Conduct & Culture
Senior Bankers Conference in Toronto, Canada, April 30, 2016.

Opening remarks to a conference organized by the Group of 30 and Oliver Wyman

William R. Rhodes[1]

Co-Chair, G30 Steering Committee for the 2015 report
Banking Conduct and Culture – A Call for Sustained and Comprehensive Reform

Good morning and let me thank you Michael[2] for your introduction and thank Oliver Wyman for the work that it has been doing with the Group of 30 to support the most recent G30 study: ***Culture and Conduct: A Call for Sustained and Comprehensive Reform.***

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 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.

With these themes on our minds here today let me state how pleased I am that this meeting is taking place. The timing is excellent. The "Panama Papers" have recently added to the intense debate across the world about banking and money laundering and I know that debate has also been vigorous here in Canada. It has contributed to discussions on the central focus of the Group of 30's new report, which is public trust in major international banks.

On a personal note, I recall that 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.

In a few minutes I will get into the critical issues that we confront in the G30 in formulating our report and its recommendations. It is important to note at the outset, however, that a prominent Canadian and currently Governor of the Bank of England, Mark Carney, in his capacity

---

[1] William R. Rhodes is *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".*

[2] Michael Zeltkevic, Partner and Head of Financial Services in the Americas, Oliver Wyman (OW).

as Chairman of the Financial Stability Board, encouraged the G30 to undertake this study. Indeed, as Governor of the Bank of Canada, when he became the first FSB Chairman, he encouraged the full series of three G3 reports that have looked at the needs for banking reform resulting from the financial crisis. He personally encouraged me to take a lead on these studies. The report being discussed here today is the third in this series of studies. The previous reports were titled *"Toward Effective Governance of Financial Institutions"* and *"A **New Paradigm: Financial Institution Boards and Supervisors."*** Let me note that Oliver Wyman has played important roles in developing these reports.

I would also to note that our G30 work has been greatly aided by another Canadian, who is speaking on the first panel today, Nick Le Pan.

Since the publication of our report last July, we have had top-levels forums at the New York Fed, in Paris and in London, as well as in South Africa, Latin America and in the Middle East. Most recently I had the opportunity to present this report to the annual meeting in Washington DC of the International Bankers Association. We expect to have meetings on the report in Japan, China and Singapore and to see it translated into Mandarin, Japanese and Spanish. The report has attracted very substantial interest and is one of the most requested in the G30's history.

As we move ahead today with our discussions it is, of course, important to stress that Canadian banks did far better than many of their major international competitors when it came to managing risk, notably in the mortgage and housing sector. Trust in banking here has not been as badly damaged as in the U.S., the U.K. and in Continental Europe. There is no doubt, however, that when we talk about global banks today we have to recognize that public trust is a major issue.

The pressures on banks to restore public confidence are made all the more difficult by the strains in the international economy. World economic growth is low and the prospects for the immediate future are not bright. The depression in commodity prices is just one major factor that has severely impacted economies in the advanced industrial countries as in the emerging market economies.

China's economic growth rate is slowing, possibly to just above 6%, while China at the same time face severe financial sector challenges. This is particularly the case when you note the tremendous growth of credit and the rise of non-performing loans in the banking system, as well as in the shadow banking system, alongside very high borrowing by municipalities and state owned enterprises. The Financial Times published an article by me on these dangers last week.

We are seeing very weak growth in Europe and in Japan, while U.S. growth is barely above an annual rate of 2%. Moreover, we are in a period of slow global economic growth, and for a third year we are seeing world trade growing at no more than 3%. Further, the financial system faces significant challenges, as the scale of international capital flows is formidable and volatility across all markets is likely to continue to be considerable.

In these difficult and challenging times many banks must also ensure that they act to strengthen their approaches to conduct and culture. In developing our report the G30 undertook nearly 80 interviews with leaders of banking in 17 countries, including Board directors as well as members of senior management here in Canada. These 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, 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 of directors 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 as 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 our challenge was to find the practical ways in which we could define the key pillars of a comprehensive reform approach to culture and conduct. Our 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.

Even when top executives in banks recognize the crucial importance of reputational risks, we find 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.

I think it is important to note that U.S. 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 continue to constantly hear the refrain that top bankers have evaded prosecution and jail and that this is wrong.

These views add urgency to the key findings in our G30 report. Permit me to summarize them: Our recommendations fall into four broad areas:

1. 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 what is just 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.

   In large, 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, 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 to do so inside and outside their institution by the public.

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. 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, than from seeing reports from whistle-blowers in the press or in documents in the hands of regulators and the politicians.

   Let me underscore with regard to processes that top executives that 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.

3. **Boards of Directors** – 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. In some cases we are going to need new approaches to Boards, where we have both diversity in Board members as well as in-depth expertise. When it comes to culture and conduct, the Board must be a vigorous leader and take full responsibility.

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, about 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.”

Ladies and gentlemen, given levels of public trust in banks – and here I am talking quite specifically about conditions in the United States and in much of western Europe - banks have a direct choice: they can either move more swiftly and publicly to institute far-reaching culture and conduct reforms, or see a whole host of new regulations and even laws come crushing down upon them.

Thank you.

<u>Some further examples of actions from the G30 report:</u>

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 be 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.