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Culture/Behavior Issues in Financial Services

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Remarks by

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Good morning. 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. It raises not only the risk of increased regulation, but also the threat of mounting political support to break-up the bigger and larger banks.

Restoring public trust and confidence relates explicitly to issues of reputational risk. 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 bank loses its reputation then it can go out of business.

Even when this is recognized as a general proposition, we find intense difficulties in many institutions in translating this into practice. 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. There were two crucial lessons that were drummed into me when I entered banking more than 50 years ago – first, constantly ensure that my highest priority was safeguarding and promoting the good reputation of the bank. Second, a crucial priority is to always provide the best possible service to the clients of the bank.

Too many bankers in recent years have set these essential priorities to one side in the drive for profitability. Also culture is unique in any given institution, each bank is different. There is no one size fits all. Culture is not like capital and liquidity that can be mandated by the regulators and supervisors. The role of the regulators is to monitor the implementation of bank culture (Trust but Verify).

Now let me turn to the work of the Group of 30. As many of you may know, the G30 was established in the late 1990s to bring together central bank governors, finance ministers, bankers and leading experts from the across the world to review and analyse the most pressing issues confronting the financial system. Over the last few years, I have been involved in the leadership of a G30 working group engaged on developing reform recommendations following the financial crisis of 2007/2008. We have published three related reports, the most recent deals with culture and conduct and is based on nearly 80 interviews in 16 countries with central bankers and senior supervisors, bank board chairs and members, CEOs, and senior managers.

The latest report, which is our topic here today, is titled:

Culture and Conduct: A Call for Sustained and Comprehensive Reform

We are fortunate to have here with us Michael Zeltkevic Head of Financial Services in the Americas, representing Oliver Wyman, who worked with the Group of 30 on writing this report.

The previous reports were titled **"Toward Effective Governance of Financial Institutions"** and **"A New Paradigm: Financial Institution Boards and Supervisors"**

In our new report we concluded that most banks must aim for a fundamental shift in their overall mindset on culture. Banks must go back to placing service to individual customers and to communities first.

Banks must promote corporate culture in disciplined ways, imposing sanctions on pay and terminating staff when necessary, even at the highest levels, when there has been wrongdoing. The bar must be raised as the failure to adequately address reputational risks is costly and over time it undermines the viability of institutions. This is not just right and good ethics, it also makes good business sense, and it is essential for ensuring a sound and healthy balance sheet.

We recognize that many banks since 2007/08 have significantly strengthened their balance sheets by writing off problem loans and increasing their capital and liquidity and are in good shape to meet the many challenges that the current global economic storms are producing. Moreover, as a result of exposed abuses, fines and agreements with authorities to implement internal risk and management reforms, we have seen a good deal of repair taking place in many firms. OK, that is the good news.

However, at least within the United States, public perceptions of repair and reform are largely absent. You don't have to be a micro-observer of our election campaign to recognize the intensity of the demands from the left and the right for far-reaching banking reform. This is a response to continuing perceptions that the culture and the conduct of banks is self-serving, rather than serving the broader public. Indeed, we recently heard Neel Kashkari, governor of the Minnesota Fed bluntly call for breaking-up the banks. We also continue to constantly hear the refrain that top bankers have evaded prosecution and jail.

Our recommendations in our most recent G30 report fall into four broad areas:

1. The tone at the top set by **senior management,** but it must go right through middle management and right through to the teller. 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 what is just required in legal and regulatory terms. The approach must be driven by a clear sense of serving the customer, serving the community and doing the right thing.

2. **Policies and processes** must be in place that use the compensation system to incentivize good conduct and penalize bad behaviour. 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 need to be in place.

3. **Role of Boards of Directors** is key – need to be vigilant in setting the right cultural policies and then monitoring 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. Banks need to establish board governance committees with explicit responsibilities to monitor corporate ethics and culture.

4. What we do not need is more regulation or the breaking up of the banks. 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, about the effectiveness of monitoring the system.

Our report is winning a great deal of attention worldwide. New values-driven cultural frameworks that are required at many banks need to include, at a minimum, compensation incentives and disincentives that promote integrity-led employee behavior. 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.

I want to emphasize again, that the commitment to building a sound culture and excellent conduct must run absolutely throughout an institution. Our G30 research, for example, found that even when there is a good tone from the top, it is often the case that the majority of middle management fail to adequately take cultural and conduct matters into account and often revert to traditional performance criteria (such as revenues, profits, return on equity); and, there is often a lack of progress in improving culture and values due to entrenched behaviors and an insufficient buy-in on conduct and values initiatives.

Finally, it is in the interest of all those responsible for the financial system and for all stakeholders in banks to come together in promoting comprehensive reform with regard to banking culture and conduct. Resistance to change needs to be overcome. Banks need to clearly understand that if they fail to act with urgency now on this kind of agenda, then public pressures for more regulations, even for breaking up the largest banks, will increase.

Thank you.

Some background examples for use during the discussion

For the senior management and boards –

- We need committed senior management and board to assure accountability
- The tone from the top must be heard in the middle and echoed from the bottom.
- Boards should be responsible for agreeing to and monitoring culture.
- Boards should receive reporting of various indicators (complaints, whistle blowing, etc.).

On performance management and incentives –

- Culture must be part of the equation in annual appraisals; current practice varies widely, from 50/50 split between performance metrics and cultural judgments, to 100 percent performance and no cultural factoring.
- Staff must understand the implication for failing on values and behavioral metrics.
- Firms should champion good values and recognize those that exhibit commitment to go above and beyond in displaying the desired behaviors and norms.
- Negative sanctions matter, but positive reinforcement matters just as much if not more to communicate norms.

On staff development and promotion. –

- Staff training and embedding and internalizing a firm's culture cannot be a one off episodic process. It should be a regular dialogue.
- Senior staff should lead it but it should cascade through the firm.
- Training should recognize that common cultural norms need to apply somewhat differently in differing contexts.

On the three lines of defense –

- The first line- must own the culture and values of the firm.
- The second line – which function holds it, should be clear and have the necessary stature to respond when issue arise.
- The third line should step in ex post where failures are found by the first and second line.