

Federal Reserve Bank of New York

Misconduct Risk, Culture, and Supervision

Stephanie Chaly
James Hennessy
Lev Menand
Kevin Stiroh
Joseph Tracy

December 2017

The views expressed in this paper do not necessarily reflect those of the Federal Reserve Bank of New York or the Federal Reserve System. We thank Jeanmarie Davis, Dianne Dobbeck, Jack Gutt, Lauren Hargraves, Michael Held, Bev Hirtle, and Meg McConnell for helpful discussions and comments on an earlier version.

Misconduct Risk, Culture, and Supervision

Stephanie Chaly, James Hennessy, Lev Menand, Kevin Stiroh, and Joseph Tracy.

November 2017

Summary

A primary goal of banking regulation and supervision is to support the sustained provision of financial services to the economy. To do this, supervisors promote resiliency and mitigate risks by examining firms' risk management, internal controls, and governance as a core part of prudential oversight. Misconduct risk, for example, can impede this critical intermediation function by diverting management attention, damaging a firm's reputation, driving a change in the composition of the firms' workforce, depleting its capital, and making a firm less resilient. Moreover, misconduct risk can harm the financial sector more broadly by decreasing trust and confidence in ways that hinder efficient intermediation. Supervisors can help mitigate misconduct risk and make the financial industry stronger by drawing from the growing literature about the root causes of misconduct and the supporting attributes of a healthy culture in financial firms.

I. Introduction

A core goal of banking supervision is to support the sustained provision of financial services to households and businesses in a fair and transparent manner. In order to meet this objective, supervisors examine financial institutions, individually and collectively, to help make them more resilient to a broad range of potential risks such as credit, market, liquidity, and operational risk. One specific risk that is gaining prominence is employee misconduct, the potential for behaviors or business practices that are illegal, unethical, or contrary to a firm's stated beliefs, values, policies and procedures.

The impact of employee misconduct extends beyond the individual and can impact the firm as a whole and the economy and financial markets more broadly. Employee misconduct can make a firm less resilient, for example, by diverting management attention, harming a firm's reputation in a way that impedes its business, driving change in the composition of the workforce, and depleting its capital. For the broader economy and financial markets, misconduct can inflict harm directly on consumers and employees. Over time, market participants may lose confidence in the financial sector as a whole and adversely impact its critical role in financial intermediation.

Gallup, for example, has found that confidence in the financial sector has fallen by half over the last decade.¹ Mark Carney, Governor of the Bank of England, recently concluded that "the incidence of financial sector misconduct has risen to a level that has the potential to create systemic risks by undermining trust in both financial institutions and markets."² These incidents can introduce frictions and raise the costs of intermediation that reduce the flow of financial services. These sorts of external effects that spill over to other firms, consumers, and businesses are a critical rationale for official sector intervention related to employee misconduct.

Supervisors have traditionally addressed misconduct risk by overseeing the effectiveness of firms' risk management and internal control functions, such as compliance and audit. This is

¹ Gallup, "Confidence in Institutions," *In Depth: Topics A to Z* (June 1-5, 2016), available online at: www.gallup.com/poll/1597/Confidence-Institutions.aspx.

² Mark Carney, "Building a Resilient and Open Global Financial System to Support Sustainable Cross-Border Investment," *Financial Stability Board* (August 30, 2016) at 7.

not a new issue and official sector concern with the damage inflicted by employee misconduct, for example, dates back to the Banking Act of 1933. That law provided the Federal Reserve and the OCC with the authority to remove bank officers and directors and prohibit them from the industry for engaging in unsafe and unsound banking practices.³

And yet, despite regulations, supervisory focus, and firms' own efforts, misconduct risk persists. In recent years, for example, high profile incidents of misconduct emerged related to reference rates, foreign exchange trading, and retail banking sales practices.⁴ In aggregate, large financial firms have paid fines in excess of \$320 billion worldwide in connection with employee misconduct.⁵

What explains this persistence? One hypothesis is that recent problems are just a stream of idiosyncratic events, random draws of "bad apples." Another is that some firms have operational weaknesses, "bad processes," that allow these outcomes. Root cause analyses of many recent cases of misconduct in the financial sector, however, suggest that misconduct is not just the product of a few individuals or bad processes, but is the result of wider organizational breakdowns. Often, large numbers of employees and managers were either complicit in improper conduct, encouraged it, or turned a blind eye to troubling behavior. This suggests a different issue.

Though there are undoubtedly many contributing factors that give rise to this type of widespread breakdown, there is a growing academic literature that focuses on a firm's *organizational culture* as a key driver of behavior and resultant misconduct risk.⁶ In this framing, culture is the set of attitudes, beliefs, practices, and values that mitigate or enhance misconduct risk. These cultural elements can be hard to define ex ante, but the impact ex post can be easily seen in the resulting behaviors and outcomes.

³ Banking Act of 1933, Pub. L. 73-66, 48. Stat. 162, Section 30.

⁴ Gary Gensler, "Remarks of Chairman Gary Gensler on Labor before the Global Financial Markets Associations Future of Global Benchmarks," February 23, 2013; Office of the Comptroller of the Currency, "OCC Fines Three Banks \$950 Million for FX Trading Improprieties," NR 2014-157 (November 12, 2014); Consent Order in the Matter of Wells Fargo Bank, N.A., 2016-CFPB-0015 (September 08, 2016).

⁵ Gavin Finch, "World's Biggest Banks Fined \$321 Billion Since Financial Crisis," Bloomberg (March 2, 2017).

⁶ See generally, Zanna Iscenko, Chris Pickard, Laura Smart, and Zita Vasas, "Behavior and Compliance in Organisations," U.K. Financial Conduct Authority, *Occasional Paper* 24 (December 2016); Alain Cohn, Ernst Fehr, and Michael Andre Marechal, "Business Culture and Dishonesty in the Banking Industry," *Nature* 516 (December 2014); Group of Thirty, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform*, Washington, D.C. (July 2015).

Firms and their boards of directors have primary responsibility to improve a firm’s culture and reduce misconduct risk, but the potential for external effects on other parts of the financial system means individuals and firms will likely underinvest in risk mitigation relative to what is socially optimal. From both a prudential perspective and a financial stability perspective, misconduct risk threatens the core supervisory objective to sustain the efficient provision of financial services to the economy, which suggests that supervisors have an obligation to promote strong internal practices that mitigate misconduct risk and create a healthy culture.

II. Misconduct Risk and Cultural Capital

Misconduct risk can be defined as the potential for behaviors or business practices that are illegal, unethical, or contrary to a firm’s stated beliefs, values, policies and procedures. Social science research on culture and behavior provides a useful framework for understanding the persistent organizational failures that trigger or allow misconduct. In this context, *culture* can be defined as the shared set of norms within a group that influences decision-making and is evidenced through behavior.⁷ Norms refer to attitudes and practices (“how we do things”), and beliefs and values (“the way things should be done”). As a working definition, an unhealthy culture is one with heightened risk of employee misconduct.⁸

Norms are often promulgated in unspoken ways. Research shows that people look to cues from the behavior of those around them to determine how to behave and interact.⁹ People learn what to do and how to do it by observing their colleagues and especially their leaders—emulating successful behaviors and avoiding unsuccessful ones. As existing members leave a group and new members join, these patterns of behavior reproduce themselves and evolve. Large groups may have multiple or even potentially competing cultures and sub-cultures among sub-groups.

⁷ Risk culture is a distinct subset of culture that reflects the way a group makes decisions about business risks.

⁸ Edgar H. Schein, *Organizational Culture and Leadership* (2004).

⁹ Henk Aarts, Peter Gollwitzer, and Ran Hassin, “Goal Contagion: Perceiving is for Pursuing,” *Journal of Personality and Social Psychology*, 87(1) (July 2014); Sushil Bikhchandani et. al. “Learning from the Behavior of Others: Conformity, Fads, and Informational Cascades,” *Journal of Economic Perspectives* (May 1, 1998).

One can think about a firm's *cultural capital*¹⁰ as a type of asset that impacts how the firm operates. Analogous to *physical capital* (equipment, buildings and property), *human capital* (the accumulated knowledge and skills of workers)¹¹, and *reputational capital* (franchise value or brand recognition)¹², cultural capital is an input into a firm's production process. Like these other forms of tangible and intangible capital, firms must invest in these assets or they will deteriorate over time and adversely impact the firm's productive capacity. To be clear, cultural capital is not loss absorbing like equity capital, but it can be loss preventing by influencing decisions, behaviors, and outcomes over time.

Cultural capital is an intangible asset – we generally see the impact rather than the thing itself – but its impact can be measured, assessed, and ultimately influenced. For example, in an organization with a high level of cultural capital, misconduct risk is low and observed structures, processes, formal incentives and desired business outcomes are consistent with the firm's stated values and beliefs promoting ethical conduct. The unspoken patterns of behavior reinforce this alignment. Employees understand and internalize the expectations of the law and the meaning of regulatory rules or supervisory guidance, and do not need to be reminded by enforcement actions and large penalties that compliance is an important part of sustained success. Problems are escalated to business unit leaders and senior managers routinely, as employees feel empowered to raise their hand and believe that their efforts will result in meaningful responses. And, senior leaders advance through the organization because, in addition to strong financial performance, they model behaviors consistent with the firm's values. This all adds to the firm's stock of cultural capital.

¹⁰ The term "cultural capital" has been defined differently in other contexts – i.e., defined as those symbols, skills and tastes a person acquires overtime from parents, institutions and surroundings that can be used as resources to achieve mobility in a stratified society. See Pierre Bourdieu "The Forms of Capital," *Handbook of Theory of Research for the Sociology of Education* (1986).

¹¹ Gary Becker, *Human Capital: A Theoretical and Empirical Analysis* (1964).

¹² See Thomas Noe, "A Survey of the Economic Theory of Reputation: Its Logic and Limits," *The Oxford Handbook of Corporate Reputation*, Timothy Pollock and Michael Barnett, eds. (July 2012). See Rebecca Demsetz, Marc Saldenberg, and Philip Strahan, "Banks with Something to Lose: The Disciplinary Role of Franchise Value," *Economic Policy Review*, 2 (October 1996) and Michael Keeley, "Deposit Insurance, Risk, and Market Power in Banking," *American Economic Review*, 80(5), 1183-1200.

By contrast, consider some characteristics of an organization with low levels of cultural capital. In these firms, formal policies do not reflect “the way things are really done.” The stated values of senior leaders are not reflected in the behaviors and actions of the organization’s members, and misconduct results from norms and pressures that drive individuals to make decisions that are not aligned with values and associated business strategies set by the board and senior leaders. Employees do not speak freely when they have concerns about the way their group is doing business, and senior managers or the board of directors do not find out about illegal conduct until it is uncovered by the authorities. Employees are focused on short-term results—such as this year’s bonus—and have little loyalty to the firm or commitment to enhancing the firm’s long-run value. Rules may be followed to the letter, but not in spirit. All of this reduces cultural capital, increases misconduct risk and potentially damages the firm and the industry over time.

III. Mitigating Misconduct Risk

If misconduct risk is bad for firms, why don’t they invest in cultural capital and reduce the risk themselves? Why do regulators and supervisors need to get involved? Firms themselves are ultimately responsible for these decisions and progress is currently being made, but there are good reasons to think that there may be wedges between privately- and socially-desired outcomes, so firms will likely not do enough. This creates a role for the official sector.¹³

Beginning within the firms themselves, there are signs that many large financial firms have increased their attention to misconduct risk and cultural drivers in the wake of serious frauds and enforcement actions over the last several years. Several large financial institutions in the U.S. have established specialized committees of their boards to consider culture and conduct issues, as well as similar groups within the firm. Many firms have initiated internal culture reform programs. Dozens of institutions with UK operations, including several of the largest U.S. banks, have joined the UK Banking Standards Board (BSB), an industry-led group devoted to raising cultural standards and changing behaviors. The BSB has engaged in extensive assessment and quantitative

¹³ Kevin J. Stiroh, “The Theory and Practice of Supervision,” Remarks to the SIFMA Internal Auditors Society (April 11, 2017) available online at www.newyorkfed.org/newsevents/speeches/2016/sti160411.

and qualitative analysis of their members' cultures.¹⁴ The six largest firms in the U.S. held a culture training workshop in January for their rising leaders.¹⁵

The degree of commitment and progress in these efforts has not been even, however, and some firms continue to experience serious misconduct issues. These firms may have been able to avoid some of the more damaging outcomes if they had taken larger steps to assess and improve their organizational culture and reduce misconduct risk.

One can turn to traditional economic theory to explain why firms might underinvest in cultural capital. Firms may operate with levels of cultural capital beneath both the social optimum and even the private optimum due to different types of market failures. Well-known phenomenon such as *externalities*, *principal-agent problems*, *adverse selection*, and *coordination failures* may explain why misconduct risk persists and why firms might underinvest in cultural capital relative to what might be socially optimal.

Externalities can drive a wedge between private and socially optimally outcomes and lead firms to underinvest in their own resiliency by ignoring the broader impact that bad outcomes at their firm can have on the financial sector and the real economy. This type of wedge, for example, is the conceptual rationale behind the enhanced prudential standards for capital, liquidity, and risk management that are currently applied to the largest, most systemically important financial institutions in order to reflect the potential loss to society of a firm's failure or distress.¹⁶ This same point applies to a range of risk-mitigating activities such as broad resiliency planning through capital and liquidity or building cultural capital.

Principal-agent problems reflect incentives for employees to act in ways that don't align with the broader interests of management or shareholders. This can lead to excessive risk-taking, underinvestment in risk-reduction and risk-control mechanisms, and a focus on short-term market pressures at the cost of long-run viability. These issues can be amplified by the opacity intrinsic

¹⁴ Banking Standards Board, *Annual Review 2016/2017* (March 2017) available online at <http://www.bankingstandardsboard.org.uk/pdf/banking-standards-annual-review-2016-2017.pdf>.

¹⁵ William Dudley, Remarks at the Culture Imperative: An Interbank Symposium, New York (Jan. 11, 2017) available online at <https://www.newyorkfed.org/newsevents/speeches/2017/dud170111>.

¹⁶ See "Consolidated Supervision Framework for Large Financial Institutions," Supervision and Regulation Letter 12-17, December 17, 2012.

to many financial activities that allows misconduct to persist and erodes the cultural capital of the firm.

Adverse selection could be a complicating factor if conduct-related events change the composition of the firm's workforce. Firms with relatively low cultural capital (and relatively high tolerance of misconduct risk) may attract and retain employees and clients more inclined to take inappropriate risks and push beyond internal limits and controls. Further, high-quality directors, executives, and employees might leave such firms or decline to join them, depleting the firm's human capital and contributing to the deterioration of cultural capital.

Coordination failures reflect the inability of private actors to reach a common objective that is in the collective best interest.¹⁷ For example, a bank may reasonably tighten its lending standards during a downturn to strengthen its balance sheet. But if every firm does the same, it will exacerbate the downturn and hurt the industry more broadly.¹⁸ Similarly, firms seeking to reduce misconduct risk face a coordination challenge, where short-term competitive pressures make it difficult to make long-term investments in cultural capital.

These types of market failures suggest a role for the official sector to encourage resiliency, including investment in cultural capital. To the extent that employee misconduct has external effects on others, reflects imperfect incentives and asymmetric information, and suffers from potential coordination failure, firms will likely underinvest in its broad risk management framework and its cultural capital.

If a goal of the official sector is to reduce misconduct risk to a socially-desirable level, it is useful to distinguish between two types of potential intervention by the official sector: supervision and regulation.¹⁹ Regulations are promulgated by administrative agencies, drawing on statutory authority. Supervision focuses on compliance with the regulatory regime and the interpretation of the law's requirement that financial institutions operate in a safe and sound

¹⁷ Andrew Crockett, *Marrying the Micro- and Macro-Prudential Dimensions of Financial Stability*, Remarks at the Eleventh International Conference of Banking Supervisors, Basel, Switzerland (Sept. 20, 2000).

¹⁸ Robert Hockett, *The Macroprudential Turn: From Institutional 'Safety and Soundness' to Systematic 'Financial Stability' in Financial Supervision*, *Virginia Law and Business Review*, 9 (2015).

¹⁹ See, e.g., Eisenbach et. al., *Supervising Large, Complex Financial Institutions: What Do Supervisors Do?* Federal Reserve Bank of New York Staff Reports, 729 (May 2015).

manner. The requirement that banks operate in a safe and sound manner is a “standard” not a “rule,” meaning that supervisors give content to the requirement over time. Standards-based oversight is designed to allow supervisors to use their judgment when deciding whether, in a specific case, a bank’s activities will reduce its prospects for solvency over time or threaten financial stability. In either case, official sector intervention is intended to help solve the underlying market failure.

In the case of misconduct risk, supervision seems particularly appropriate because its hard-to-define and evolving nature likely prevent easy regulatory solutions. Though some rule-writing could help re-align incentives, such as those contemplated under Section 956 of the Dodd-Frank Act, misconduct risk can take many different forms. Essential drivers of culture and hence of misconduct risk, for example, relate to leadership and “tone from above,” areas that are inherently behavioral and qualitative in nature.

It is useful to note that the need for a supervisory focus on employee misconduct and its underlying drivers dates back to the origins of bank supervision, and the early emphasis on the “responsibility and integrity” of bank managers and directors and its relationship “to public confidence.”²⁰ Part of the role of supervisors is to close gaps in the rules to advance safe and sound banking practices that support the sustained provision of financial services. Issues like misconduct risk and culture likely fall in these gaps because they involve the attitudes and norms that are required to have a functioning rule-based legal framework in the first place. It takes a rule-obeying culture—a culture of compliance—to make regulations effective. This suggests rules are dependent upon culture, not a substitute for it.

IV. Misconduct Risk as an Externality

From a supervisory perspective, the potential for employee misconduct at one firm to impact the broader financial sector is a critical rationale for intervention. Incidents of serious misconduct have negative externalities, tarnishing the industry and even the regulatory community, reducing

²⁰ An Act Supplementary to the Act to Incorporate the State Bank of Ohio, and Other Banking Companies, Chapter 299, *Laws of the State of Ohio* (January 6, 1846).

trust and confidence in financial services and imposing reputational and economic costs on others. Similar concerns motivate the Treasury Market Practices Group (TPMG), which develops best practices for trading in the treasury markets, and led to the creation of the FX global code for currency trading.²¹

Organizations with low incidence of misconduct and high levels of cultural capital, for example, are more likely to enjoy high levels of trust with their stakeholders. This is important because confidence and trust are public as well as private goods, as they impact the costs of intermediation and the need for inflexible legal rules for all.²² Trustworthiness limits contracting, bonding, and monitoring costs.²³

According to Gallup, 53 percent of Americans reported having “a great deal” or “quite a lot” of confidence in banks in 2004, compared to only 27 percent in 2016. Over the same period, the number of people reporting “very little” or “no” confidence jumped from 10 to 26 percent.²⁴ Globally, the European Systemic Risk Board (ESRB) notes that the industry is one of the least trusted sectors. Reduced trust in banks degrades the long-term functioning of the financial system more broadly.²⁵

It can be difficult to isolate the effect of misconduct on economic activity and market trust, but the ESRB points to evidence that the functioning of the U.S. residential MBS market has deteriorated in reaction to mis-selling and malfeasance, which has changed the behavior of professional investors.²⁶ We might also expect to see new entrants such as financial technology firms increase market share over time if they are able to establish a stronger reputation and greater public confidence. This is an area where more research is needed.

²¹ Global Foreign Exchange Committee, FX Global Code, available at www.globalfx.org/fx_global_code.htm.

²² See Sir David Walker, Trust and Trustworthiness in Banks and Bankers, Remarks at a Workshop on Reforming Culture and Behaviors in the Financial Services Industry, Federal Reserve Bank of New York (Oct. 20, 2014).

²³ As Walter Bagehot, *Lombard Street: A Description of the Money Market* (1873), put it “The peculiar essence of our banking system is an unprecedented trust between man and man; and when that trust is much weakened by hidden causes, a small accident may greatly hurt it, and a great accident for a moment may almost destroy it.”

²⁴ Gallup, “Confidence in Institutions,” *In Depth: Topics A to Z* (June 1-5, 2016), accessed online at www.gallup.com/poll/1597/Confidence-Institutions.aspx.

²⁵ Luigi Zingales, “The Need for a Market-Based Ethics,” *A Capitalism for the People* (2012).

²⁶ ESRB, *Report on Misconduct Risk in the Banking Sector* (2015), at 7.

A second potential spillover of proper conduct and strong cultural capital is what might be called *regulatory morale*, analogous to *tax morale*. This regulatory morale can be considered a resource that supports all official sector objectives by making firms and employees more likely to comply with regulations. As mentioned earlier, the effectiveness of rules depends on a high degree of voluntary compliance, both in letter and in spirit. For example, in tax law, voluntary compliance is known as tax morale, and tax policy focuses on preserving this vital asset.²⁷ In countries where people simply do not feel that it is necessary to pay their taxes, it is very expensive to raise revenue. Enforcement and deterrence are comparatively costly compensatory tools that sometimes have limited ability to motivate compliance.

In banking, firms may go right up to the fine line of a rule, or to find a way around a rule's strictures to defeat its purpose. The erosion of voluntary compliance by supervised firms can jeopardize critical official sector objectives ranging from consumer protection to financial stability.²⁸ Culture plays a role in determining how much effort will be devoted to defeating regulations, rather than complying with them. In this way, culture is an important complement to rules and not a substitute. Part of the role of supervisors has always been to monitor the gaps in the rules and to ensure that firms are complying with relevant regulations, not compromising them.

V. What Can Supervisors Do?

Supervisors from many jurisdictions are increasingly focused on misconduct risk, and have developed new tools and practices for identifying low cultural capital and finding ways to influence its build-up. This is critical because firms must overcome the fundamental obstacles described earlier and there are limits to the deterrence and enforcement approach to addressing these challenges. Firm-level fines, for example, can be a useful mechanism to provide incentives to invest in compliance and controls, but may be insufficient due to the types of market failures

²⁷ Ronald Cummings, et. al., "Tax Morale Affects Tax Compliance: Evidence from Surveys and an Artefactual Field Experiment," *Journal of Economic Behavior and Organization*, 70(3) (2009); Erzo F. P. Luttmer and Monica Singhal, "Tax Morale," *Journal of Economic Perspectives*, 28(4) (2014).

²⁸ For example, one study showed that corporate employees were more likely to follow policies and obey rules when they believed that these rules deserved to be obeyed. Generally, another study shows that people are more likely to obey the law because they believe it is legitimate than because they fear punishment. Tom Tyler, *Why People Obey the Law* (2006); Tom Tyler and Stephen Blader, "Can Businesses Effectively Regulate Employee Conduct?: the Antecedents of Rule Following in Work Settings," *Academy Management Journal*, 48 (2005).

discussed earlier. To understand how a firm proactively manages misconduct risk and to improve resiliency and reduce misconduct, supervisors are increasing their focus on decision-making practices and behavior as a core aspect of governance. Drawing from the growing literature about the root causes of misconduct and the underlying factors that drive unhealthy cultures can support this objective.

The Group of Thirty has conducted a stock-take and recommended best practices for overseeing misconduct risk and culture. They conclude that supervisors should “credibly identify serious problems institutions are not addressing” with respect to culture and conduct; “challenge board executives on how they oversee, understand, measure, and manage” culture and conduct problems; promote “early intervention” to address problems before “serious deficiencies” result in enforcement actions and severe outcomes; lead “standard-setting initiatives” and convene industry leaders to identify forward-looking issues; and, use public communication to identify “emerging practices that could pose conduct challenges and that deserve attention by firms.”²⁹

The Financial Stability Board (FSB) has undertaken a wide-ranging review of efforts to strengthen governance frameworks in order to mitigate misconduct risk, recently publishing a report summarizing activities currently underway, reviewing the literature on root causes for misconduct, and assessing areas in need of further work.³⁰ Over the next year, members will be specifically addressing issues such as: (a) rolling bad apples, when dismissed employees move from firm to firm; (b) responsibility mapping, which considers how firms assign responsibilities to board members and senior management with respect to misconduct risk; and (c) cultural factors that can undermine governance structures and drive misconduct. These efforts build on FSB supervisory guidance on risk culture issued in 2014.³¹

²⁹ Group of Thirty, *Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform*, Washington, D.C. (July 2015), at 15, 54-56.

³⁰ Financial Stability Board, *Stocktake of Efforts to Strengthen Governance Frameworks to Mitigate Misconduct Risks* (May 23, 2017) available online at <http://www.fsb.org/2017/05/stocktake-of-efforts-to-strengthen-governance-frameworks-to-mitigate-misconduct-risks/>.

³¹ Financial Stability Board, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture* (April 7, 2014) available online at <http://www.fsb.org/wp-content/uploads/140407.pdf>.

In the UK, the Financial Conduct Authority (FCA) has developed a conduct risk framework called the “5 Conduct Questions”³² as part of the agency’s broader culture and governance priority set out in its 2016/2017 Business Plan.³³ Supervisors use these lines of inquiry to probe director and senior manager efforts to identify potential cultural weaknesses and reduce misconduct risk.³⁴ The “5 Conduct Question” framework also allows the FCA to compare and contrast firms’ efforts to combat misconduct, and to share the range of practices across the industry.

The UK government has also launched a senior manager’s regime,³⁵ to increase accountability and responsibility for conduct issues among executives, and conducted a parliamentary inquiry, which resulted in the establishment of the UK Banking Standards Board in 2015 to facilitate firms’ own efforts to address weak culture.

In Australia, the Prudential Regulatory Authority began risk culture assessments of supervised institutions in 2015.³⁶ Their supervisory teams explore whether institutions’ boards establish and maintain sound risk cultures, including promoting desirable changes to the existing risk culture as necessary. The underlying assumption in this approach is that a sound risk culture reduces the frequency and impact of misconduct-driven losses, and contributes to increased trust in the financial industry. They look to identify root causes in the organizational system for poor results. Their approach also aims to foster self-assessment and self-reflection by firms’ leadership.

Since 2011, the Dutch National Bank (DNB) has employed a specialized unit with a range of social science backgrounds to conduct culture and behavior reviews of firms it supervises.³⁷ They have developed extensive experience on methods and approaches to assessing organizational culture weaknesses through examining how behaviors related to decision-making, communication,

³² Financial Conduct Authority, Conduct Risk Programmes, available online at <https://www.fca.org.uk/firms/5-conduct-questions-feedback>.

³³ FCA Business Plan 2016/17 available online at <https://www.fca.org.uk/publication/corporate/business-plan-2016-17.pdf>, at 34-35.

³⁴ Financial Conduct Authority, Senior Managers Regime, available online at <https://www.fca.org.uk/publication/corporate/applying-smr-to-fca.pdf>.

³⁵ <http://www.bankofengland.co.uk/pru/Pages/supervision/strengtheningacc/default.aspx>.

³⁶ Australian Prudential Regulatory Authority, *Information Paper: Risk Culture* (October 2016) available online at www.apra.gov.au/CrossIndustry/Documents/161018-Information-Paper-Risk-Culture.pdf.

³⁷ De Nederlandsche Bank, *Supervision of Behavior and Culture* (2016) available online at https://www.dnb.nl/binaries/Supervision%20of%20Behaviour%20and%20Culture_tcm46-334417.pdf.

leadership and group dynamics amplify or mitigate risk. The DNB’s industrial psychologists work with traditional supervisory teams in diagnosing root cause problems that might heighten misconduct risk or result in other outcomes that reduce safety and soundness.

In March 2017, the Hong Kong Monetary Authority issued guidance that directs supervised institutions to develop and promote a sound corporate culture through a three-pillar framework: governance, incentives, and assessment and feedback.³⁸ As part of the governance pillar, supervised institutions must have a dedicated board-level committee to advise and assist the full board in its culture-related responsibilities. The guidance also requires supervised institutions to have incentive systems that account for individual and business unit adherence to culture and conduct standards.

As one of its key priorities for 2017-2020, Canada’s Office of the Superintendent of Financial Institutions (OSFI) plans to assess how risk culture and other drivers of behavior support or undermine effective risk management across a range of its supervised institutions.³⁹ OSFI has also looked at the role of risk culture in firms’ acquisition decision-making processes.⁴⁰

In the U.S., supervisors oversee a range of factors that impact culture and misconduct risk. For example, supervisors routinely evaluate the oversight responsibilities of directors, the stature and investment in control functions such as internal audit and compliance, and consider how firms respond to events at their own firm and those raised at other firms. New Federal Reserve guidance for board effectiveness is out for public comment.⁴¹ Additional efforts include review of conduct in sales practices at large retail banks. This work will, among other things, consider how these incentives and structures may drive misconduct.

These official sector interventions can be seen, in part, as attempts to mitigate the impact of the market failures described in Section III. For example, the Group of Thirty efforts around standard-setting and convening the industry and the UK’s Banking Standards Board should help

³⁸ Hong Kong Monetary Authority Circular, “Bank Culture Reform,” issued on March 2, 2017, available online at <http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2017/20170302e2.pdf>.

³⁹ OSFI 2017-2020 Priorities available online at <http://www.osfi-bsif.gc.ca/eng/docs/pp1720.pdf>.

⁴⁰ <http://www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/sp-ds/Pages/jh20160505.aspx>.

⁴¹ <https://www.gpo.gov/fdsys/pkg/FR-2017-08-09/pdf/2017-16735.pdf>.

solve coordination failures and drive industry solutions. The rolling bad apples problem identified in the FSB work is an example of adverse selection that could impact both firm-specific and industry-wide outcomes. In the U.S., work around sales practices includes a focus on compensation mechanisms that can contribute to principal-agent problems.

There may also be a role for supervisors in adding to the work that firms have already begun. Many of the largest institutions are instituting culture reform programs involving changes in leadership practices, increased individual accountability, adjusting incentives, and employee training. As part of these efforts, firms are developing integrated dashboards and tools to pull together data from across their organization, breaking down silos, and spotting behavioral patterns and trends. Further, firms are changing their internal policies to enhance their performance management, promotion, and compensation practices to reflect the “how” as well as the “what” in employee performance.

Supervisors can support the sharing of leading practices among firms from a horizontal perspective. The official sector may also be able to facilitate firm-led efforts to develop benchmarking tools and other industry-wide assessments.

VI. Conclusion

Bank supervisors and regulators promote the sustainable provision of financial products and services to the economy over time. This can be disrupted by employee misconduct, which hurts individual firms by diverting resources and attention, hurting reputations, and depleting their equity capital through large fines. Moreover, misconduct can hurt the industry more broadly by decreasing trust and confidence in the financial sector. As a result, supervisors have been increasing their focus on this critical area and working to promote appropriate investments in cultural capital that can mitigate misconduct risk.

Supervisors should also recognize that the same underlying cultural dynamics that drive misconduct risk may also drive other equally consequential outcomes related to different risks and business decisions. Firms with a stronger culture may not only face lower misconduct risk, but may also exhibit greater resilience overall, higher customer satisfaction, better employee morale and well-being, and enhanced productivity over the long-term. These benefits certainly accrue to the firm, and would likely also benefit the broader financial system and economy.