GOVERNANCE AND CULTURE REFORM
FEDERAL RESERVE BANK *of* NEW YORK

REFORMING CULTURE AND BEHAVIOR IN THE FINANCIAL SERVICES INDUSTRY

Progress, Challenges, and the Next Generation of Leaders

The Federal Reserve Bank of New York ("New York Fed") held its fourth conference on reforming culture and behavior in the financial services industry on June 18, 2018.

Key themes included:

- There is international consensus that culture is an important part of a firm's sustained healthy performance. The industry and the official sector are increasingly collaborating across borders to promote higher standards for conduct and to address common cultural challenges.

- The reputations of firms are as interconnected as their operations. The industry must work together to address culture, as a problem at one firm affects its peers.

- Firms should avoid becoming complacent about banking culture and conduct as broader economic conditions improve.

- Organizations must assess and reform their incentive structures (including compensation, career advancement, and other forms of recognition) to align with values, business strategy, and customer interests.

- Senior leaders—boards and executives—can use a variety of methods to assess their cultures and subcultures. Supervisors and regulators can offer feedback on culture and conduct that combines independence with broad knowledge of industry practices. Boards in particular may find this input helpful.

- Supervisors in many jurisdictions are exploring how to incorporate cultural and conduct assessment into their work, although their approaches vary. Some assess culture under a prudential supervision mandate, others under a conduct mandate, and others through integration into more traditional concerns about safety and soundness, risk management, and financial stability.

- As the financial crisis fades from institutional memory, it will be increasingly important for firms to impart lessons learned from the brink to the next generation of cultural leaders. Firms can partner with universities to develop training programs that emphasize sound ethical judgment alongside technical proficiency.

Opening Remarks

Bill Dudley, the New York Fed's retiring President and CEO, welcomed this year's conference participants, including his successor, John Williams.[1] Mr. Dudley said he was proud of the work that the New York Fed has done to advance the global conversation around culture.

Mr. Dudley made three main points. First, he urged institutions to evaluate incentives. Firms need to ask themselves if their compensation aligns with their values. He pointed to the Group of Thirty recommendations, and noted that his proposal for performance bonds had not yet been embraced by industry.

Second, he urged firms to engage in benchmarking. Pointing to the work of the U.K. Banking Standards Board ("BSB"), he encouraged firms to both understand the shared norms within their firms and compare their cultures to other firms. While some have cited legal risk associated with assessment and information sharing, Mr. Dudley urged banks to take that risk, as the risk of inaction can be greater.

Third, he urged banks to share more information with one another about employee misconduct. He acknowledged the U.K.'s "regulatory references" program in this regard. Nonetheless, other information sharing hurdles remain. He noted the work of the Financial Stability Board ("FSB") in developing a toolkit to avoid "rolling bad apples," employees with undisclosed records of misconduct who move between firms.[2] He also asked the audience to consider the costs and benefits of requiring firms to share information on employee misconduct with one another.

Finally, he urged candor from all industry participants. To official sector representatives in the audience, Mr. Dudley recommended that they take account of culture in their approaches to supervision. He again directed their attention in particular to assessing whether a firm's internal incentives promote the organization's stated values and business models.

[1] Mr. Dudley's full remarks are available at: https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/Dudley-cultureconference-180618.pdf. *See also* William Dudley, "Coda: Candid Reflections on the Culture Conversation" (June 15, 2018), *available at* https://medium.com/new-york-fed/coda-candid-reflections-on-the-culture-conversation-9fa61fb25ec1.

[2] http://www.fsb.org/wp-content/uploads/P200418.pdf

Panel One: Finance, Culture and Society

Moderator: **Gillian Tett**, U.S. Managing Editor, *Financial Times*

Panelists: **Bill Dudley**, Former President and CEO, Federal Reserve Bank of New York
Betsy Duke, Chair, Wells Fargo & Company
James Gorman, Chairman and CEO, Morgan Stanley

Main points

- The industry needs to work collectively on restoring trust because misconduct at one firm brings down the reputation of all firms.
- Restoring trust entails demonstrable commitment to social expectations—providing suitable financing to creditworthy participants in the economy. This may require foregoing a sale if the product is not in the client's best interest.
- Recent economic success can lead to excess. "Bad loans are made in good times."
- Large organizations will inevitably have different cultures within specialized departments. Don't ignore the differences, but remain unequivocal on shared values.

A better title for this panel might have been "What can bank leaders actually do about culture?" Beneath this question is a paradox. Gillian Tett remarked that anthropologists observe culture from the bottom-up. That's because a group's culture is evident in the shared norms and artifacts that influence the everyday behavior of its members. But, as the three panelists explained, leaders seeking to change a culture can only institute change from the top-down. The tension between the two forces—top-down change and bottom-up effect—was summed up by Elizabeth Arzadon, whom Ms. Tett quoted at the outset. "Leaders know culture is powerful—they can see its effect. There may be some economic barriers to putting it at the top of the organizational priority list, but the bigger barrier is that deep down, leaders avoid embracing the issue of culture because they lack confidence in their ability to do anything about it."[3]

All panelists agreed that ignoring culture was not an option. To accomplish change, a leader must put herself in the shoes of employees and clients. The panelists were, however, realistic about the pace of cultural change.

Betsy Duke and James Gorman each offered three observations on culture within their firms. According to Ms. Duke, organizations engaged in complex tasks have a tendency to develop silos, each of which may have its own variation on the organization's culture. It becomes more difficult to

[3] Elizabeth Arzadon, "Cultural challenges? Blame isn't the answer" (Jun. 6, 2018), *available at* https://medium.com/new-york-fed/cultural-challenges-blame-isnt-the-answer-8d63598952f4.

manage culture across the entire organization if the baseline differs from group to group. What's more, she has seen a tendency to escalate good news, not bad news. Some of the motivation may be noble—a heightened sense of personal responsibility for solving problems, as opposed to trying to hide information. Still, this consistent bias toward good news can create a misimpression of the status quo. Finally, an organization's scale amplifies problems, particularly as they are filtered through levels of hierarchy. Similarly, the financial consequences of a single mistake will be much larger in an organization with a far greater number of customers—in the tens or hundreds at a community bank, but many thousands at a bank the size of Wells Fargo. Therefore, as scale of an organization increases, the firm's error tolerance rate needs to decrease.

Mr. Gorman emphasized the need to match products to a client's need. This entailed both a realistic assessment of suitability, and, critically, an honest sales pitch about product performance. Further, culture in financial firms is different from other organizations because of the inherent, distortive effects of money as the product. Money amplifies the mistakes of human behavior, and the volume of money at stake is so high that mistakes result in sums that are shocking to the public. There was, in addition, a historical and structural force at play. When investment banks changed from partnerships to public companies, they retained the energy of owning one's own business but lost the discipline that comes with it—"skin in the game," so to speak.

Bill Dudley pointed out another historical change: Regulation of the financial sector gives the perception that moral responsibility for conduct has shifted from the industry to regulators. As regulation increases, so does the expectation that regulators should be accountable for misconduct. Similarly, an excessive supervisory focus on controls and compliance may distract front-line risk-takers from thinking about the consequences of their choices. Mr. Dudley argued that those who draft laws and regulations should consider the effects those rules will have on behavior, including their unintended consequences. Firms, moreover, have the best tools to shape behavior because they control their incentives. Supervisors, meanwhile, can evaluate whether incentives are consistent with good behaviors. Ms. Tett asked whether, in light of those observations, laws and regulations should be framed as principles rather than specific restrictions. Mr. Dudley responded that all laws and regulations have an underlying purpose, whether they are written as flexible standards or narrow rules. The industry can easily figure out what the broader purpose of a law is, and should make choices that promote both the spirit and the letter of the law.

Mr. Gorman agreed that financial firms need to consider the broader effects of their choices. He described finance and society as an ecosystem in which survival depends on interrelation, not autonomy. So, financial firms should engage productively with regulators, since financial regulation is a fact of life.

Mr. Gorman also argued for a balance within firms between individual self-interest and the firm's interest—specifically, client service. In his view, employees must place *at least* equal weight on the two goals, and should place greater weight on the firm's interest. That way, an employee can be said to work for the institution's clients, whom the firm exists to serve. Ms. Tett suggested that serving clients could be best achieved by seeing issues through their eyes, but observed that it was difficult to find time for empathy in such a fast-paced industry. Mr. Gorman countered that busyness cannot be an excuse. A firm needs to be viable to have a good culture, Mr. Gorman added, and it's hard to find your culture—which drives durability—until you find your strategy— which drives viability.

Continuing the theme of client service, Ms. Tett asked Ms. Duke for her views on Wells Fargo's recent scandals. Ms. Duke began by recalling that she was interested in the Wells Fargo culture when she joined its board in October 2016, and was encouraged by what she read on paper. The subsequent scandals stunned her because reality so differed from what was presented to the board. She learned several lessons. First, "tone from the top" is relative. Employees often place greater weight on what their immediate supervisors say than on the messages from the board of directors. Second, it is difficult for a board to learn what employees really think. It helps to embrace techniques developed in the field of behavioral science, which are improving assessments of employee engagement and culture. Finally, it is important not to assume that every level of leadership shares the outlook and incentives of top-tier executives.

Ms. Tett asked the panelists how they dealt with difficult issues that were not discussed—a phenomenon that anthropologists call "social silences." Ms. Duke pointed to the unintended consequences of incentives. Mr. Gorman described a "tyranny of success"—that future growth will be achieved by doing more of what brought success in the past. For example, mortgage origination and securitization were historically profitable. A desire to increase profits strained the natural limits of those business lines and created pressure to cheat. Mr. Gorman also said that the financial crisis remains a vivid reminder of how failing to probe potential weaknesses in high-profit areas can lead to catastrophic consequences. He described the memories of the crisis as "scar tissue." Ms. Duke agreed, citing the old maxim "bad loans are made in good times."

Returning to Ms. Duke's point about silos, the panel discussed whether the desire for a firm-wide culture was at odds with the reality of many lines of business housed under a single roof. Mr. Gorman thought the major risk was in pretending that all lines of business are the same. He argued for accepting differences, but insisting on common values. To that end, he suggested that executive-level committees include members from all divisions, not just profit centers. He also argued that if a division was an outlier in terms of values, the firm needed either to replace its management or sell the division.

Mr. Dudley urged the audience to manage internal and external expectations about the time it will take to change culture. Legacy problems take a long time—often as long as a decade—to identify and resolve. Evidence of improvement may have a similar time lag. Meantime, the industry should work steadily at better assessing its culture and adjusting incentives. Mr. Gorman added that he has adopted a motto of "no new mistakes." That is, it is his job to identify issues that have the potential to affect more than 0.5 percent of the firm's capital, which for him amounts to approximately $350 million. In turn, he expects leaders down the line to have a similar focus on identifying and addressing proportional problems.

Finally, Ms. Tett asked the panelists a number of questions about how the industry can restore trust. Mr. Gorman acknowledged that all companies are being asked to do their part in society. He cautioned, however, that financial firms cannot be general agents of social change. Rather, they should focus on providing financing, which is the role of every financial firm from a community bank to a global bank. Ms. Duke added that it should be clear to all that a scandal at one financial firm affects all firms. She expects trust to be reestablished gradually, and over varying lengths of time with individual customers, business customers, counterparties, regulators, and employees. In the case of Wells, the firm began the process with an effort to understand and acknowledge its mistakes.

– Industry Progress and Challenges –

Presentation: New Banking Standards Board Survey

Dame Colette Bowe, *Chairman*, Banking Standards Board (U.K.)
Alison Cottrell, *CEO*, Banking Standards Board (U.K.)
Mikael Down, *Director of Policy and Analysis*, Banking Standards Board (U.K.)

Main points

- The BSB[4] offers a quantitative and qualitative assessment of a firm's culture across nine factors: honesty, competence, reliability, responsiveness, personal/organizational resilience, accountability, openness, respect, and—above all—a shared sense of purpose.
- The assessment is independent, confidential, and funded by member banks. The BSB reports assessment results directly to a firm's board.
- The BSB has observed a correlation between employee perceptions of fairness and their physical wellbeing, an important component of the "resilience" aspect of their assessment.
- The BSB has also found that a prime reason for not speaking up is a futility—the concern that nothing will happen as a result of raising one's hand.

The BSB is a private organization, funded by banks, that offers an independent assessment of culture within firms and benchmarking across the industry. It was created by the financial services

[4] https://www.bankingstandardsboard.org.uk/

industry in the U.K. as a result of a recommendation by a Parliamentary commission following the financial crisis. It is a voluntary organization, and neither a regulator nor a trade association.

Mikael Down explained the factors and methods included in the BSB's assessment. In addition to quantitative survey results, the BSB conducts employee focus groups and interviews with executives, which inform the qualitative portion of the BSB's written assessment. Using an on-line dashboard tool, member firms may compare their results against a benchmark group of other participating firms. Survey data may be further analyzed and compared on a more granular level—by division or subdivision of the participating firm. This allows firms to compare results among strata of their organization—for example, contrasting results from executive offices against rank-and-file, or revenue producers against control functions. The data may also be compared based on certain demographics, including gender and tenure.

Alison Cottrell emphasized that the BSB does not prescribe to firms what their purpose is or what their values should be.[5] Instead, it holds up a mirror to show how closely its stated values are followed in practice.

In general, the BSB survey has found that firms are good at communicating what their values are. Higher-performing firms are more likely to have data indicating that those values are put into practice. They tend to have a higher percentage of employees who witness other employees speaking up. Among employees who state they are unlikely to "raise their hand," a concern about futility is a core deterrent, more so than a fear of retaliation. Another general trend concerns wellbeing. There is a correlation in the data between employees who perceive a lack of respect and fairness with employees who report negatively on questions of physical wellbeing and resilience. The contrapositive also holds: Employees who feel respected and treated fairly also report higher levels of wellbeing and resilience.

Colette Bowe added that information the BSB reports to the boards of member firms is treated confidentially and she emphasizes that it is the board's role to articulate the firm's purpose, and consequently the board should know if employees follow through. It is up to the firm how much of the report to share with employees, regulators or the public. In Ms. Bowe's experience, boards appreciate hearing directly from the BSB, and have directed management to work on matters of employee wellbeing and resilience, among other issues.

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[5] *See also* Alison Cottrell, "Getting the Measure of Managing Culture" (June 4, 2018), *available at* https://medium.com/new-york-fed/getting-the-measure-of-managing-culture-77e583877ba8.

Panel Two: New G30 Report on Banking Conduct and Culture

Introduction: **Bill Rhodes**, *President and CEO*, William R. Rhodes Global Advisors

Moderator: **Stuart Mackintosh**, *Executive Director*, Group of Thirty[6]

Panelists: **Cathy Bessant**, *Chief Operations and Technology Officer***,** Bank of America
Michael Corbat, *Chief Executive Officer*, Citigroup
Roger W. Ferguson, *President and CEO*, TIAA
Gail Kelly, *Former CEO*, Westpac Banking Corporation

Main points

- Senior leaders of a firm are responsible for its culture. That entails regular monitoring and, when needed, course correction. Ultimately their goal should be to embed purpose and values into an organization's policies, incentives and practices.
- Management needs to overcome any reluctance to understand technological innovation, which is prevalent in financial services. Machine learning and artificial intelligence can be demystified, so that business leaders can inform their development and use. An awareness of professional ethics and firm values is also important among IT developers and staff.
- Diversity and inclusion—common corporate goals—should be well-integrated into a firm's efforts to build a stronger culture.

The panel was introduced with remarks from Bill Rhodes.[7] Mr. Rhodes said the Group of Thirty's forthcoming report on banking culture will assess the progress that banks have made in restoring trust. Mr. Rhodes relayed that, based on initial observations, there is still plenty of work to do. Some but not all firms have adopted the recommendations in the Group of Thirty's 2015 report.[8] For example, performance reviews at some firms are now divided more-or-less equally between financial performance and conduct. Mr. Rhodes also emphasized that the change in mindset towards culture spurred in recent years must be made permanent in order to restore trust. To that end, he urged every financial firm to form a board-level committee dedicated to assessing the firm's culture on an ongoing basis. He also encouraged dialogue between firms and their supervisors, who can monitor culture and conduct and provide valuable input.

The panel began with Gail Kelly providing her take on the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services, also known as the Banking

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[6] Stuart Mackintosh, "Culture and Conduct Reform: A Permanent Mindset Change" (June 13, 2018), *available at* https://medium.com/new-york-fed/culture-and-conduct-reform-a-permanent-mindset-change-7694166f5bec.

[7] Bill Rhodes's full remarks are available at: https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/Rhodes-cultureconference-180618.pdf.

[8] *See* Group of Thirty, Banking Conduct and Culture (2015), *available at* http://group30.org/images/uploads/publications/G30_BankingConductandCulture.pdf.

Royal Commission.[9] She noted that Australian banks didn't suffer during the financial crisis, which may have created a sense of complacency, or "chronic ease," which was combined with a certain insularity. The effect was the opposite of the "scar tissue" that Mr. Gorman described as desirable earlier in the morning.

Ms. Kelly asserted that Australian banks went wrong when their structures and business models were misaligned with their purposes and values. She feels that most banking employees are well-intentioned, but that a sense of ethics needs to be embedded into a bank's policies and practices. Cultural failures happen where there is a misalignment of values and purpose with incentives and structures. She further elaborated that many firms had adopted a highly legalistic approach to conduct. That is, the norm of behavior was to ask what was legally permissible, not what was right. Ms. Kelly also posited that certain data (e.g., customer complaints, employee engagement surveys, etc.) can provide a false sense of security, or "blind trust," around culture. If senior leaders only see statistical averages, they may not recognize risk evident in tail data—statistical outliers that carry latent and potent risk.

The other members of the panel discussed how culture is improved and maintained at their organizations. Roger Ferguson provided a different perspective as the leader of TIAA. His organization's sole purpose is the provision of quality retirement and other financial products to its members. Unlike many financial firms, TIAA has no obligation to outside shareholders, and as such has no tension between serving the interests of shareholders and clients. Still, TIAA like other firms recognizes the importance of culture. He talked about the need for leaders to "punch through the clouds," much in the manner of Zeus from Olympus, so that senior leaders can connect with the experience of those "on the ground". For example, he and his senior leadership team hold regular "all hands" meetings across business lines. He also seeks to create habits of good conduct throughout TIAA through surveying and training.

Similarly, Michael Corbat highlighted the methods that Citi uses to focus on positive culture. To be successful, an organization must look at the drivers of culture, not just outcomes. He cited Citi's firm-wide engagement survey, which has run for roughly 20 years. He and his fellow managers find year-over-year comparisons to be especially helpful because culture is a dynamic concept. Results from Citi's survey are reported to its board, which was among the first to form a stand-alone committee on corporate culture.

Cathy Bessant described Bank of America's process around culture and conduct, which is institutionalized through reports to the board's enterprise and risk committee. Since the crisis, control functions (including human resources, legal, etc.) provide feedback on performance and conduct of executives. The organization also evaluates executives using feedback "two deep" into the organizational chart to ensure that staff are comfortable providing feedback and raising concerns.

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[9] https://financialservices.royalcommission.gov.au/Pages/default.aspx.

The panel next turned to emerging technologies—specifically, machine learning and artificial intelligence ("AI"). There was agreement from all participants that demystifying these technologies is both necessary and possible. As Ms. Bessant noted, while a big deal is made about the technology, it is ultimately just data and algorithms, familiar to banks for a long time. What is different is the increased computing power, which has amplified the volume and range of data analysis. It is important for leaders to remember that AI is a product of human intelligence, subject to the same types of cognitive bias and logical flaws. Mr. Ferguson noted the importance of requiring engineers and IT developers to follow ethical standards common to the rest of the firm. As he put it, technology is not alchemy. Management should take the time to learn how technology is developed and operates, and to exercise the same cultural oversight of technical departments that they would of customer-facing roles.

Ms. Kelly and Mr. Ferguson also provided their perspectives on diversity and inclusion. Ms. Kelly noted how there has been a general shift from command-and-control leadership to a new style, which she termed "generous leadership." The latter is more open and transparent. The rising generation of employees requires this more inclusive style of leadership. A generous leadership values diversity and inclusiveness, and generally leads to a learning organization, where voicing doubt or a lack of understanding is welcomed. Ms. Kelly noted that, for women especially, Westpac (her former institution) improved its environment through hiring more women. Once a critical mass of women in the organization had been established, reaching gender parity became easier, and the benefits of flexibility emerged.

Mr. Ferguson made two additional points. First, he cited research by Scott Page of the University of Michigan showing that diverse organizations are higher performing than non-diverse peers. Second, he noted that, in addition to compositional diversity, diversity of thought is critical and was a significant breakthrough at TIAA.

– Keynote Address –

The Honorable Jay Clayton, Chairman of the United States Securities & Exchange Commission ("SEC"), addressed the conference about the role of culture in preserving the integrity of financial markets. Mr. Clayton focused his remarks on culture within financial institutions and at the SEC.[10]

[10] Jay Clayton's full remarks are available at: https://www.sec.gov/news/speech/speech-clayton-061818.

Citing a recent paper by the U.K.'s Financial Conduct Authority, Mr. Clayton began with the proposition that a culture exists in every organization.[11] Indeed, an organization's culture is often the product of multiple sub-cultures and, ultimately, the collective effect of countless day-to-day choices by the group's members. It is therefore important that leaders address culture and acknowledge that they are not writing on a "blank slate." Leaders cannot change culture by fiat. The starting point for managing culture is understanding what it is, as compared to what the leaders might like it to be, and the reasons for the status quo.

A "good culture," broadly speaking, is one that is "consistent with long term shareholder, employee, customer, and societal interests, as well as law and regulation." In Mr. Clayton's experience, that goal is shared across senior levels in the private and official sectors. It is important that firm leadership consider input from the official sector in creating their own assessment of the firm's culture. It is also important that the official sector be receptive to feedback on its own conduct and culture. For example, Mr. Clayton said it was important for SEC staff to reflect on its everyday interactions with market participants. "Are we zealously pursuing our mission? Are we consistent and clear? Are we fair? Do we listen? Do we learn? And, most important, are we striving to deliver for America's long term Main Street investors?" Elaborating on the last point, Mr. Clayton emphasized that the purpose of "seeking fairness and efficiency in this largely institutional market" is to "serve the interests of our long term retail investors."

The culture of a financial firm also serves an interstitial role—filling the gaps between laws, regulations, and internal rules. Culture gives guidance to employees on how to act when public and private rules permit a range of choices, some of which may be legal but undesirable. Not everything that is legal is right. Assume, for example, that a salesperson were to justify a quoted price by misstating his cost, and thus his profit margin. Federal law may not prohibit that misstatement. But it is still a lie, and a firm's culture should deter the salesperson from lying to a customer. Mr. Clayton recommended that, when confronted with mistakes that have a moral or ethical dimension, firms should assess not only whether there was a control deficiency, but should also ask why that behavior occurred in light of the firm's culture, purpose, and values.

Finally, Mr. Clayton argued that it was incumbent on professionals within financial firms to recognize the public consequences of their choices. He assured firms that the SEC would provide feedback on their cultures and asked firms to do the same for the SEC.

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[11] Financial Conduct Authority, Discussion Paper DP18/2, Transforming Culture in Financial Services (2018), *available at* https://www.fca.org.uk/publication/discussion/dp18-02.pdf.

– Assessing and Transforming Culture –

<u>Presentation: Auditing Culture</u>

Elizabeth Arzadon, *Fmr. Special Advisor*, Australian Prudential Regulation Authority

Main points

- Firms get too caught up in generic terms like "values" and "tone from the top," which can distract from realistic, evidence-based assessments of actual behavioral patterns that drive culture.
- Assessment of culture can rely on traditional, well-established techniques of internal audit—especially independent judgment and rigorous, risk-based methodology.
- Firms need to resist the temptation to allow strong financial performance to mask latent cultural risks.

Elizabeth Arzadon began by stating that there was too much use of terms like ethics, values, and "tone from the top." These concepts are, in her view, not as closely related to culture as many people may suppose. Ms. Arzadon urged an approach to culture that relies on empirical observations of a particular group's behavioral patterns over time. In her view, firms should decide what a "good" culture means. An auditor's job is to assess how closely reality matches the organization's goals.

Basic, generally-accepted principles of audit, such as independence and a risk-based approach, should apply to audits of culture. Ms. Arzadon's methodology compares multiple, independent data points grounded in outcome evidence (control breaches, regulatory fines, litigation liabilities, etc.) and behavioral assessments (group observations, interviews, etc.). Evidence should include employee perceptions as well as examples, since perceptions influence behavior as much if not more than objective facts.

A rigorous, evidence-based approach leads to a convincing assessment. It is important to *show* a firm's culture to its leadership, as opposed to merely telling them about culture. Auditors must not be afraid to share their evidence. Determining how best to communicate findings is critically important to its acceptance by senior leadership of a firm.

Ms. Arzadon offered three general observations drawn from her years as a cultural auditor. First, auditors should look for the unintended side effects of strategies employed to drive performance and manage risk. Second, firms tend to overestimate the power of formal processes, and under-estimate the need for sound individual judgment. Finally, leaders of firms must be aware of the "shadow side of strengths." For example, over reliance on a strong risk management function can undermine the first line's sense of ownership for risk.

Panel Three: International Supervisory Approaches

Moderator: **Kevin Stiroh**, *Executive Vice President and Head of the Supervision Group*, Federal Reserve Bank of New York

Panelists: **Norman Chan**, *Chief Executive*, Hong Kong Monetary Authority
Jonathan Davidson, *Director of Supervision*, Financial Conduct Authority (U.K.)
Jeremy Rudin, *Superintendent of Financial Institutions*, Office of the Superintendent of Financial Institutions (Canada)
Willemieke van Gorkum, *Head of Division of Horizontal Functions and Integrity Supervision*, De Nederlandsche Bank

Main points

- There is a growing global consensus that assessment of firm culture is important to supervisory goals of safety and soundness and financial stability.
- Supervisors have pursued a variety of approaches to culture and its drivers. This diversity enables productive comparisons and assessments of the strengths and weaknesses of the different methods.
- The common factor of these approaches is the ability to hold up a mirror to a firm—that is, to reflect back to a firm's board and senior leadership the observed norms or patterns of behavior and the misconduct risk that they pose.
- Without resorting to enforcement, supervisors can influence change within firms by presenting credible evidence of root causes of misconduct or cultural risk.

This panel addressed three questions, framed at the outset by Kevin Stiroh: (1) What motivates the supervision of behavior and culture? (2) What are some tangible examples of success? and (3) How can progress be measured?[12]

What motivates the supervision of behavior and culture?

Norman Chan argued that culture covers behavior outside of the scope of public laws and regulation. Recounting an anecdote about the Chinese philosopher Confucius, he observed that laws

[12] Mr. Stiroh previewed this discussion in a Medium post. Kevin Stiroh, "How Do Supervisors Contribute to the Conversation on Culture?" (June 1, 2018), *available at* https://medium.com/new-york-fed/how-do-supervisors-contribute-to-the-conversation-on-culture-79a707617192.

are good at prohibiting certain behavior (fraud, for example), but ineffective at prescribing good behavior. Laws would not, for example, tell a broker how to look out for his customer's best interest. That said, it was right for the official sector to pay attention to culture at regulated firms. In Mr. Chan's view, firms have been resistant to official sector input out of a concern that regulators will impose their views of culture on private firms. But it is important that officials offer feedback about culture because they have an informed perspective and represent the interests of public stakeholders.

According to Willemieke van Gorkum, supervisory attention to culture helps identify macroprudential risks. Importantly, however, De Nederlandsche Bank ("DNB") does not prescribe a particular culture, or brand some cultures "good" and others "bad." Rather, it provides feedback to firms on whether the observable behavioral dynamics within groups are increasing or mitigating potential risk. If the behavioral patterns are increasing potential risk, DNB expects that the firm will make adjustments.

At the Financial Conduct Authority ("FCA"), attention to a firm's culture is part of the agency's general approach of supervision: to prevent misconduct. Its approach is therefore more interventionist than other regulators. Jonathan Davidson pointed out that the FCA's regulations include five simple conduct rules—for example, "You shall act with integrity." The purpose of these rules is to give employees at regulated firms an ally in confronting difficult choices. Employees may be more likely to speak up and be taken seriously if they can say that regulatory requirements are on their side. To assess how well the five conduct rules work in practice, the FCA examines firms across multiple dimensions, including its incentives and observable gaps between stated values and practice. In Mr. Davidson's experience, misconduct is caused more often by a lack of skill (poor training or advice on how to handle a difficult issue) than a lack of will (a poor moral character).

By contrast, Jeremy Rudin told the audience that the Office of the Superintendent of Financial Institutions ("OSFI") does *not* regulate or supervise corporate culture *per se*, which in his view is outside of OSFI's mandate for prudential supervision. It advises, however, that firms should be attuned to risk culture because firms need to assess whether their risk management practices are effective. For example, a firm may have voluminous underwriting policies, but may permit copious exceptions. It is essential to know how decisions about those exceptions are made in order to determine, as a supervisor, if the underwriting policies are effective. Much of a firm's culture is on display in examining how institutions make that type of decision. Mr. Rudin emphasized that OSFI does not tell banks to be innovative or traditional, customer-oriented or market-driven. That is their business. The effectiveness of controls within a firm is, however, a prudential concern. To assess effectiveness, supervisors have to look at actual choices and conduct, not just stated rules.

What are some tangible examples of success?

At DNB, behavior and culture reviews have become an integral part of supervision. The DNB has conducted over 100 behavior and cultural reviews to date. In one example that was shared, supervisors determined that excessive optimism on the part of a CEO prevented the institution from learning from mistakes. One symptom of this tendency was that risk management was only involved in key decisions at a late stage. When presented with these supervisory findings, the CEO initially denied them. He came around after supervisors shared the findings with the bank's board. The findings confirmed the intuition of several board members, who lacked a credible basis with which to confront the CEO. Following the board's involvement, the CEO accepted the supervisory finding and made changes to include the firm's risk management function earlier in the decision-making process.

Mr. Rudin raised the possibility of a confirmation bias in supervisory success stories: If you believe culture is important, you may be inclined to view evidence of improvement as attributable to cultural change, rather than to other factors. Anecdotes from supervisors are not a "clean experiment." Mr. Rudin further expressed skepticism on whether any firm has a unified culture. That said, he supported attempts to replicate the DNB's results, and noted that OSFI is adopting a modified version of the Dutch approach in Canada. Mr. Rudin concluded there was value in the approach because it increased the points of contact between supervisors and firms. In his experience, the "c-suite" tends to tell supervisors what is already written in official firm policies. The approach pioneered by the DNB collects and analyzes a broader set of inputs, arguably yielding a more informed result.

Mr. Chan pointed out that the Hong Kong Monetary Authority was both a prudential and conduct regulator, so there was no concern about whether culture fit into the organization's legal mandate. In his experience, boards are very receptive to feedback from supervisors about culture. Mr. Chan argued that all boards of financial firms should have a culture committee with express responsibility for understanding and issuing clear expectations around the organization's culture. The committee should also assess, among other things, whether incentives promote or hinder the firm's culture. It should also establish avenues for feedback—both from within the firm and from the outside, especially from supervisors.

How can progress be measured?

Mr. Davidson acknowledged that—both in the public and official sectors—assessment of culture is not a mature discipline. That said, there were many opportunities to gauge progress, even shy of perfection. He also argued that if regulators conduct assessments, that will spur firms to improve their own internal assessments of culture. Of course, regulators and firms should recognize that an organization's culture changes slowly. Culture comes, in large part, from history. It takes time to build a new history.

Ms. van Gorkum posited that "culture"—an admittedly nebulous concept—can be broken down into observable, measurable parts. A good example is group decision-making dynamics, which are the focus of much of the Dutch approach. In her experience, feedback on these dynamics can lead to critical improvements in governance and behavioral patterns, which can mitigate risk and lead to better financial outcomes. Over time, consistently better results may be linked back to improvements in governance and behavioral patterns.

– Preparing the Next Generation –

Panel Four: Strengthening Business School and Industry Partnerships

Introduction: **Richard Lyons**, *Dean*, Haas School of Business, University of California, Berkeley

Moderator: **Michael Strine**, *First Vice President and COO,* Federal Reserve Bank of New York

Panelists: **Will Bousquette**, *Chief Operating Officer of the Investment Banking Division,* Goldman Sachs
Scott DeRue, *Dean,* Ross School of Business, University of Michigan
Jonathan Harvey, *Managing Director and Head of Talent and Culture,* Barclays
Lynn Paine, *Senior Associate Dean for International Development and Professor of Business Administration*, Harvard Business School

Main points

- Firms have moved away from rotational programs and toward specialization. This can make it more difficult to attract well-rounded leaders and ensure staff has an enterprise-level perspective on desired cultural norms.
- Staff turns over quickly, and a large percentage of the major firms were not in the organization during the financial crisis. Lessons about culture, finance, and society learned first-hand during the crisis now need to be imparted to a new generation.
- Firms care about hiring staff that already have a strong understanding of ethical decision-making, particularly in difficult situations.
- Through research, universities can help financial firms better understand drivers of culture and the interplay between incentives and ethical decision-making.
- The New York Fed will launch a standing forum for business schools and financial firms which intends to drive action from the partnership on cultural reform efforts.

Richard Lyons introduced the panel with comments on how business schools and banks can partner to build a more ethical industry. He recounted the evolution of discussions between business schools and industry leaders, convened by the New York Fed. He highlighted the transformation of the conversations from skepticism to partnership. Academics can help financial firms better understand drivers of culture and the interplay between incentives and ethical decision-making. Firms, in turn, could be clear on the ethical tools that junior managers need to succeed in finance, helping business schools to design a curriculum that better integrates ethical decision-making. Mr. Lyons closed his remarks with some provocative questions about "values" in finance, which, in his view, were suspiciously homogenous across firms. He asked why a firm wouldn't distinguish itself with a value that was truly different, and challenged the industry to consider whether a motto from the armed forces—"Officers eat last."—might be worth adopting.

Michael Strine announced at the start of the panel discussion that the New York Fed will launch a standing discussion forum for business schools and banks, formalizing the ad hoc meetings that had taken place over the past several years. [13]

The panelists represent organizations that had participated in the New York Fed's meetings between business schools and banks over the past year. Will Bousquette recalled that academics were surprised by how much industry participants cared about producing ethical leaders. Although Goldman Sachs runs significant in-house training, the ability to "learn ethics on the job" is challenging. Goldman hires a significant number of students directly out of school, which can mean that a third of employees have spent fewer than two years at the firm. Truly serious ethical dilemmas arise infrequently on the job, especially among junior staff. In Mr. Bousquette's experience, junior staff can have a tendency to think that all they need to do is "escalate" an ethical dilemma. The firm, however, expects more than that. As those junior personnel become more senior, dilemmas will be escalated to them. Practice in resolving conflicts between competing business priorities and values is important. Because of this, Goldman relies on universities to provide the type of ethical training needed to support a positive culture.

What is more, 78 percent of Goldman's employees did not work there during the financial crisis. The memory of the crisis—of how close the industry came to failure as a result of a perfect storm of ineffective risk management, ethical lapses, and a culture of short-termism—is probably not as strong in employees who did not experience it firsthand. That is further reason why business education matters—to teach new hires the lessons learned from the financial crisis about the importance of ethical behavior and risk culture.

Scott DeRue had been surprised to hear banks asking him to emphasize ethics. His immediate reaction to this request was, in essence, "Don't ruin the people we send you!" He

[13] Panelists Mr. Bousquette and Mr. DeRue contributed a Medium post on this topic. William Bousquette and Scott DeRue, "Reinforcing Ethics in Financial Services" (June 11, 2018), *available at* https://medium.com/new-york-fed/reinforcing-ethics-in-financial-services-c56bf01b5ca0.

described the role of business schools as developing a supply of talent that has the technical proficiency for jobs in finance, and can also serve as culture carriers on arrival.

Jonathan Harvey noted themes from earlier in the day on insularity and silos. Many firms have dropped rotational programs, where new hires gain exposure to different lines of business. Instead, most banks have a strategy of specialization, meaning most new hires do not get a sense of the breadth of the business. Many leaders are still promoted based on their technical success in one area, and less on the basis of their leadership. This could pose a dilemma for business schools: Should they educate generalists or specialists? If a firm hires and promotes more generalists, business schools will have less incentive to prepare their students exclusively to specialize.

Mr. DeRue noted that his school has a broad educational approach, in contrast to other programs. His students, however, respond to the messages they receive from industry. If industry hires into specialties, then students will respond to those incentives.

Lynn Paine noted that business ethics is more widely taught at business schools than it was in the 1980s. Harvard Business School, for example, offers a business ethics course that involves judgments in the face of conflicting responsibilities and values. Students have pointed out that it is easy to be ethical in a costless environment—that is, in a classroom. It is harder when money is on the line. The challenge is teaching in such a way as to build habits—ethical muscle, so to speak—needed to say and do the right thing in spite of real world pressures.

Mr. Strine cited widespread agreement among employers about the importance of soft skills, sometimes referred to as Emotional Quotient ("EQ") and Decency Quotient ("DQ"). Given this agreement, he asked the panel what was impeding a focus on these skills in business school admissions and hiring at financial firms.

Ms. Paine first noted that these are competencies, not simply attributes, and that there is a significant learning aspect to developing these skills. It is particularly important for leaders to be in a continual process of self-development given the changes they inevitably face over the span of their careers.

Mr. DeRue described changes that the Ross school has made to its interviewing to better capture soft skills, including group interviews. Empirical data on industry promotions prompted the changes. Very briefly, seven out of eight factors relevant to promotion did not have to do with technical expertise. They were, by contrast, EQ and DQ types of skills. Mr. Harvey also described a recent program where people are moved between the investment banking and control lines of business to develop empathy and teamwork between the functions.

Mr. Bousquette noted that Goldman has moved toward behavioral interviewing, but that behaviors are difficult to grade in the course of a 20-minute conversation. Goldman is trying to include more practitioner-led training once people are in the door. Mr. Bousquette noted that this is an opportunity for partnership with schools, as training is difficult. Their practitioners are not teachers, but do have a practical knowledge and experience that other trainers might not. Mr. DeRue offered a complementary observation. Business schools need to develop case studies for people in the role of analysts, not just c-suite level executives. It can be difficult to teach young students, particularly undergraduates, about relatively abstract decisions made at much more senior levels. This was an opportunity for universities and firms to work together.

Ms. Paine returned to a theme noted earlier in the day: The intensity of the modern scandals have raised the stakes for firms. Ethical scandals have bigger impact on shareholders, which spur firms to act. Furthermore, there is greater understanding of human behavior through the rise of behavioral science, which should help firms improve their cultures and patterns of behavior. Ms. Paine also noted that there are many questions that university research could explore and answer for firms. Mr. DeRue suggested that firms look at culture as a retention tool, as powerful as compensation, which can always be outdone by a competitor.

– Closing Remarks –

The conference concluded with two sets of remarks.

Sir David Walker, Chairman of Winton Capital, praised significant progress on trustworthiness since the financial crisis.[14] Banks are much more resilient now than a decade ago. Somewhat paradoxically, trust in banks remained low. That was, in his view, because banks still needed to work on improving conduct and culture.

He then turned to "core themes for good practice." The first of these is governance. Setting the behavioral norms and values at a bank is the responsibility of the board, and they need to work to maintain visibility and dedication toward culture and behavioral issues.

Second, he cited executive example and accountability. Leaders must be continuously exemplary in order to establish the norm for conduct within the firm. The CEO needs to be aware of *how* business is conducted as closely as the CEO knows the business's P&L statistics. Similarly,

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[14] Mr.Walker's full remarks available at: https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/Walker-cultureconference-180618.pdf. See also David Walker, "Looking to Leadership for Continuity on Culture" (June 8, 2018), *available at* https://medium.com/new-york-fed/looking-to-leadership-for-continuity-on-culture-344d68023598.

incentives and career advancement for senior leadership should be as dependent on conduct as it is on contribution to revenue.

Third, Mr. Walker argued that regulatory changes should be made in the U.S. to move to annual rather than quarterly reporting. In addition, annual reports should include readouts from the board about culture and behavioral issues.

Fourth, Mr. Walker encouraged good stewardship of a bank's culture over the long term. In his view, culture is the most important component in brand value, which is a significant balance sheet asset. Since the financial crisis, more value has been lost because of misconduct than from business performance. Partial responsibility for maintaining this brand value should lie with the banks' owners, particularly professional asset managers. They should be attentive to the quality of a bank's culture in addition to expectations for financial performance. Professional fund managers should be in a position to offer support to a board which is attentive to these issues but also make dissatisfaction clear if a board or CEO is resistant to change.

John Williams, on his first day as President of the New York Fed, wrapped up the conference.[15] He thanked his predecessor Bill Dudley and the attendees for their work in bringing bank culture to the forefront, and offered his own observations on the importance of banking culture in supervision and in practice.

Mr. Williams first noted both the strength of the economy and the importance of the improvements to the regulatory regime, stating that "we are in a much, much better place." However, he cautioned that, while many critical areas have been addressed, the root causes of many of the problems in the financial sector have not been fully addressed. Underscoring comments made throughout the day, Mr. Williams warned that good times can obscure problems and should not distract from the need for constant reinforcement of and attention to culture. He noted that a robust regulatory regime was necessary for a healthy financial system but it is not sufficient. Strong financial indicators cannot tell you whether or not people are cutting corners or taking excessive risk, and we cannot be complacent.

Turning to how to achieve a better banking culture, Mr. Williams said that transforming a culture is a five-to-ten year project, and that keeping it strong is an ongoing mission. Mr. Williams advocated for supervision that holds management and boards of financial institutions to high standards in terms of culture and conduct, and encouraged incentives that align with strategic goals.

In conclusion, Mr. Williams urged the audience to stay vigilant on the "soft" issues, such as culture and governance. He also made clear that the New York Fed would continue its work on banking culture going forward.

[15] John Williams's full remarks are available at: https://www.newyorkfed.org/newsevents/speeches/2018/wil180618.