

CULTURE IN BANKING
(NY Fed. 18th June, 2018)

1. When I was asked to review SIFI governance 9 years ago, the principal focus was on hard financial risk. Culture barely entered the picture. This omission reflected that principal concern at the time was the causes of the global financial crisis. These were abundant. But cultural failure as we discuss it today was not among them. The paradox is that many banks are probably more deserving of trust today, more trustworthy, than a decade ago, despite the fact that measured levels of trust persist in being much lower.
2. But this is emphatically no time for complacency. Awareness of standards of behaviour in banks is now greatly amplified by social media, client and customer mobility and heightened political interest. Trust is a powerful driver of customer and client attitude, and the presence or lack of it as part of brand is set to become a more significant differentiator among banks. It is easily dislodged by inadvertent slippage and, once lost, it is hard to rebuild. But it is not only a source of competitive advantage: the reputational fallout from conduct failure in one entity may have a contagious effect, besmirching the whole industry. Plainly this is what has happened.
3. Bank balance sheets are now much more resilient. This has been achieved through clear regulatory imposition on “hard” balance sheet items such as capital, leverage and liquidity. But regulatory resolution of this kind is not available in respect of “soft”, behavioural issues. Values, and performance against them, are essentially qualitative matters. Culture has to be owned by the board and cannot be imposed from outside.
4. Looking ahead, I will try to distil from the now very large accumulated experience – much reflected in discussion here today - core themes for good practice. I avoid the term “best” practice. Where there is determination as to direction of travel, there will always be more than one way of getting there.
5. First, **governance**: responsibility for setting the behavioural values of the entity is unequivocally for the board. A board is unlikely to discharge this responsibility to the full without frequent and regular attention to culture as a major board agenda item. The demeanour of the CEO, the degree to which he or she embodies the desired values and the way in which senior management engages with the board on behavioural matters speaks volumes. In my view, the board’s capability and the visibility of its continuing commitment is likely to be enhanced by constitution of a dedicated board committee on culture and behavioural

issues. Members might be encouraged, and should in my view be expected, to “kick the tyres” through visits to business units or corporate functions. Such dip-sticking appraisal does not require detailed understanding of technology or process, but an outside board member’s opinion on the behavioural atmosphere and tone at the front line or in the engine room could be critical input. Such engagement and time commitment should surely not be an unreasonable expectation?

6. Second, **executive accountability**: commitment to culture in the executive suite need to be continuously exemplary. Any incident of perceived behavioural failure at or near the top can exert a powerfully corrosive effect unless it is effectively and demonstrably redressed in short order. The objective for the bank’s leadership is to create a working environment in which working to the right behaviours is natural and the norm for every staff member. Good conduct is not merely the avoidance of purposeful misbehaviour: the leadership and management challenge is to match focus on reducing bad conduct with the positive of promoting good behaviours that aligns with and furthers the bank’s purposes and values. The inseparable corollary is that financial incentives and opportunities for career advancement should be as dependent on “how” a staff member behaves internally vis a vis colleagues and externally vis a vis clients as to the “what” of the revenue to which he or she contributes.
7. To be dependable, a bank’s culture has to be embedded from the top to the bottom of the organisation, and the task is incomplete without reassurance to the CEO and board from good intelligence flow. It should be no more acceptable for a senior executive to be unaware and inattentive to behavioural weakness in a business unit or function than to be uninformed on a failure in profit and loss performance. The responsibility of the senior executive and, ultimately, the CEO, is inalienable in this respect. Ignorance and a purported defence that “I didn’t know” is not acceptable, implying either or both misjudgement in delegation or inadequacy in the reporting process. The CEO needs to be as alert to how business is being done as to the P and L contribution that it is generating.
8. Third, **time horizons and reporting**: listed companies report very fully on their financial performance on a quarterly basis, frequently giving guidance where the market consensus differs from the internal expectation of numbers. All this relates to immediate and hard financial performance, commonly without reference to behavioural matters. The core criticism of such quarterly reporting, which led to its removal as a regulatory requirement in the UK and the EU, is that it risks leading to excessive focus for company boards and the market on the short-term. This is a concern that I fully share. An entity under market pressure to show stronger short-term financial performance may be induced to cut corners or, at any rate, give lower priority to behavioural matters that may get in the way of immediate returns. It is clear that this is precisely what happened in one or more banks where board and executive pressure was applied to increase

account openings and cross-selling. So it is in my view timely and welcome that the corporate practice of quarterly earnings guidance is coming under increasing critical scrutiny from some major business leaders in the US. I would hope that this debate goes further to address the continued appropriateness of the mandatory requirement for quarterly earnings reporting.

9. Given the potentially long timeline for repairing culture, annual reporting on such issues should be the norm. This should be substantive, setting out the fully the cultural values set by the board with an account of progress, with qualitative assessment complemented to the extent practicable by reference to survey data. The report should be by the chairman of the board or of the dedicated board committee, drafted with the same seriousness as to tone and content as the hard financial numbers in quarterly or annual financial reporting. The critical term here is “authentic. Boards will not be believed if their communication is spun in a way that simply presents a positive gloss.

10. Fourth, **stewardship**: many bank shareholders have probably lost more in value from penalties associated with behavioural failures over the past decade than from weakness in hard financial performance. Even where cultural weakness persists but the consequences or penalties are not immediately dramatic, shareholders will sustain loss over time through weaker overall performance and attrition of brand value. The interests and obligations of most institutional asset owners, and thus their fund managers, are preponderantly medium to long-term, hence the priority of their interest in behavioural patterns and brand value in their portfolio companies. This obviously has special relevance in the case of banks, where the dependability of behaviour has a significance akin to that of, say, engineering quality in a manufacturing company. The culture of a bank is, for its shareholders, a key asset and the fact that the asset is intangible does nothing to vitiate its economic significance. For a bank, its demonstrated culture, and the trust that it engenders, is likely to be the single biggest ingredient in brand value.

11. A major market development over the past decade is the greatly increased share of index management. But this does not reduce the interest of ultimate asset owners in behavioural performance, not least since most stocks in their indexed portfolios are likely to be held on a relatively long-term basis. This underscores the obligation of asset owners to ensure that their interest in sustainable performance is appropriately reflected in the terms of mandates awarded to third-party fund managers. Whether or not a portfolio is indexed, such mandates should call for major fund managers to complement their focus on short-term financial performance with attentiveness to the quality and sustainability of a bank’s culture, critical for its financial performance in the longer-term. Such appraisal, by a senior and experienced governance capability at the fund manager, should include assessment of the commitment of the chairman, board and CEO to embed and sustain a resilient culture and the

credibility of the board's report on progress being made. The ultimate object would be for the fund manager to indicate supportiveness for a board which is demonstrably on the right cultural track but, alternatively, an unmistakable signal of dissatisfaction where it is not. Given the greatly increased importance of culture, there may be a case for collective initiative by several shareholders where a board is inattentive to shareholder concerns and resistant to change.

12. Ownership of a bank's culture is inalienably for the board. But alongside active stewardship engagement by shareholders, appropriate high level guidance by the supervisor can be critically influential. The societal interest in such supervisory oversight stems from the fact that trust in an industry as critical as banking is a common good which can be all too readily negatively impacted by behavioural failure in a single entity. As such failures often come to light only after the event, the negative reputational overhang can persist long after an occurrence of misconduct, even after the specific issue has been addressed. As leaders of the banking industry are now painfully aware, mistrust has a long tail and rebuilding trust may unavoidably be a slow process.

13. In this environment, supervisory influence is probably most effectively brought to bear through appropriate communication with the chairman and board to underscore the supervisor's keen interest in good behavioural outcomes, and in the board's commitment to the inputs to achieve them. This approach, clear but not intrusive, has in my experience long characterised the stance of the New York Fed. It is in my view a great credit to Bill Dudley and the Fed. team that they have judged and sought to exert positive influence in this sensitive space, separate and distinct from formal regulatory direction, in the way that they have. I hope that this practice will continue under the Fed's new leadership.

15. The bottom line is that for boards, executives, shareholders and supervisors the task, like keeping fit, has no end point, and sustainable bank culture demands substantial proactive attention on a continuous basis.

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