“Strengthening Culture for the Long Term”

Remarks by

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at

Reforming Culture and Behavior in the Financial Services Industry:
Progress, Challenges, and the Next Generation of Leaders

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Good morning. Thank you for joining the New York Fed's conference on culture and behavior in the financial services industry. Let me begin by welcoming John Williams on his first day as President of the New York Fed. He will give concluding remarks this afternoon. John and I are very much on the same page when it comes to the issue of bank culture, and I am very happy about that. But, as always—and especially today—the views I express are my own, and not those of the New York Fed or the Federal Reserve System.[1]

I am proud of the work that the New York Fed has done on bank culture. This institution was not the first or only voice in what is truly a global dialogue. But, I believe we have made meaningful contributions and have helped legitimize a topic that many viewed with skepticism a few years ago.

I also believe that there is much more to do. This morning, I will speak briefly about three unmet goals. First, we need further evaluation and recalibration of incentives within firms. Second, we have to benchmark culture across the industry. Third, we must overcome hurdles to sharing information about employee misconduct.

The Work So Far

Many of you have attended previous culture conferences at the New York Fed. For those who have not, let me explain why the New York Fed took up this work and what we have learned.

Four years ago, we decided to shine a spotlight on the culture of the financial services industry. The litany of post-crisis scandals—especially the LIBOR and FX rate manipulation scandals—galvanized our involvement. We wanted to encourage the industry to address the root causes of misconduct. We also wanted to promote a sense of stewardship commensurate with the important role that financial firms play in society.

Around the same time, directors and senior executives at a number of firms were asking similar questions. Many foreign authorities were also probing the root causes of misconduct. Several were contemplating new regulatory responses. In short, others recognized, as we did, that the financial crisis and subsequent scandals had called the industry's trustworthiness into question in a fundamental way. This was an important point that Sir David Walker made at the start of our first culture conference in 2014.[2]

The short-term consequences of a lack of trustworthiness—such as supervisory orders, fines, or other civil or criminal penalties—may be finite and passing. The long-term consequences, however, may be more serious and enduring. Increased regulation—sometimes an inefficient substitute for trust—could limit the scope and scale of activities of financial firms. Employees may choose to apply their talents in other, less controversial fields instead of finance.

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[1] Stephanie Chaly, Gerard Dages, James Hennessy, Thomas Noone, Glen Snajder, Joseph Sommer, Angela Sun, and Joseph Tracy assisted in preparing these remarks.

[2] See David Walker, "Trust and Trustworthiness in Banks and Bankers," Remarks at the Federal Reserve Bank of New York (Oct. 20, 2014), at https://www.home.barclays/content/dam/barclayspublic/docs/BarclaysNews/2014/10.%20October/Speech_Trust%20in%20Banks%20and%20Bankers.pdf.

Customers might look outside of traditional channels for financial services. Shareholders could downgrade their expectations about future returns and reduce their exposures to the financial sector. And, when the next financial crisis inevitably occurs, the loss of trustworthiness might diminish the public's support for forceful intervention, potentially placing the stability of the financial system at risk.

These consequences are serious, but avoidable. A good culture can help prevent them.

So, what is a good culture? There are many ways to frame an answer. I like what Baroness Onora O'Neill proposed at our last conference: In a good culture, shared norms align with the public and private purposes of a financial institution over both the short term and the long term.[3] This means that financial professionals and their institutions are able to generate sustainable returns in a competitive market, but in a way that collectively, and over the long term, is consistent with financial system efficiency and stability. I look forward to discussing the role of finance in society in today's first panel, moderated by Gillian Tett of the *Financial Times*. And I am grateful that Jay Clayton, Chairman of the U.S. Securities and Exchange Commission, will contribute his views later today.

Our prior conferences have considered a number of ways to improve culture. We have discussed how leaders can overcome hierarchies and send a credible message to all levels of their organizations. Raising one's hand and effective challenge have also resonated year after year. Preet Bharara spoke memorably about the dangers of a "culture of silence," in which good people choose to remain quiet when they witness misconduct around them.[4] Another theme has been the importance of finding allies. Many supervisors, academics, consumer advocates, institutional shareholders, and policy makers are interested in improving culture in financial services. Partnering with others can help improve the standards of behavior.

Today's conference highlights one such opportunity. For several years, the New York Fed has brought together industry leaders with business school professors and deans to discuss how business education can contribute to improved standards in financial services. We'll hear about the outcomes this afternoon from a panel moderated by Michael Strine, our First Vice President. I hope you will find the discussion helpful in thinking about what type of person you want to hire.

Moreover, once you have identified the right people, how do you compel them to stay? I am convinced that improving the industry's trustworthiness will make finance a more attractive place to build a career. Like attracts like. Employees with a creative streak thrive in workplaces that embrace innovation. Similarly, employees with a well-developed sense of ethics seek work environments characterized by integrity. Finance should be both intellectually and ethically fulfilling—a field where people can use their heads during the day and sleep well at night.

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[3] See Onora O'Neill, "What is banking for?" Remarks at the Federal Reserve Bank of New York (Oct. 20, 2016), at https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/ONeill-Culture-Workshop-Remarks-10202016.pdf.

[4] See Preet Bharara, "Criminal Accountability and Culture," Remarks at the Federal Reserve Bank of New York (Oct. 20, 2016), at https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/PreetBharara-Remarks-Culture-Conference.

The Work Ahead

I applaud the progress that has been made to date. But, the emphasis of this conference should be on what can still be accomplished.

Incentives

In my view, improving incentives is the most direct way to improve culture and conduct. Incentives drive behavior. Behaviors establish social norms. Shared social norms are the foundation of a group's culture. Because incentives fall mainly within an employer's control, employers can use them to influence employee behavior and corporate culture.

Foremost, how are employees paid? Do compensation arrangements—the mix of fixed and variable compensation, debt and equity, vested and deferred—encourage behavior that is aligned with the values of a firm as they are publicly stated? If not, how can they be improved?

Arguably, career progression is as important as compensation. Who is promoted? Who is let go? Are high-revenue producers kept on and rewarded even when they do not exhibit good behaviors or ethics? What do these decisions say about the commitment of a firm's management to good culture? Employees, after all, look to see who succeeds and who does not, and model their own behaviors around the former, not the latter.

Other forms of recognition can also encourage behaviors that advance an organization's values and mission. In the day-to-day workplace, how do employers acknowledge employee contributions? When employees speak up, how are they treated? What are the incentives, or disincentives, around asking for help on difficult technical and ethical issues?

Many of today's panels will discuss incentives in their various forms. I am particularly interested to hear the panel that will discuss the Group of Thirty's work. Three years ago, the Group of Thirty proposed that compensation should take equal account of financial performance and professional conduct.[5] Have firms embraced that recommendation? If so, what have been the results? If not, why not?

In this vein, my own proposal on compensation seems to have fallen on deaf ears. Four years ago, I proposed that firms create a performance bond in which senior managers and material risk takers defer a portion of their variable compensation for five or 10 years.[6] In the meantime, that pool of money would be available to pay regulatory fines or to help recapitalize a firm in distress. In my view, that structure would better align the interests of senior leaders with the interests of creditors and shareholders. It would also promote financial stability by reducing

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[5] See Group of Thirty, "Banking Culture and Conduct," 49 (2015) ("To ensure that staff assessments are thorough and consistent, approximately half the rating of balanced scorecards should be based on how business results are achieved and behaviors and conduct exhibited, as opposed to the achievement of the business results themselves (that is to say, the balanced scorecard should be split 50/50 between performance, and conduct and culture metrics)."). http://group30.org/images/uploads/publications/G30_BankingConductandCulture.pdf.

[6] See William C. Dudley, "Enhancing Financial Stability by Improving Culture in the Financial Services Industry," Remarks at the Federal Reserve Bank of New York (Oct. 20, 2014), at https://www.newyorkfed.org/newsevents/speeches/2014/dud141020a.html.

the incentives for excessive risk-taking and by providing a source of funds for recapitalization of a troubled firm.

The concept is hardly novel. What I have proposed closely resembles the old partnership model of investment banks. What's more, a similar regime governs compensation of senior managers and material risk takers in the United Kingdom.[7] This demonstrates that the concept can work on a broad scale. But, to the best of my knowledge, no firm in the United States has voluntarily adopted such a regime.

If there are implementation problems with creating a mechanism similar to what I proposed, let's discuss them. If there are alternatives, let's explore them. The key point is that firms need to take a hard look at how they reward employees. If we ignore the issue, we risk repeating many of the mistakes that contributed to the crisis and subsequent scandals.

Benchmarking

Beyond incentives, benchmarking remains a challenge for U.S. financial firms. Later today we will hear from the leaders of the Banking Standards Board in the United Kingdom. Their pioneering work assists UK firms in understanding the shared norms that contribute to employee behavior.[8]

The Banking Standards Board has shown that benchmarking across firms—even firms with widely different balance sheets and business models—is within our grasp. So, why aren't we doing this in the United States? Some cite legal risk. Here again, let me return to a message in the Group of Thirty's report from 2015: Some risks are worth taking.[9] Besides, most firms—if not all—already conduct their own proprietary culture surveys. Why not adopt a standard list of questions? You might gain new insights into the characteristics of your organization and how you stack up against others. An independent, third-party survey could help identify patterns of behavior across different lines of business within a firm, and across the industry. Moreover, you might get higher-quality information. After all, it is not unheard of for internal surveys to suffer from bias, such as employees adjusting their responses to be consistent with management's expectations. At the very least, firms would demonstrate that they take seriously their role in a broader, industry-wide effort to improve conduct and to be more worthy of trust. I do not see what harm could possibly come from that.

Information sharing

The industry can also improve the way it shares information about misconduct. We've heard in previous years about changes in how firms explain instances of misconduct to their employees. There is a trend toward sharing information internally about what happened, why, and how to avoid the same mistakes in the future.

[7] See, e.g., Prudential Regulation Authority Rulebook, Remuneration §§ 15.17-19 (establishing mandatory deferrals), 15.20-23 (requiring performance adjustments).

[8] See Banking Standards Board, *Annual Review 2017/2018*, at https://www.bankingstandardsboard.org.uk/annual-review-2017-2018/.

[9] Group of Thirty, *supra* n.5, at 53 ("As noted, some banks have accepted the higher legal or financial risks that accompany disclosing this information, and this report encourages more of that attitude.").

Unfortunately, other information hurdles remain. Later today, Jeremy Rudin, Canada's Superintendent of Financial Institutions, will describe a project he recently undertook on behalf of the Financial Stability Board. The result of that year-long effort was a toolkit that addressed, among other issues, ways that firms can better identify so-called "rolling bad apples."[10] The key lesson from the report is that while firms do not control the information they receive, they can improve their own internal processes. For example, employers can—and, in my view, should—check whether their communications with prospective employees set clear and consistent expectations about conduct. A truly "bad apple" may avoid a firm that is upfront about its values and unapologetic about how adherence to those values affects careers. In addition, employers can—and should—train employees on interviewing techniques that focus on ethical judgment as well as technical competency. These techniques may help employers notice potential red flags—candidates perhaps more willing to engage in unethical behavior. Private and public institutions alike should consider the messages within this report.

We should also consider the costs and benefits of requiring firms to share information with each other. In the United Kingdom, a component of the new Senior Managers and Certification Regime is what's called "regulatory references."[11] These are mandatory, employer-to-employer reports about a job candidate's prior conduct. Regulatory references have the same goal as an idea I have proposed: a database of banker misconduct.[12] Banks would have a duty to report misconduct and a duty to check the database before hiring a new employee. The database would require a new federal statute to establish these duties, as well as a safe harbor for employers and enhanced protections for employees.

Importance of candor

Meeting these three goals—improving incentives, benchmarking, and information sharing—will require candor. Let's be frank about what works, what does not, and why.

One other issue that would benefit from greater candor is the role of supervisors. Changing culture is the industry's responsibility. We are fond of saying that the official sector has "a role," but we do not often get beyond that. Today, I hope to go a bit further. We will hear about a number of different approaches from a panel of senior supervisors from Hong Kong, the United Kingdom, Canada, and the Netherlands. For members of the audience today who come from the official sector—about half of you—I invite you to consider how your methods compare to the approaches discussed in the panel. I also challenge you to consider whether, as prudential supervisors, you could do more. In my opinion, it is important that supervisors assess whether incentives are likely to yield conduct that promotes safety and soundness, respect for law, and financial stability.

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[10] See Financial Stability Board, *Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors* (Apr. 20, 2018), at http://www.fsb.org/2018/04/strengthening-governance-frameworks-to-mitigate-misconduct-risk-a-toolkit-for-firms-and-supervisors/.

[11] See Financial Conduct Authority, Template for regulatory references given by relevant authorized persons and disclosure requirements, at http://www.handbook.fca.org.uk/handbook/SYSC/22/Annex1.pdf

[12] See Dudley *supra* n.6. See also Michael Held, "Reforming Culture and Conduct in the Financial Services Industry: How Can Lawyers Help?," Remarks at Yale Law School's Chirelstein Colloquium, Mar. 8, 2017, at https://www.newyorkfed.org/newsevents/speeches/2017/hel170308.

Conclusion

Working at the New York Fed for the last 11 years has been the honor of a lifetime. I am grateful to Tim Geithner, who entrusted me with the responsibilities for running the Markets Group, and to the New York Fed's board of directors and the Federal Reserve's Board of Governors for the opportunity to lead this organization.

More importantly, I am grateful for having had the privilege to work each day with the staff at the New York Fed. Many people cite the performance of the New York Fed staff during the crisis as our finest hour. I certainly wouldn't dispute that. But, that type of response did not come out of the blue. Every day, staff at the New York Fed work to fulfill the mission of this organization. We were able to perform well in the crisis because there was such a practiced and shared commitment to the public interest.

The culture of the New York Fed is not perfect. No culture is. It was and continues to be important that this institution strives to improve and is responsive to criticism. But, I have never doubted the dedication of the New York Fed's staff to its public mission.

In particular, I want to thank all the members of the staff who have contributed to the New York Fed's work on culture. The culture initiative shows another strength of this institution—its ability to draw from many professional disciplines to advance common goals. Thank you all for your great work.

And, thanks again to everyone here today. I wish you all a productive conference and look forward to seeing further progress on the bank culture front.

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