NOVEMBER 9, 2016

REFORMING CULTURE AND BEHAVIOR IN THE FINANCIAL SERVICES INDUSTRY: EXPANDING THE DIALOGUE

The Federal Reserve Bank of New York held its third conference on reforming culture and behavior in the financial services industry on October 20, 2016. This year's theme was "Expanding the Dialogue." The agenda included:

> ***New topics.*** Two panels addressed the responsibilities and capabilities of investors and the effects of digitization on industry culture. Other panels offered new perspectives on perennial topics: the role of finance in society, the assessment of culture and behavior, and potential changes to incentive and accountability regimes.
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> ***Fresh viewpoints.*** Many speakers emphasized the importance of considering multiple data sources and diverse points of view. This year, an organizational psychologist, a moral philosopher, and several foreign supervisors presented their thoughts on reforming culture.

The central message was consistent with previous years. ***It is ultimately the industry's responsibility to change its culture and behaviors.*** Other lessons from this year's conference were:

- All organizations struggle with "silos"—isolated units of expertise and specialization at risk for developing aberrant ethics and behaviors.
- Trustworthiness is the irreducible standard of conduct in banking. Trustworthiness requires routine, honest, and competent interactions with customers, employees, investors, and regulators.
- There are operating benefits to an alignment of near-term incentives, long-term corporate goals, and a clear view of the ultimate purpose of finance in society.
- Silence (or acquiescence) is an unacceptable response to misconduct. Mere protection of employees who "raise their hand" is inadequate. Affirmative recognition and encouragement may be useful tools for changing culture.
- Good culture and good regulation are complements, not substitutes.

Opening Remarks and Morning Keynote Address

Bill Dudley, the New York Fed's President and CEO, welcomed this year's conference participants, especially the non-executive directors, investors, and foreign supervisors in attendance. The reasons for reconvening a conference on culture remained unchanged from previous years. Banks play a critical role as financial intermediaries in the national economy, but the misconduct on the scale observed since the financial crisis impairs that role. It is therefore appropriate to consider all possible causes of misconduct, including culture.

Reforming culture, however, requires more than talk—however well-intentioned the words may be. Banks need to make demonstrable progress on changing behavior. In Mr. Dudley's view, that process begins with changing incentives. "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." Mr. Dudley encouraged the audience to question, among other things, compensation decisions, the stature of control functions, and the way employees are treated when they report misconduct.

As in previous years, Mr. Dudley stated that the industry has the primary responsibility to change its incentives and reform its culture. He also encouraged conference participants to consider how new laws or regulations could help overcome collective action problems. One example is a database of banker misconduct to combat the problem of "rolling bad apples." Another is a baseline survey of culture to help measure progress. Mr. Dudley noted that he had proposed these ideas two years ago, but had yet to see the industry move them forward.

Finally, Mr. Dudley called for habits of reflection and personal responsibility by both bankers and regulators. Citing Ignazio Angeloni of the European Central Bank, Mr. Dudley posed six questions:

- Are you doing what you promised to do?
- Are you using your best knowledge and intention in doing it?
- Are you doing what public authorities, superiors, colleagues and business partners expect you to do, and if not why?
- Are you conforming to the mission and the values of your company, as they are publicly stated?
- Will your actions enhance public confidence in your company and in the financial sector?
- Finally, and crucially, would you behave similarly if your actions were publicly observed?[1]

Several speakers referred to these questions throughout the day,—especially the final question.

[1] Ignacio Angeloni, "Ethics in finance: a banking supervisory perspective," Remarks at the Conference on "The New Financial Regulatory System: Challenges and Consequences for the Financial Sector, Sept. 26, 2014.

Baroness Onora O'Neill—a professor emeritus of moral philosophy at the University of Cambridge—delivered a keynote address. Her topic was the purpose of banking. "How would you answer the question, 'What is banking for?' Or, if you are a bank employee, director, or investor, 'What is *your* bank for?'"

Purposes, she argued, are an organization's public and private reasons for existing. They will likely be several, but "maximizing shareholder value" should not number among them. Some banks—credit unions, for example—are non-profits and do not have shareholders. Moreover, the phrase leaves unanswered the critical issues of "how value will be maximized, and over what period." Instead, Baroness O'Neill suggested that the audience consider a bank's "social license"—the consent of society to do business. What expectations about the purposes of banks does a social license create?

Once purposes are clear, banks can consider their standards of conduct. "Standards" are *not* the same as "values." The former tend to be objective and shared. The latter, subjective and individualized. The most obvious standard for banking is trustworthiness, which comprises three elements: competence, honesty, and reliability. Bankers should be skillful. They should do what they say, and say what they intend to do. And they should be dependable—to the point of "boring regularity."

A good culture, according to Baroness O'Neill, works in tandem with regulation to support a standard of trustworthiness. Left to its own, regulation may promote a habit of equating good conduct with legal conduct. This is because laws tend to set minima. They delineate what is wrong, but do not necessarily indicate what is right. Culture, by contrast, provides norms with greater applicability to everyday conduct. A good culture aims for what is right, not what is merely legal. And, as with purpose, "[t]he first step is surely to achieve clarity about the sort of culture an institution ought to develop." Success will require "time and effort, good communication, and leadership that exemplifies and lives as well as preaches the culture—and constant reinforcement."

Panel One: Finance and Society: A Global Perspective

Moderator: **William C. Dudley,** *President and Chief Executive Officer,* Federal Reserve Bank of New York

Panelists: **Norman Chan,** *Chief Executive,* Hong Kong Monetary Authority
Dame Nemat (Minouche) Shafik, *Deputy Governor,* Bank of England

Main points

- Reforming culture depends on industry commitment. Real progress will begin with changing incentives to promote firms' purposes.

- Culture can support good behaviors in ways that regulation alone cannot. For one thing, market transactions and practice outpace regulation and enforcement. For another, laws can prohibit certain bad conduct, but tend not to prescribe what is good conduct.
- It is in the industry's self-interest to reform internal incentives to reflect long-term goals rather than short-term profit, and to collaborate on best practices and standards for market conduct.

This panel discussed the role of the official sector in promoting industry-driven reform. According to Ms. Shafik, misconduct in financial services is not episodic or caused exclusively by rogue actors. Years of "ethical drift"—evidenced by a running tally of $275 billion in fines—demand a sustained period of "ethical lift." Tackling misconduct will require a combination of "hard law," "soft law," and better culture. "Hard law" means public rules and regulations, and is the official sector's responsibility. By contrast, "soft law" and culture belong to the private sector. Included in these categories are best practices, ethical codes, and incentives. Mr. Chan added that laws may deter clear misconduct, but are limited in deterring "not quite good conduct"—behavior that toes the line of permissibility. A good culture can pick up where laws leave off. It can prompt the question "What is the right thing to do?" instead of "Can I get away with it?"

Ms. Shafik observed that changes in competition and technology may have contributed to a widespread misalignment between practice and purpose. Technology, for example, may separate service providers from customers. And, as seen in the LIBOR and FX scandals, technology has provided new opportunities for collusion. Controls around new technologies have historically not kept pace with innovation. This phenomenon only underscores the need for a good culture: norms that apply when no one is watching.

The discussion moved quickly to incentives. Mr. Chan cited compensation systems based solely on short-term financial performance as prime examples of incentives that are misaligned with principles. They tend to not account for *how* profits were earned, inviting employees not to care. Moreover, if job security is tied purely to financial performance, employees will do whatever is needed to meet or exceed profit targets. Ms. Shafik contrasted these examples with a compensation program that places compensation at risk of clawback for several years—enough time for the risks of a transaction to mature.

Promotion is another powerful incentive. Mr. Chan recommended that firms establish qualitative benchmarks for career advancement. He further advised that senior managers and directors should review compensation and promotion incentives as they apply to all levels of the organization.

Ms. Shafik added that the responsibilities of senior managers and directors should be clear. A new requirement that firms allocate responsibilities among executives and key independent directors is the cornerstone of the United Kingdom's Senior Manager's Regime, a set of regulations that took effect in March of this year. Senior managers have a new legal duty of responsibility for the areas committed to their oversight. Ms. Shafik acknowledged that there was some initial reticence about the program. That has changed. Firms now tend to see the clear allocation of responsibilities as a useful governance tool. Indeed, the Bank of England recently completed the process itself. The result is greater clarity about job responsibilities.

The panel considered the persistent problem of "rolling bad apples." These are employees who depart a firm as a result of misconduct, but who are hired by another firm without any disclosure of their employment history. Mr. Dudley reiterated his support for a federal statute creating a central database of misconduct to close the knowledge gap. Banks would have to report misconduct when an employee leaves the firm. And they would have to check the database before a new employee can start work. A statutory safe harbor for employers would promote honest reporting. Enhanced due process protections for employees would guarantee notice and an opportunity to change inaccurate records. Ms. Shafik commented that legal hurdles in the United Kingdom favored a bank-to-bank reference requirement over a centralized database. She noted, however, the ease of having all the information in one place. Mr. Chan added that, regardless of the means, the official sector needs to address the perception that bankers can get away with misconduct.

The panelists also discussed the role of leadership in reforming culture. Mr. Dudley advised that a bank's leaders need to be inquisitive. If misconduct has occurred in one division, a CEO should ask whether similar misconduct might have occurred elsewhere within the organization. Likewise, if misconduct is revealed at a peer institution, the response should be an internal inquiry, not schadenfreude. Ms. Shafik added that identifying a problem early and reporting it to a regulator promptly should result in leniency. Mr. Chan suggested that firm leadership place an emphasis on multiple feedback channels, including customer feedback, to identify nascent patterns of misbehavior.

Turning to the role of the official sector, Ms. Shafik observed that—at least in the United Kingdom—the right statutory mechanisms for accountability are in place. What's needed is the industry's commitment to better market discipline and better ethics—soft laws to complement hard laws. She noted that industry groups in several countries, working under the auspices of the Bank for International Settlements, were preparing a common code for foreign exchange markets. This could serve as a model for cooperation on other issues.

In Mr. Chan's view, banking regulators from different countries need better coordination because they face common problems. Regulators should not tolerate the argument—heard in financial centers around the world—that a stricter regulatory or enforcement regime will cause firms to relocate to more "business-friendly" jurisdictions. If supervisors are united in their goals, albeit with different approaches, there will be no refuge for scoundrels.

Mr. Dudley offered that central banks, which participate in certain financial markets, could embed principles and best practices in their counterparty agreements as a further way of accomplishing "ethical lift." He also encouraged the official sector to evaluate collective action problems: incentives, "rolling bad apples," and culture benchmarking, to name a few. Finally, he noted the utility of the official sector's convening power to promote more discussion of common challenges—but only if discussions yield actual progress.

Panel Two: The Role of Investors

Moderator: **Maureen O'Hara**, *Robert W. Purcell Professor of Finance*, Johnson Graduate School of Management, Cornell University

Panelists: **Glenn Hosokawa,** *Director of Fixed Income***,** California State Teachers Retirement System (CalSTRS)
Matthew J. Mallow, *Senior Managing Director and Chief Legal Officer*, BlackRock
Sir David Walker, *Chairman*, Winton Capital Management

Main points

- Equity investors often bear the cost of misconduct: fines, the cost of investigations, and lost business opportunities. Ignoring the problem of misconduct will be costly.
- Some investment companies themselves have tended to invest greatly in their own internal cultures, presumably out of a belief that culture affects performance. Why not require the same from firms in which investments are made?
- Any role for debt or equity investors in reforming culture will be more limited than the roles for the board and senior management. But this is not to say that no role exists. Finding a practicable balance will be the work of the investor community—singly and collectively—going forward.

This panel and subsequent panels operated under the Chatham House Rule. Accordingly, the following panel summaries do not contain attributions to any person or institution.

This panel presented a range of views on the responsibilities and capabilities of investors. There was, however, some common ground. Participants agreed that culture and behavior matter for long-term performance. They cited, as examples, ratings agencies that now consider governance metrics, not just return on equity, in evaluating firms. Further, fund managers and asset managers themselves have tended to invest greatly in their own internal cultures. This must be seen as evidence of a belief among investors that culture affects performance. Quite sensibly, these fund and asset managers want to see similar ethical standards applied within the firms in which they invest.

There was also broad agreement about the challenges faced by investors with an interest in reforming culture and behavior. One of the challenges is leverage. Here, that term means persuasiveness—the ability to convince or compel. It does not refer to a debt-to-equity ratio. Some investors can "vote with their feet" and sell the shares of a firm they think is poorly managed or has a poor culture. But many investors cannot. Managers of index funds, for example, cannot threaten to sell a stock that is indelibly part of an index. Still, as one speaker observed, being locked into an investment is a good reason to be active on issues of culture and governance, since they affect long-term performance.

Another limitation on leverage is the size of the typical ownership stake. Investors rarely own more than 5 percent of a bank because of regulations governing bank holding companies. This keeps ownership stakes small, and limits investor leverage in demanding reforms from management. In addition, investors in banks tend to rely on official sector supervision to provide an additional level of monitoring beyond what is undertaken by senior management or the board. Government oversight can build a sense of complacency or an abdication of opportunities for greater shareholder or bondholder questioning—what economists call a moral hazard problem. Moreover, investors are largely not insiders. They lack the daily insight and monitoring capability to assess a firm's culture. Their calls for reform will likely be non-specific, and therefore less persuasive.

So what's an investor to do? There are several options. An investor can be choosier about the financial institutions they choose as counterparties. Investors are consumers of financial services. They can decide not to do business with banks that are disreputable. Further, an investor can vote its shares in favor of more progressive reforms. This may involve voting against a director seen as resistant to reforms, or in favor of ballot items mandating changes to governance or incentives.

Investors can also request meetings with bank managers and raise questions about culture and governance—an approach described as "engagement." Those questions, and any accompanying advice, may be persuasive if based on experience learned from other industries. Institutional investors who meet with hundreds of firms a year can offer different perspectives on common corporate problems of governance, growth, internal costs, and competition.

Face-to-face meetings with executives and directors can provide greater insight into corporate governance than any rating score might reveal. An investor may learn, for example, whether executives have adopted an ex ante approach to deterring misconduct, as opposed to an ex post strategy of waiting for misconduct to emerge before responding. An investor might ask: Does a CEO expect that direct reports responsible for business lines will actively monitor for misconduct? Or, is behavioral management a silo for human resources, legal, compliance, or audit? Has the CEO prepared a five year plan for growing the company, and does that plan address changing governance needs?

Similar questions might be posed to a board. Has the board engaged an independent evaluation of its firm's culture? If not, why not? Does the board have a designated reputation or culture committee? If not, why not? Has the board undertaken a review of its own decisions and dynamics? If not, why not? One speaker stated that these questions are very much on the minds of boards in many industries. If a bank's board has not addressed them, then it deserves no sympathy for any misconduct that subsequently occurs.

When speaking with bank managers and directors, certain investors may be more persuasive if they convey the objectives of their constituents: governments, pensioners, union members, and universities, for example. Those constituents—to whom money managers often owe a fiduciary duty—may want to see reform within banking and other industries in which they invest. One speaker observed that investors who raise concerns about social responsibility can bolster the relevance of directors who want to push their institutions toward reform.

The panel also discussed the influence of analyst evaluations and quarterly earnings reports. There was some agreement that these data points tended to emphasize short-term gain over sustainable, long-term returns. These short-term pressures could undermine the natural, long-term interests of pension funds, sovereign wealth funds, and endowments—not to mention buy-and-hold individual investors saving for retirement.

Still, there was a difference of views as to how active investors should be on matters of culture. One speaker argued that asset managers—like banks—play an important role in society. They help to allocate capital and perform a type of intermediation (matching savers and borrowers). If performed well, this intermediation contributes to economic growth and stability. If performed poorly, the opposite results may follow. Like banks, therefore, money managers should think about the consequences of their decisions on the broader society. If so, then it is unacceptable to invest in firms solely on the basis of the bottom line, without regard for *how* a firm earns its profits (sustainably and ethically, or recklessly and fraudulently). This speaker commended money managers for making progress on certain social and environmental issues. In his view, reducing financial misconduct is easily as important as reducing toxic effluents.

Several speakers discussed whether incentives within fund and asset managers were aligned with their long-term aims and the interests of their constituents. One person recommended that institutional investors should consider fund manager compensation plans before awarding an investment contract. Are managers rewarded purely on financial performance? Or do their risk profiles, criteria for choosing investments, and engagement with portfolio companies matter too? Over what time period was performance measured—one year? Five years? Does that timeframe align with the intended length of an investment?

The panel concluded with a discussion about the opportunities that can arise from greater coordination among investors, especially those whose clients espouse a public interest. There are, of course, legal restrictions on investor cooperation. Still, there may be avenues for advocating for collaborative, pro-competitive reform, especially in the adoption of best practices.

Panel Three: The Role of Supervisors

Moderator: **Kevin J. Stiroh**, *Executive Vice President*, *Head of the Supervision Group*, Federal Reserve Bank of New York

Panelists: **Susan Axelrod**, *Executive Vice President, Regulatory Operations*, Financial Industry Regulatory Authority (FINRA)
James Proudman, *Executive Director, UK Deposit Takers Supervision*, Bank of England/U.K. Prudential Regulatory Authority
Mirea Raaijmakers, *Co-Head, Expert Center on Governance, Behaviour & Culture*, De Nederlandsche Bank

Main points

- Culture—evidenced through observable behavior—is a factor in good risk management.
- Supervisors are unlikely to prescribe a certain culture for firms, but have the experience to observe signs of a bad culture.
- Experienced researchers in organizational or industrial psychology can add expertise to supervision teams.

This panel addressed three questions: Why do culture and behavior matter from a supervisory perspective? How can supervisors influence behavior and culture in financial institutions to support our objectives of a safe, sound and stable financial system? And What have supervisors learned about their own institutional cultures?

Why do culture and behavior matter from a supervisory perspective?

The question, while basic, has relevance because, as was noted at the outset of the discussion, there is not universal agreement on whether culture is within a supervisor's bailiwick. Some argue that financial problems are usually rooted in risks associated with poor decision making behavior. Others contend that supervision should be concerned only with outcomes (quantitative or qualitative), or that questioning culture is too intrusive, or that supervisors lack the expertise to make informed judgments on a bank's culture. Indeed, several speakers disclaimed any interest in supervising culture per se. In their view, responsibility for culture lies with the firm and, to a lesser extent, with the industry more broadly. However, supervisory assessments might be improved by examining behaviors (the evidence of a firm's culture). In addition, the stability of the financial sector and the safety and soundness of particular firms may be improved through valuable outside perspectives—professional points of view other than those of lawyers and economists.

Studying group behaviors can enable a supervisor to make more informed judgments about risks associated with culture and behavior. A study of the way a group interacts, grounded in established scientific methods, can complement (rather than supplant) more traditional methods of assessing a firm's risk profile. And, if the supervisory feedback is specific, the members of the group may find it valuable in deciding how to reduce unwanted, but unnoticed risk.

A supervisor's outside perspective can offer benefits unavailable in a purely internal assessment of behavior by the firm. For example, while many (perhaps almost every) firm states in public documents that it believes in a strong, value-driven culture, many firms have encountered misconduct. There may be common reasons for this gap between theory and practice, and those reasons may come to light through a comparison of conduct across firms. Supervisors, who observe conduct across multiple firms, have more data than the individual firms on which to base observations culture. This outsider's insight can therefore benefit a firm's own self-assessment.

How can supervisors influence behavior and culture in financial institutions to support our objectives of a safe, sound and stable financial system?

Cultural weaknesses often show up as conduct risks. They may be observable in a variety of small behavioral signals—for example, in how a firm responds to an episode of misconduct. If there is a breakdown in controls, does the firm treat the breakdown as a problem in technology? Or, does management question underlying patterns in human behavior, often a result of the operating environment, that may have contributed to the problem? Firms may also signal their approach to misconduct risk by the degree to which they make use of the vast information about conduct that is present already within firms. Are they searching for patterns in past misconduct that may give early indicators of future scandals? Or, are they taking a more wait-and-see, ad hoc approach? Is senior management leading or merely reacting? And when a supervisor meets with a firm about its response to a specific episode of misconduct, how senior are the representatives from the firm who are presenting information? What does that say about the firm's approach to accountability and the seriousness of its approach to misconduct risk?

Supervisors might also ask some very simple questions about accountability. Simply asking "Who's in charge" may sometimes serve to point out a lacuna—perhaps a case where there is no consensus about who has responsibility for making a decision. Alternatively, a supervisor might inquire about how managers are held accountable for performing managerial responsibilities—completing performance evaluations, for example. Supervisors might also ask, in a review of risky transactions, when were control functions brought into the discussion process: at the beginning before the risk has been undertaken, or after the decision had already been made for business reasons? Simple questions about succession planning, hiring, and remuneration standards may also help to uncover divergences between stated policy and observable practice.

To the extent that a supervisor lacks expertise in studying behaviors, there is a wealth of knowledge among experts in organizational behavior: methods grounded in established techniques in statistics, psychology, and the social sciences (economics, anthropology, sociology, and the like). These fields tend to work through a variety of techniques, including an examination of the written record, interviews, observation of meetings, and surveys.

One speaker made the point that studying the behavior of groups in banking—of a board of directors, management committee, or trading desk, for example—is no different from a methodological perspective than studying the behaviors of groups in other contexts. All groups of people exhibit certain common, observable patterns and habits, no matter what the setting or task. What these professionals are looking for are normal human behaviors that, placed in the context of risk taking, can lead to undesirable outcomes. For example, within committees, people tend to have greater affinity toward some members as compared with others. Sometimes an affinity can cause a block or silo to develop, which may create risks of less diverse perspectives being offered to the group that is responsible collectively for making a well-considered decision. The consequences of decisions without proper consideration can be felt throughout an organization. Employees can and do see dysfunctional leadership, and adjust their behavior accordingly. The risk of reducing perspectives, however, may not be noticeable by members at the time. A speaker argued that boards and executives of financial institutions have a responsibility to increase awareness of and actively manage this risk.

Formal attention to group dynamics and social systems within firms may reduce the tendency to blame a few "bad apples" for a scandal. Firing the bad apples does not solve the problem. One possible reason is that termination is rarely a consequence for employees who knew about misconduct, but did nothing to prevent or stop it. Those employees (the apples next to the bad apples) have a form of responsibility, but are rarely held accountable in a bad apples narrative. Another reason is that behavior is, to a significant degree, a product of a particular social system, which is harder to condemn or to change. A principal lesson of social science research, reaffirmed over the last fifty years, is that context can strongly influence conduct. Behaviors reflect social norms. Some of these norms are evident in workplace habits, and are observable to supervisors. Other norms are displayed more prominently outside of a supervisor's view—at a pub after work, for example. The fact that some aspects may not be observable should not deter supervisors from looking at what they can.

What have supervisors learned about their own institutional cultures?

The panel discussion ended with a reflection on what supervisors have learned—and might change—about the cultures of their own organizations. There was consensus that the techniques applied to supervised firms can benefit supervisors too. One speaker recommended that if a supervisor intends to apply behavioral research techniques to the board of a supervised firm, it might also apply those techniques to a senior oversight function within the supervisor's organization. After all, the human dynamics at work should be the same. Similarly, the small signals of a firm's approach to behavior and culture might also be observed within a supervisory body. For example, how does a supervisor handle self-reporting of misconduct?

Midday Keynote Address

The Honorable Preet Bharara, United States Attorney for the Southern District of New York, addressed the conference about the role of culture in federal prosecutions. Culture is an important aspect not only in decisions on whether to sue or indict a bank, but also in discussions about how to reform any institution where purpose and practice diverge. In each of those contexts, he has observed three qualities of a culture that must be changed: minimalism, formalism, and silence. He went on to illustrate these points through examples from corporate investigations and prosecutions in many different industries.

Minimalism, in Mr. Bharara's view, is the attitude of doing as little as possible to comply with the rules. It means going as close to the line as possible without going over. Companies, however, are run by people. People make mistakes. A company that seeks consistently to do the bare minimum in complying with the law will surely violate it at some time, and will often get caught.

The second attribute of a bad culture—formalism—is the quality of equating what's right with what's legal. While formal rules are important, Mr. Bharara emphasized that principles matter in equal measure. He further argued that the word "compliance" tends to reinforce an internal preference for rules over standards. This tendency is perhaps a result of ease of administration; rules tend to be more binary than standards, and require less judgment. Another possible explanation is the desire to please supervisors, who may tend to be focused on rules because adherence to rules is more easily verified than adherence to standards. That approach, however, misses the broader point of supervision.

Formalism may affect leniency decisions during a criminal investigation. Mr. Bharara routinely challenges the heads of corporations to point to specific communications that emphasize complying with principles, not just technical rules. He also recounted an anecdote from a business school student, who reported that only one firm out of many asked questions about integrity during interviews. One possible, benign reason for a lack of discussion about ethics is the assumption that applicants are ethical. Even so, it may be worth repeating the obvious. More troublingly, a lack of questions about ethics may signal that the firm does not care about them.

Silence is another feature of a poor culture—and perhaps the most dangerous. Mr. Bharara posited that no matter how good an internal compliance program, there will be instances of misconduct at any corporation. What distinguishes corporations is their response, especially the willingness of other employees to report wrongdoing at an early stage. Staying silent harms the firm because it delays the attention and remedies that misconduct may require. Mr. Bharara acknowledged the human tendency to be a team player or to avoid being branded a "traitor." In some corporations, there may be a tacit understanding that whistleblowers either lose their jobs or find their job environment so difficult that they quit. It is up to a corporation's senior managers to use all of their tools—incentives, communications, etc.—to reinforce the view that speaking up is desirable, not punishable.

<u>Panel Four: Firm Progress Report</u>

<u>Moderator</u>: **Stuart Mackintosh**, *Executive Director*, Group of Thirty

<u>Panelists</u>: **Stephen Cutler**, *Vice Chairman*, JPMorgan Chase & Co.
Eric Grossman, *Chief Legal Officer*, Morgan Stanley
Michael Roemer, *Group Head of Compliance*, Barclays

Main points

- Prior misconduct—in house or at peer firms—should be a basis for proactively looking for potential wrongdoing and scandal. It would be wasteful not to learn from history.
- Firms are attempting to improve their cultures in many ways. Common features of reform programs include a greater emphasis on hiring candidates with good judgment, training on moral complexity, and encouraging employees to speak up.
- Firms agreed that some sort of database of banker misconduct would be useful. This proposal would require an act of Congress.

Wells Fargo's recent cross-selling scandal provided the backdrop—at times implicit, at times express—to this discussion among panelists and audience members. Although acknowledging that the facts of that scandal were still emerging, several speakers noted that there were already valuable lessons. Perhaps most important, reports of misconduct at peer institutions should prompt firms to examine themselves for similar problems. Cross-selling scandals are not new to banks. The mis-selling of personal insurance in the United Kingdom led to significant fines in the aftermath of the financial crisis. U.S. mortgage origination practices before the financial crisis provide further lessons about the connection between poorly designed incentives and misconduct in retail banking. While it is tempting to hope that one's own firm is doing better, hope should not excuse a lack of inquiry and evidence of reassurance.

A further danger affecting large banks lies in becoming numb to large numbers. Senior executives routinely deal in billions of dollars and thousands of employees. So there could be a tendency to see the firing of a thousand or even five thousand employees as statistically or relatively insignificant. The fault in this thinking is a failure to see facts through a different lens—how, for example, a regulator, senator, or customer might react to the news.

Scandals repeated across an industry may be evidence that, at least in some firms, prior lessons have not been taken to heart. One speaker expressed a hope that firms that weathered an existential risk will have vowed never again to come so close to failure. Panelists reported few skeptics about culture among managers of many large firms—perhaps because of the memory of the financial crisis. They observed instead a consensus that a firm's leaders must actively manage its culture—if only because of the plain effect that fines and a loss of market capitalization have had on the bottom line. Still, the panelists identified several shared concerns.

One concern is that reform takes a long time, during which a firm will inevitably confront misconduct. There is a temptation to declare that misconduct is evidence that the work already performed has been in vain. But the better lesson is that continued work is important. What is harder to see are the misconduct issues that have been avoided. Culture reform should be more like a life-style choice than a New Year's resolution. Culture forms and reforms over the long term. Steady attention is required.

Another concern is that many decisions are morally or ethically complex, and are therefore not easily addressed in training programs or written guidance. Indeed, some bankers can go an entire career without confronting (or, perhaps, recognizing) moral complexity, and so lack experience when a dilemma does present itself. They may not even recognize the dilemma at the moment. Some firms are instead focusing training on key principles and on techniques for spotting issues and escalating concerns. Others are looking at ways to overcome "group think," so that different views can more easily enter discussions and perhaps provide new insight. Training programs emphasize that responsibility for making ethical decisions cannot be relegated to a second or third line of defense, and must instead be part of business operations.

The annual turnover rate for employees—which could be in the 10 to 20 percent range at large firms—provides an opportunity to instruct a significant percentage of the firm's workforce about the right way to conduct business. Hiring and orientation processes provide opportunities to communicate a clear message that there is no acceptable level of misconduct based on return. On the other hand, a high rate of turnover also means that many employees will have a short-term employment expectation with any particular firm, and so may find it difficult to put the interests of the firm and its clients before their own interest. One speaker suggested that the short-term nature of many banking jobs requires more attention on ethical decision-making in hiring. Interviewers should, in this person's view, ask job candidates questions about ethical complexities. Another speaker noted that compensation and promotion incentives can also convey the need for good practice, regardless of the length of the employee's tenure. With all of that said, speakers agreed that banks will always fight against a tendency for short-term thinking.

The panelists also discussed the value of traditions and leadership within firms. One panelist recalled a ritual upon being promoted to vice president. The head of the firm personally lectured on business ethics and the importance of safeguarding the reputation of the firm. A generation of bankers shared the memory of that encounter. They had a common touchstone for resolving difficult decisions. Several speakers noted that their firms considered ethics when promoting to the managing director level, and have instituted advanced training on ethical dilemmas for senior employees.

Another difficult issue was the difference between incentives that help deter misconduct versus incentives that reward good conduct. Based on the discussion, the former appears more achievable than the latter. Incentives *against* misconduct are available through reduced compensation and prospects for promotion—including termination. One speaker, though, warned against unintended consequences of a "zero tolerance" approach, which could have a chilling effect on internal reporting. Honest mistakes have to be tolerated; concealment of mistakes cannot be. Incentives *for* good conduct are trickier, and may involve non-financial rewards. Recognition of good conduct under difficult circumstances—and accompanying esteem—was seen as more appropriate than an increase in pay.

The panel concluded with a discussion on areas for industry collaboration. These areas may include a standard culture survey and a database of banker misconduct. About the database, one speaker opined that the FINRA broker-dealer database worked well, and that there was no reason why a similar reporting model should not apply to the entire industry. Another speaker observed that the risk of lawsuits is, to some extent, the cost of doing business the right way. (Some employees will be fired for misconduct, and will be aggrieved.) Another risk of the database may be over-deterrence. Employers may be reluctant to report with full candor if the very existence of a report can end a person's career, regardless of the severity of the misconduct. There was agreement, though, that a national database would require national legislation, and thus the assent of Congress.

Panel Five: Measuring Culture and Conduct

Moderator: **Bill Schaninger**, *Director,* McKinsey & Company

Panelists: **Alison Cottrell,** *Chief Executive Officer***,** U.K. Banking Standards Board
Lisa Masters, *Leadership Development Executive, Global Wealth & Investment Management,* Bank of America
Melanie Stopeck, *Managing Director, Talent and Development Group,* Citigroup

Main points

- Measurement is hard, but can be de-mystified. Assessment involves the use of multiple techniques and indicators, both quantitative and qualitative. Much can be learned from the experience of other industries.
- Employee surveys remain the principal tool in assessing conduct and culture, both within firms and across the industry. Surveys, however, can incorporate bias. Results should be corroborated with other data available to firms.
- Convincing employees that senior managers pay attention to survey responses—and that there will be no retaliation for negative feedback—is essential.

The words “measurement” and “measuring” are perhaps poor descriptors of the work underway to *assess* or *judge* culture and conduct in the financial services industry. For one thing, some might dispute whether “culture” is amenable to measurement. One speaker argued that factors contributing to culture may be measured, but culture itself could only be judged. Behaviors, for example, could be categorized, counted, and perhaps priced. Incentive programs as well could be looked at from both quantitative and qualitative perspectives. But these are only some of the many inputs into a firm’s overall culture.

Others argued that culture could be measured, and pointed to surveys as the key assessment tool. Survey techniques may vary, but tend to include a mix of multiple choice and open-ended questions. Either way, the survey can be designed to identify gaps between the firm’s culture on paper and in practice. For example, a survey may offer multiple choice questions that use the CEO’s own words about the firm’s standards. Another technique might ask for a short, free text description of what those standards mean—again, using the CEO’s language. Either technique can help identify ambiguity in the CEO’s message, which can then be clarified.

There was further agreement on the value of corroborating survey results with benchmarks obtained from independent consultants. There was one suggestion that comparison to industries with critical safety concerns—to nuclear power plants, for example—might be particularly useful. Consultants may also offer new perspectives on interpreting survey data, especially in noting patterns across responses.

Regardless of the method used to assess culture, a firm also has to perform follow-up work, especially for disappointing results. Here, focus groups appeared to be a common and useful tool. Consultation with independent control functions might also be helpful in interpreting business line results.

Employee surveys may be vulnerable to biases. One speaker reported survey results began to improve sharply approximately ten years ago. Around that time, the firm changed its survey from “anonymous” to “confidential”—meaning that results could be attributable to particular employees. Recognizing this trend, and a potential fear of attribution, management attempted to reassure employees. There is now greater transparency around the review process, along with assurances that critical feedback will receive attention from senior leaders and will not impede careers.

Although most of the discussion on this panel concerned surveys, speakers identified other tools that could be useful in assessment exercises. “Big data” analytics may help interpret survey results—especially when seeking to uncover any reporting bias in survey responses. Rates of attrition and customer complaints may also corroborate (or impeach) survey data. Qualitative analysis can also help. One speaker reported a practice of requiring managers of certain desks to review snapshots of employee communications. These managers look to identify both good conduct and potential misconduct.

Finally, one speaker noted the importance of peer feedback—both within firms and across the industry. Industry collaboration could help create a stronger sense of professionalism in the industry. It should not be an anti-competitive concern to share practices on managing people, or to promote higher ethical standards broadly within the industry.

Panel Six: Technology and Culture

Moderator: **Thomas H. Glocer**, *Former Chief Executive Officer*, Thomson Reuters
Director and Chairman, Operations and Technology Committee, Morgan Stanley

Panelists: **Megan Butler**, *Director of Supervision for Investment, Wholesale and Specialists*, U.K. Financial Conduct Authority
R. Martin Chavez, *Chief Information Officer*, Goldman Sachs
Axel P. Lehmann, *Group Chief Operating Officer*, UBS

Main points

- Much technological innovation is value-neutral. What matters is how it is used, and that requires judgment about whether new products and services align with a firm's purposes.
- An inherent risk in technology is that specialization can lead to silos. This can occur among lines of business, or among a firm's leaders if one person is relied on as the "technology expert."
- Culture remains an important check on new technology gone awry. Asking questions and maintaining independent ethical judgment will remain as important for banks in the future as in the past.

The final panel of the day featured a discussion of the impact of technology on culture. One way that technology may affect the culture of a bank is through new competition in the market for financial services. Mark Carney has described this trend as a "great unbundling."[2] Large banks may become more selective and less universal. They may cede some products or markets to firms that originated in the technology sector. One speaker argued that Mr. Carney's forecast underscored the need to adopt innovation as a survival strategy. Innovation may offer greater efficiency in existing infrastructure, a lower likelihood of computation error, and platforms for new products and services. These new opportunities may allow banks to be more responsive to customers and to reach previously underserved markets. At the same time, innovation may give rise to new risks for fraud and financial crime. Controls must therefore keep pace with opportunities.

[2] Mark Carney, "Enabling the FinTech Transformation: Revolution, Restoration, or Reformation?," Speech at the Lord Mayor's Banquet for Bankers and Merchants of the City of London, June 16, 2016.

The risks that accompany technological innovation received extended attention. One panelist discussed the concept of "speed bumps" to reduce transaction speed. In this speaker's view, faster transaction speed is neither good nor bad. It creates opportunities and risks. Regulation offers one approach to minimizing risk—for example, the SEC's requirement of a certain distance of cable to create a "speed bump" of sorts on placing and canceling orders. Culture can provide another important and complementary risk management tool. A well-managed culture will place an emphasis on the alignment of purpose and practice. Developers of new trading technologies should ask how their innovations advance the purpose of the organization. Does a new product or service enable the firm to better serve its customers? Or might an innovation create risks in tension with a bank's social responsibilities?

A firm's managers need to understand the technology in order to recognize potential externalities and unintended consequences. That requires a broad base of technological understanding among executives and directors. This is *not* to say that the leaders of banks need to have a mastery of algorithms or coding. And, it perhaps goes *without* saying, that managers need to rely on people who know more than they. Managers and directors, however, need enough of a baseline understanding to keep current with the general pace of technological innovation in the industry, and to be able to ask probing questions. For example, they need to understand how electronic trading works to be able to ask whether it is acceptable for their firm to submit and immediately cancel orders if there is no true intention of trading. (And to argue credibly that, perhaps, this practice is *not* acceptable.)

One speaker connected questions about the propriety of a new product or service to other themes mentioned earlier in the conference—to Preet Bharara's warning about minimalism and Onora O'Neill's advice on articulating corporate purposes, among other points. For example, if new technology can flag technical non-compliance, is there a risk that employees will conflate an automated answer with an ethical decision? If the terminal says OK, may I execute a trade? Panelists agreed that software cannot substitute for judgment about the propriety of an action in light of the firm's purposes.

Another way technology can affect culture is through the creation of silos. Citing Gillian Tett's new book, *The Silo Effect*, one speaker noted that silos tend to emerge in areas of specialization. Specialists tend to rely on jargon and technical expertise, which can be inaccessible to outsiders. Over time, specialization can lead to isolation. Isolated groups can develop their own cultures, creating the possibility of cultural conflict. This phenomenon is common to many industries. And other industries have devised ways to overcome silos. One method is integrating project teams, preferably from the beginning of a project. Experienced bankers, compliance officers, and lawyers should all have a place on a development team. Proposals generated without legal or market perspectives might need greater scrutiny for unforeseen risk.

"Blockchain" also featured in the discussion. Several speakers debated whether distributed ledgers—or any technology, for that matter—can take the place of personal trustworthiness. In general, there was agreement that distributed ledgers can mitigate problems associated with a concentrated risk of failure. But technology alone will not repair the industry's reputation. At best, innovation may make products and services more reliable, and thereby provide a better basis for trust. Innovation will not necessarily make the industry more honest.

Panelists concluded the session with advice that banks not see tech companies as incompatible. Thirty years ago, typing was an unusual skill among bankers. Today it is rare for a memo to be dictated and sent to a typing pool. The same may happen to coding at banks. Banks may learn from technology—not only how to code, but how better to serve customers.

Closing Remarks

Bill Dudley concluded the conference with a few observations on the day. First, there was broad consensus that reforming culture is in the best interest of banks and society, and that a good culture complements the goals of bank regulation and supervision.

Second, changing culture is possible, albeit difficult. Mr. Dudley cited the candid discussion of survey bias as an encouraging sign that the industry was working through its challenges. He warned, however, that reform efforts cannot be episodic. Sustained attention is required.

Finally, Mr. Dudley offered some thoughts on the potential for and potential limitations of regulation. Accountability cannot be abdicated to the official sector, and responsibility must mean more than merely following the rules. Following the law is necessary, but not sufficient, to achieve the public and private purposes of banking.