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Culture & Conduct Risk in the Banking Sector

Why it matters and what regulators are doing to address it

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Contents

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.