As events evolved last week around Deutsche Bank and Wells Fargo Bank so William R. Rhodes was interviewed by Bloomberg radio and CNN (*Quest Means Business*). He highlighted his concerns about reputational risk, conduct and culture. He explained the importance of these issues in an article that was published on September 21, 2016.

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Reputational Risk, Corporate Culture and the Board

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Even when top executives in banks recognize the crucial importance of reputational risks, the approaches and processes are not sufficiently adequate. One of the problems relates to the pressure to produce profits and reports that please investors every quarter. Photo CC/Flickr

Public trust in banks has been severely diminished in recent years coming out of the Great Recession. This poses threats to the financial system and to economic growth. In the United States today, we see this raising not only the risk of increased regulation, but also the threat of mounting political support to break up the biggest banks.

A constant series of prominent misdeeds by banks ranging from the Libor scandal to mortgage-backed securities troubles, nepotism and solvency inevitably diminish public confidence in all major corporations, not just those in the financial sector.

Restoring public trust and confidence relates explicitly to issues of reputational risk, and actions require forthright leadership by corporate boards. Banks must deal with four major areas of risk: credit risk, market risk, operational risk and reputational risk. I believe that reputational risk is by

far the most important, because if a corporation loses its reputation, it can go out of business. In recent years, the Group of 30 has undertaken a series of studies to review the global financial system in the light of the events that created the Great Recession. The most recent G30 report in this series, which I developed with several colleagues, is called *Culture and Conduct: A Call for Sustained and Comprehensive Reform.*

The report interviews nearly 80 leaders of banking in 17 countries, which produced four broad findings:

- First, weak corporate culture and widespread inappropriate conduct contributed to the 2008/2009 financial crisis and, in diverse forms, have manifested themselves since then.

- Second, these failings eroded public trust in banks and undermined confidence in the financial system. Trust is essential for sustainable success and solid culture; a well-embedded culture is a competitive benefit for a sustainable financial sector and for individual banks.

- Third, at best, we have seen piecemeal reforms with regard to culture and conduct in some major banks. What is both urgent and essential is that reforms are comprehensive; they need to fully engage the managements of banks, the boards and official supervisors, and a comprehensive approach demands actions that reach well beyond regulatory compliance.

- Fourth, that each enterprise develops its own culture. It determines the core values that are central to the culture. Culture cannot be imposed on a firm through new rules and regulations; each enterprise develops its own culture and there is no size that fits all. You cannot impose regulations for culture in the same ways you can for liquidity and capital. We believe there are important roles for regulatory authorities, but we do not believe that more regulation is a desirable path.

Against the background of these findings, the challenge was to find the practical ways to define the key pillars of a comprehensive reform approach to culture and conduct. The interviews showed that while many senior managers in banks had started down the right road and made the right public comments on culture, there was a significant failure to implement.

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Even when top executives in banks recognize the crucial importance of reputational risks, we found that approaches and processes are not sufficiently adequate. One of the problems relates to the pressure to produce profits and reports that please investors every quarter. The focus on short-term profits all too often pushes aside what needs to be the paramount duty and responsibility of banks: to serve their customers and their communities first.

After extensive discussions, we finalized a series of key findings that fall into four broad areas of recommendations, starting with the board:

1. **Boards of Directors.** When it comes to culture and conduct, the board must be a vigorous leader; it must set the right cultural policy and take full responsibility. Issues of conduct and culture need to be important considerations when critical top management

compensation decisions are taken. At the same time, boards have key roles in establishing the guiding criteria for determining internal promotions and external hires. The G30 proposed that banks emphasize diversity (cognitive, gender, racial, background) throughout the organization as a key contributor to improved values and conduct and sustained behavioral change.

In assuming responsibility in the crucial area of culture, the board has an obligation to monitor performance. Scorecards for this purpose are necessary. A diverse board can strengthen the focus on all elements of culture. Those firms that understand that culture is core to their business and central to their internal and external messaging throughout the company do better than those that are addressing culture from a regulatory or reactive standpoint. Boards should receive reporting of various indicators (complaints, whistle-blowing, etc.).

2 **The tone at the top** set by senior management is absolutely key. The executive team must recognize that a major priority on a continuing basis is to promote the corporate values, to ensure that good conduct is valued and that processes exist to correct weaknesses. The approach must go well beyond just what is required in legal and regulatory terms. Compliance procedures are not enough. The approach must be driven by a clear sense of serving the customer, serving the community and doing the right thing.

For global institutions engaged in a wide array of diverse operations, it is exceedingly difficult to communicate the tone in the most effective manner. The board chair, and where applicable, the lead director, the CEO and the senior managers, must communicate right through middle management to the teller level. They must walk the talk every day. They must be seen doing so inside and outside their institution by the public.

3 **Policies and processes** must be in place that use the compensation system to incentivize good conduct and penalize bad behavior. Executives must be dismissed if necessary, even at the most senior levels. Recruitment policies and staff development approaches need to assign far higher priority to culture and conduct.

Effective whistle-blower protection policies also need to be in place. Now, we know that there are not more whistleblowers in businesses because of real fears of losing their jobs and other forms of retaliation. This needs to change, not only because it is right, but because it is far, far better for banks and their top officers to learn about actual and potential problems from the inside, versus seeing reports from whistle-blowers in the press or in documents in the hands of regulators and politicians.

With regard to processes, let me underscore that top executives who delegate responsibilities for compliance and risk management too extensively to HR and legal departments are making a mistake. The chief compliance office and the chief risk officer need to have direct lines of report to the CEO and access to the full board and the appropriate committee of the board of directors. They need to be able to report their concerns at the highest levels in the most direct manner.

4 We have called previously for a far more robust, high-level exchange of views between

senior management, boards and official supervisors. We believe this is essential in the realm of culture and conduct. We believe supervisors need to acquire the skills to fully be able to address these issues, to regularly engage at the highest levels of banks in constructive discussions about conduct performance and the effectiveness of monitoring system. There needs to be effective benchmarking of key attributes that inform on conduct and culture that can serve as the basis for such discussions. The approach of the regulators here should be: "trust but verify."

Public trust in business must be strengthened. The cultural bar must be raised: This is not just about right and good ethics; it is also essential for ensuring a sound and healthy balance sheet.

William R. Rhodes
President and Chief Executive Officer of William R. Rhodes Global Advisors and author of *Banker to the World: Leadership Lessons from the Front Lines of Global Finance*; Co-Chair, G30 Steering Committee for the 2015 report *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform*.

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