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Breakingviews

Guest view: Banks need to lead on cultural change

By Guest Contributor
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By William Rhodes

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The scale of bank regulatory reforms in recent years has been unprecedented, but public trust remains low. While lenders have taken actions to boost capital, reduce leverage and strengthen liquidity, many banks have not shown the same commitment to adjusting their core culture, including their risk culture, to address key weaknesses.

I have long argued that there needs to be a vigorous public discussion about cultural changes in financial institutions and now, finally, this is starting to happen. I expect that the Financial Stability Board, as well as national regulatory and supervisory authorities on both sides of the Atlantic, are likely to insist on reforms to instill better behavior at banks.

Today, however, too many people at the helm of many banks have still not adequately recognized that a deficiency or failure of culture, including reputational risks, can be as destabilizing – or more so – to an institution than problems of capital or liquidity.

Culture is about behavior. It is about how individuals and groups act even when they are not being observed. A good culture underpins and is reflected by the actions of a company's employees. The cultural tone of a firm is set by the actions of the chief executive, his or her top management colleagues and the board of directors, while being reflected in the actions taken daily by middle management and right down to the teller level.

New values-driven cultural frameworks are required at many banks. These need to include, at a minimum, compensation incentives and disincentives that promote integrity-led employee behavior. There also need to be more explicit guidelines with regard to managing "know-your-customer" regulations and guarding against all forms of illicit financial flows.

The reforms should embrace ways to set the institution's risk appetite so that it is clear to all employees that profit maximization needs to be consistently viewed within a context that places the interests of customers and the reputation of the firm in top positions.

When I started in banking almost 60 years ago, and for many decades thereafter, the golden rule at major banks was that a good reputation was paramount. Increasingly in recent years, largely due to perceived greater shareholder pressures for more profitable performance, as

well as increased competition to hire talent, compensation maximization has taken center stage in some segments of the banking industry, and this must change.

As new frameworks are put in place it is essential to strengthen the accountability of managers for activities that not only relate to credit risk, market risk and operational risk, but also to all aspects of reputational risk. Banks need to establish board governance committees with explicit responsibilities to monitor corporate ethics and culture.

This was not done in the early 1990s when some banks in the United States and UK introduced new codes of conduct. The failure to explicitly ensure that boards of directors monitored the implementation of these codes was one reason why in many cases they proved to be ineffective. We need to learn from that past experience and ensure that new approaches are embedded, sustained and monitored.

To make this meaningful, institutions need to develop ways to stress test their corporate cultures to highlight weaknesses and establish benchmarks for measuring performance. Banks are stress testing for all kinds of operational risks, but they are not doing enough on the reputational risk side. They also need to ensure, if they have not done so already, that programs covering whistleblowers are effectively implemented.

Many banks have responded to the public concerns by introducing extensive employee communications and compliance training. These are important steps, but they continue to place the blame for serious problems on individual rogue employees, rather than fully recognizing the responsibilities of senior management and boards of directors.

The Group of 30 has published two reports in recent years that have proposed far-reaching changes in banks with regard to many aspects of operations and relationships with regulators and supervisors. These reports have touched on issues of culture and a further report is now being prepared, which has been encouraged by leaders of the Financial Stability Board and other supervisors and regulators, that will go into greater detail on cultural matters. The G-30 has called for informal exchanges between CEOs, boards of directors and official supervisors on a regular basis on issues of corporate culture.

This is the right balance. The supervisors can set regulations on behavior in a range of areas, from “know-your-customer” to applicable standards for foreign exchange trading. But an effective corporate culture needs to be designed explicitly for the unique characteristics of each institution and there is no one-size-fits-all approach that the authorities can impose on all banks that works when building such a culture.

There is enormous public skepticism that the leaders of banks will take decisive actions that deliver real cultural change. It is now clear that if bankers fail to move rapidly and comprehensively, then the regulators will seek to dictate the approaches that banks should take.

Moreover, further misdeeds will assuredly prompt the authorities to impose even greater fines and I am convinced that bank shareholders will not take this lightly. The pressures are now mounting for senior managers and members of boards of directors at major banks to lead decisively and implement the core cultural changes that are needed to restore public confidence.