in the international banks."[158]

The Central Bank has also begun to examine culture at banks, taking its cue from the DNB's behavioral approach. The regulator has noted that this effort is not aimed at "quick fixes," but rather, "sustained change." Formal inspections, which have recently started, are aimed at answering the following questions:

- What influence, positive or negative, do individual actions and group dynamics have on the financial performance, integrity and reputation of an institution?
- Which facilitating or restraining role does the institution's prevailing culture play?
- Which measures are necessary to mitigate the risks related to human behaviour as much as possible?

Ultimately, the supervisor sees governance and culture as "likely to be the difference between the success and failure of the bank, including ensuring the fair treatment of its customers."

In a 2016 speech, Ed Sibley provided a candid assessment. "While progress has been made," he says, "there is much more to be done to ensure that governance, culture and ultimately the *behavior* of banks continues to improve and meet the requirements of stakeholders. It is clear to me that there is still a way to go before it can be said that banks operating in Ireland are among the best in these areas."[159]

In March 2017, the Governor of the Irish Central Bank, Philip Lane, announced "We are undertaking behaviour and culture assessments of each of the five main lenders — AIB, Bank of Ireland, Ulster Bank, PTSB and KBC — and will report our findings to the minister for finance in June." Lane indicated that post-review actions could include requiring lenders to conduct an annual internal audit of culture, the creation of ethics sub-committees for bank boards, and a review of incentive schemes to assure they do not reward inappropriate behaviour.[160] At the end of the year, these five banks announced the creation of a Irish Banking Standards Board, modeled after the UK BSB, with a goal of rebuilding trust and confidence in the industry.[161]

Hong Kong

In Hong Kong, the Monetary Authority (HKMA) and the Securities and Futures Commission (SFC) provide regulatory oversight over the financial industry's banking and securities sector. During the past few years, both have strongly reinforced the need for banks to foster a sound corporate culture and to heighten their focus on governance and personal accountability.

HONG KONG MONETARY AUTHORITY

The HKMA has been active in recent years in promoting culture initiatives at banks, and it has supported supervisory initiatives that focus on risk culture and banking governance, culture and capacity building, and board of director empowerment.

In March 2017, the HKMA issued guidance to its supervised institutions about developing and promoting a sound corporate culture, emphasizing that while there have been considerable efforts thus far, "much more needs to be done."[162] The HKMA notes that there is no "one size fits all" approach to firm culture, but that a "holistic and effective framework" should include what it labels as the "three pillars" for promoting sound bank culture: (i) Governance (ii) Incentive systems and (iii) Assessment and Feedback mechanisms.[163]

Annexed to its circular, the HKMA outlines more specific factors to be considered. It requires banks to review their policies and procedures relevant to culture and to make any necessary enhancements

Norman Chan ***REUTERS / Bobby Yip - stock.adobe.com***

within one year. While it does not go as far as to assign specific responsibilities to individuals under a UK-style accountability regime, the HKMA has advocated for the use of "summary sheets" that make clear to staff the conduct that is expected of them. Bank culture reform initiatives and "core risks" should have clear ownership structures, and banks should designate specific "culture risk champions."

As regards incentives, the HKMA has highlighted that banks should utilize a separate rating that would look at adherence to corporate values and weight this appropriately when determining variable remuneration. For assessment and feedback mechanisms, the HKMA has advocated the use of culture dashboards that would monitor key indicators, sharing of lessons learned, and properly designed escalation systems so that employees are encouraged to speak up when they have issues and concerns.[164]

Perhaps most notably, HKMA Chief Norman Chan serves as the current chair of the FSB's Standing Committee on Supervisory and Regulatory Cooperation. Among other things, the Committee is responsible for setting relative priorities and identifying and monitoring best practices for meeting regulatory standards. Chan is known to favor an approach to supervision that emphasizes principles over rules and to view firm culture as critical to seeing the stated firm values and principles acted out among employees.

SECURITIES AND FUTURES COMMISSION

In December 2016, the SFC implemented a "Managers in Charge" (MIC) regime modeled on the UK's SMR. In so doing, it became the first Asian regulator to adopt a regime for enforcing personal accountability. The SFC requires its licensed firms to identify the managers in charge for eight new core functions. Those functions include overall management oversight, key business lines, risk management, and compliance.[165]

One important aspect of the MIC regime is that the appointed manager may reside outside of Hong Kong and may be one of several MICs in charge of a Core Function. The introduction of the MIC regime in Hong Kong will thus likely be a testing ground for how firms with complex organizational structures may satisfy local regulatory requirements for corporate governance applied at the local legal entity level.

Singapore

Singapore has paid close attention to culture issues at financial institutions and, in 2017, it signaled that its focus on culture and conduct issues will intensify. Ravi Menon, head of the Monetary Authority of Singapore (MAS), has repeatedly reinforced the importance of "getting the culture right" as key to building trust in the integrity of the financial sector.[166] Menon has highlighted that MAS balances two roles – that of regulator as well as business developer of the financial sector – and emphasizes that this is built on being a trusted financial center.

In his 2016 speech, "Singapore's Financial Centre: Resilience, Dynamism, Trust," Menon forthrightly acknowledges, "Financial institutions from all over the world come to Singapore because this is a jurisdiction they can trust... Upholding high standards of integrity in the financial industry is an absolute priority."[167]

Lee Boon Ngiap, who oversees the regulation and supervision of capital markets at MAS, has further argued that culture supervision should carry as much weight as traditional prudential supervisory concerns. He has asserted that culture is as important as capital and liquidity and should receive equally close attention.[168]

> "Assessing culture and its impact on conduct inherently poses a greater challenge than prudential supervision because culture cannot be quantified nor easily monitored. But we believe it is as important as capital and liquidity, and should receive equally close attention from regulators and financial institutions."
>
> **Lee Boon Ngiap**
> Assistant Managing Director, Monetary Authority of Singapore, March 6, 2017

In the same March 2017 speech, he cautioned that a focus on culture will not necessarily translate into more rules. "But financial institutions can expect MAS to engage them more regularly on what they are doing within their own organisations to shape the right culture."

To promote a "positive culture," MAS is taking a careful look at "tone at the top" and has noted that it would like to see culture and conduct issues as "a regular feature of board meetings," as well as active management monitoring of culture and conduct outcomes, with feedback from customers being taken into account. The MAS is also paying attention to incentive schemes and observes that conduct should be reflected in remuneration policies. MAS is further focused on firms' escalation policies, recruitment, training and ability to "self-police" by conducting "root-cause analysis" of underlying culture issues when misconduct arises.

While MAS has not as yet issued specific guidance on conduct risk, it has developed a string of regulations and guidelines on corporate governance, the safeguarding of investor interests, customer fair-dealing and a balanced score-card basis for remuneration of financial advisors.[169] These guidelines and regulations, combined with closer supervisory attention to the culture aspects at the firms it oversees, is indicative of the regulator taking proactive steps to press forward with culture and conduct reform in its financial sector.

"No amount of regulatory reforms or supervision can assure a stable financial system if the culture and conduct of firms and individuals are flawed," said Ong Chong Tee, Deputy Managing Director of the MAS for Financial Supervision in a February 2018 speech. "An effective banking supervisor must be able to assess a bank's understanding of its risks, its business practices as well as judge its corporate governance and culture... This can only be done if banking supervisors do not see their role as a mere compliance function."[170]

Australia

Australia's regulators have focused on culture and conduct issues for several years, though some well-publicized events in late 2017 have driven even more attention and action.

In August 2017, government regulators alleged that the Commonwealth Bank of Australia had breached anti-money laundering and terrorist financing rules. In response, other government agencies launched inquiries, shareholders sued the bank, the CEO announced his resignation, and some members of the board of directors stepped down.

With the story continuing to garner much public attention, in November 2017, the Prime Minister created a Royal Commission to look into allegations of misconduct in the financial services sector. The announcement noted that "trust in a well-functioning banking and financial services industry promotes financial system stability, growth, efficiency and innovation over the long term," and that "the highest standards of conduct are critical to the good governance and corporate culture of those providers."[171]

The Commission, which is required to submit a final report within a year, is empowered to investigate whether any misconduct by a financial services entity is attributable to the "particular culture and governance practices" of the firm or the overall industry. It is noteworthy that it is not supposed to make recommendations regarding macro-prudential policy, regulation, or oversight.

AUSTRALIAN PRUDENTIAL REGULATORY AUTHORITY

Since 2015, the Australian Prudential Regulatory Authority (APRA) has developed a team of regulatory experts focused on issues related to governance, culture and remuneration. Its supervisory teams have conducted reviews of risk culture at banks, in the course of their routine supervisory activities, and have held series of risk culture workshops with senior industry leaders.

Notably, APRA has stood up an internal behavioral science team, tasked with developing means of assessing firm culture, and systems that prompt desired behavior. The leaders of this team have worked with, and have been significantly influenced by, behavioral scientists from the Dutch National Bank. This may betoken an increasing degree of international regulatory consensus and collaboration across jurisdictions.

APRA supervisors have acknowledged that their supervisory work has been exploratory in nature. Going forward, the regulator has indicated that it will intensify its supervision of risk culture by conducting pilot risk culture reviews, aimed at promoting prompt corrective actions, and will perform a stock-take of current industry remuneration practices.

The Australian government has introduced significant new rules under the Banking Executive Accountability Regime (BEAR). Passed into law in February 2018, this new regime will come into effect in July this year. It is set to fundamentally change APRA's role, giving the regulator stronger powers to fine banks for misconduct, and to remove and disqualify the firms' board members and senior executives. Additionally, APRA will be given stronger powers to review and adjust remuneration policies when it sees inappropriate outcomes. The new legislation also defers up to 40 percent of variable remuneration for banks' executives and up to 60 percent for CEOs.

The regime largely mirrors the UK's Senior Managers Regime by requiring registration of senior executives with APRA and by prescribing responsibility mapping of roles and responsibilities by senior executives. It covers executives who have management or oversight functions as prescribed under the legislation or who otherwise have significant influence over all, or a material part of, the bank's operation. In a significant extension, it also covers non-executive directors, recognizing their critical oversight role.

AUSTRALIAN SECURITIES AND INVESTMENT COMMISSION

ASIC has steadfastly supervised conduct and culture issues through its surveillance activities. In 2016, ASIC indicated that it would more deeply integrate cultural indicators into its risk-based surveillance. The active surveillance that ASIC is conducting is not entirely new but, rather, the regulator is looking to "join the dots" more effectively to prevent misconduct.[172]

ASIC Key Questions for Boards to Ask about Culture

- Has the culture of the organization been independently assessed? What were the results of that assessment? Do the firm's stated values match the actual experiences of customers, employees, suppliers, etc.?
- Is culture a regular feature on the board and audit committee agenda?
- Does the board hear from key employees, such as business line managers, to help with obtaining insights into the company's culture, subcultures and team-specific issues?
- Is there board engagement with external stakeholders such as customers, suppliers and regulators?
- Is there monitoring that captures data on key indicators – for example, gathered through employee feedback and surveys, customer complaints, progress on employee training on culture issues and using data analytics to gain insights on culture?
- Is the information in internal and external audits being fully utilized (since these generally touch many parts of the organization and are exposed to a variety of cultural indicators)?

"ASIC is concerned about culture because it is a key driver of conduct within the financial services industry. By focusing more on culture, we expect to get early warning signs where things might be going wrong to help us disrupt bad behavior before it happens and catch misconduct early. We also think it will help us with identifying not just individual instances of misconduct, but broader, more pervasive problems," then-Chairman Greg Medcraft explained.[173]

ASIC's surveillance teams have developed an internal document called "Culture Indicators for Surveillance," which list of positive and negative culture indicators. While the indicators are numerous, ASIC has highlighted a few on which it is focused, including whistle-blowing activity, breaches or over-limit reports, customer complaints, diversity of views and positive challenge, recruitment, training and rewards.[174] ASIC has also suggested a number of questions that boards should ask to see whether there are any red flags.[175]

ASIC recently appointed a new chairman, James Shipton, a former executive at the Hong Kong Securities and Futures Commission. Taking office in February 2018, Shipton made clear that firm culture has been and would remain a topic of interest for him and ASIC.

"I've been a great advocate of cultural reform in the financial institutions and in the financial markets for a long time. I very much intend to continue this important work," he remarked at a news conference when his Chairmanship was announced. "Financial markets are ultimately built on trust — trust in the integrity of the market and trust in market participants. I see ASIC as a guardian of that trust and as an institution that is there to constantly remind market participants that finance only exists to serve the broader community and the economy."[176]

Greg Medcraft ***REUTERS / STEVEN SAPHORE - stock.adobe.com***

In 2016, the Australian Bankers' Association (ABA), launched a Banking Reform Program and, in 2017, published a progress report.[177] In that report, the ABA highlighted its work on stopping poor conduct from moving around the industry by establishing an industry register to identify "rogue advisers" and by enhancing recruitment procedures through a Conduct Background Check Protocol. It reaffirmed its backing of whistleblowing programs by establishing a set of high-standard whistleblowing policies and reviewing best practices to ensure whistleblowing protections. It also renewed a past commitment to reforming compensation practices.

Later in 2017, following the formation of the Royal Commission and the resulting focus on culture, the ABA issued a new code of conduct, which is currently awaiting approval from ASIC. And in March 2018, shortly before the Commission's hearings began, the association proposed to make the code mandatory for all banks with retail operations.[178]

United Arab Emirates

The United Arab Emirates' financial regulatory authorities primarily consist of the Dubai Financial Services Authority (DFSA), the Abu Dhabi Global Market's (ADGM), the Abu Dhabi Financial Services Regulatory Authority (FSRA) and the Central Bank of the UAE.

Within the Dubai International Financial Center (DIFC), the DFSA's regulatory mandate consists of supervising the wider cross-section of the financial sector, including asset management, banking and credit services, securities, collective investment funds, custody and trust services, commodities futures trading, Islamic finance, and insurance firms.[179]

One regulatory objective, listed in its 2015 Annual Report, is to "prevent, detect, and restrain conduct that causes or may cause damage to the reputation of the DIFC or the financial services industry in the DIFC."[180] To this end, in 2016, the DFSA focused on conduct-related supervisory issues including corporate governance practices and the suitability of products and services for clients.[181]

The DFSA has also joined the dialogue with other regulators, hosting a business conduct roundtable featuring discussion on culture assessment, behavioral economics, and innovative approaches to supervision. Such initiatives pave the way for the regulator to become more influential in fostering culture and conduct supervision in the region.

FINANCIAL STABILITY BOARD

FSB FINANCIAL STABILITY BOARD

As reflected above, regulators in key financial centers across the globe have increased their attention to culture and conduct issues, albeit at varying levels of intensity and with different enforcement philosophies and priorities. In an effort to gain greater consistency and coordination, regulators have also looked to international standard setting bodies to push for international-level guidelines. The Financial Stability Board is at the center of such work.

The FSB has developed a multi-phase work-plan for addressing misconduct risk. In 2015, it established a working group under the leadership of Canada's Superintendent of Financial Institutions Jeremy Rudin. The work-plan for the group included a stock-taking exercise of efforts made both by regulators and financial institutions to strengthen governance frameworks in the financial sector. In May 2017, the FSB published the results of its stock-take exercise and set out three areas requiring future direction and focus.[182] These are:

Rolling bad apples. This issue involves employees who are dismissed for misconduct (or suspicion of misconduct) at one bank and are then rehired at another bank. The FSB plans to define the size of the problem and then look at ways to deal with it. Recognizing that the primary responsibility for hiring sits with bank executives, the FSB also notes that it the banking sector faces a collective action problem: firms have an incentive to conduct vigorous due diligence but may also face constraints in providing information about current or former employees to other firms and other third parties. More work is needed to analyze various legal, structural and regulatory constraints that complicate this agenda item.

Responsibility mapping. More jurisdictions are extending the concept of detailing expected roles and responsibilities for board members and senior managers, and mapping how they relate to one another if these roles and responsibilities are to be undertaken effectively. The FSB intends to examine the ways in which responsibility mapping could be used in supervisory, examination or enforcement practices in order to mitigate misconduct risk. It also plans to examine the issues involved in "operationalizing such a requirement in an international environment," to include consideration of various legal challenges and how this aim might be applied in a holding company arrangement.[183]

Culture. The FSB notes that, in many instances of misconduct, there is evidence that the "norms and expectations that most strongly influence behavior within financial institutions can be very different from the institutions' stated value and principles… Word and deed can diverge." The FSB thus plans to explore how firm culture can "support proper identification, application, and monitoring of governance mechanisms to deliver good conduct, as well as how governance mechanisms may mitigate misconduct risks posed by the culture of a firm."[184] The report emphasizes that, while firms are responsible for their culture, supervisors also have an important role – as their access to information and individuals put them in a unique position to gain insights into firm culture. It explains, "supervisors and regulators could play a role in promoting culture as a mitigant to misconduct risk."[185]

In July 2017, the FSB reported to G20 leaders that it will complete its work in these areas in early 2018. It will then determine whether "any further steps (such as guidance) would be beneficial."[186] At this time, the FSB has not released any update on its work.

CONCLUSION:
What's Next

There is now widespread agreement that firm culture is critical. It impacts employee behavior, the success or failure of individual firms, the material interests of shareholders and the broader stakeholder community and, ultimately, the health of the world financial system and economy.

With this recognition has come significant developments in regulatory efforts to assess and diagnose culture at financial institutions. Some diagnostic indicators are straightforward and easily measureable. But others are far harder to observe and may actually be more important in determining organizational health.

What is the tone in the middle of the firm? The "echo from the bottom?" Do employees act in a manner consistent with stated corporate values? If so, why? And, if not, why not? Are there informal incentives, such as in-group acceptance, that demonstrably shape behavior? How is this to be tested? What sub-cultures might exist that operate contrary to overall firm aims?

As one looks across the globe, every jurisdiction has emphasized the importance of culture and is working to develop relevant diagnostic tools that can support supervisory activities. Most jurisdictions are also graduating from a check-the-box type of assessment, where they merely look to assure that a bank has proper policies and procedures in place, to approaches that emphasize data-backed behavioral science. They are looking beyond "mere compliance," and are seeking to assess real practice on the ground – "the way it's done here."

Moreover, regulators are encouraging firms to adopt a similar approach to their internal governance, out of their own enlightened self-interest. In addition to representing a source of operational risk, some argue, culture might also be viewed as a valuable form of "capital" — one worth investment. As NY Fed head of bank supervision Kevin Stiroh wrote in the *Harvard Business Review* last month, "The possibility of employee misconduct — the potential for behaviors or business practices that are illegal, unethical, or contrary to a firm's stated values, policies, and procedures — is a form of risk just like liquidity risk or operational risk. Investments in cultural capital is one way to reduce that risk."[187]

Going forward, there is very likely to be a broad shift in focus from regulation to supervision, with attention to a firm's level of investment in "cultural capital." Under this "soft power" approach, regulators will seek to hold themselves forward as providers of insight and support to firms making proactive efforts to cultivate "cultural capital" and to mitigate conduct risk. Of course their enforcement role will remain firmly in place. But regulators have acknowledged that enforcement actions resulting in hundreds of billions of dollars in punitive fines have failed to eliminate misconduct in the industry. While important, enforcement alone is insufficient.

We thus see many regulators working to strike a more collaborative stance with firm leadership, and to "nudge" the industry in a new direction. As Andrew Bailey stated just a few weeks ago at the FCA's Transforming Culture in Financial Services conference, "The role of regulation in culture is not to attempt sweeping rules, but rather to use rules and supervision to create the right incentives and to provide tools to diagnose the key characteristics. And, we can prompt and persuade."[188]

One would expect to see these trends continue and to see greater convergence in how regulators in different jurisdictions approach these issues. While they may not adopt the same rules and enforcement policies, they are likely to extend their current focus on culture and conduct, share information regarding the success and failure of different supervisory experiments, and learn from one another's experience. Successes will surely be mimicked. Firms will have an opportunity to engage with their regulators in this new approach, which may benefit all concerned.

Our View:

From an industry perspective, there is likely to be continued convergence in how banks address these issues. First, it is increasingly acknowledged that there is a clear link between a healthy firm culture and successful business results. Additionally, no bank wants to become the next poster child for misconduct, as the reputational and financial risks can be devastating. Especially in an industry that relies on a "social license" to operate, the benefits of complying with (or staying ahead of) regulation is materially impactful.

Moreover, with a conflicting desire to reduce GRC spend and boost ROE, while at the same time reducing the liability exposure and headline risk that comes with conduct scandals, firms may be expected to focus on this issue at the level of the C-Suite and Boards.

But, without industry-wide, credible, data-driven and quantitative metrics around the qualitative challenge of shaping, mapping and anticipating the behavior of employees, we must expect that supervisors will be forced to make subjective judgments about whether a bank meets some appropriate "standard" for culture and conduct management.

With different regulators, in different jurisdictions, using different bases for making different judgments about the operations of a given firm in different locales, opportunity for confusion, and for best-intentions to operate at cross-purposes, is clearly ample.

Firms and regulators thus share a common interest in collaborating to produce a consistently applied means of addressing culture and conduct risk challenges. As Bill Dudley explained last year at a Banking Standards Board event in London, "Since the beginning of our work on culture, my colleagues and I have recognized that measurement is indispensable to improving bank culture."[189]

An understanding of the manner in which culture sits among the root causes of misconduct is a necessary first step. The next step will be to deploy diagnostic tools that provide real-time metrics about how an organization's culture functions and encourages employees to behave. Data-analytics teams at some firms have been tasked with creating their own "behavioral models" for such use.

While this is to be encouraged, it does not provide for a standardized "industry-utility" that permits benchmarking between (and within) firms. We hear increasing calls for this among firms and regulators alike and expect to see developments in this direction in the near term.

In 2014, Bank of England Chief Economist Andrew Haldane spoke of his dream that, one day, regulators might be able to monitor the flow of capital across the globe in real-time, "from a Star Trek chair using a bank of monitors," and to thus spot where problems may be brewing, in much the same way as meteorologists study weather patterns to spot the early formation of a hurricane.[190]

In the way that epidemiologists track and then forecast the spread of a pathogen through a population, bank leaders and supervisors alike might make use of such a Star Trek system to map and anticipate the spread of behaviors across a firm, permitting for the adoption of proactive corrective measures and for more timely, efficient and effective interventions.

New technologies are now making this possible, benefiting banks, regulators and, ultimately, the public. These new capabilities create an opportunity for increased collaboration among regulators and firms in crafting a superior approach to the management of culture and conduct related risks. We hope that this Compendium will support those efforts.

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