OCTOBER 28, 2014

WORKSHOP ON REFORMING CULTURE AND BEHAVIOR IN THE FINANCIAL SERVICES INDUSTRY

The New York Fed hosted a workshop on Monday, October 20, 2014 dedicated to reforming culture and behavior in the financial services industry. Approximately 100 participants attended, including representatives from the industry, domestic and foreign regulators, and academia. The purpose of the day-long event was to discuss the roots of cultural and behavioral failures in the industry and strategies that might improve the status quo.

Key areas of discussion included:

- The need to rebuild public trust in the financial services sector;
- Historical changes to the size and structure of financial services firms and the nature of competition in the industry;
- How compensation incents behavior;
- The responsibility of senior leadership for initiating, measuring, and sustaining cultural and behavioral change;
- Initiatives that firms have undertaken to curb undesirable behavior; and
- How law enforcement shapes cultural and behavioral trends.

The workshop also featured remarks from New York Fed President William C. Dudley, Barclays Chairman David Walker, and Federal Reserve Board Governor Daniel K. Tarullo. Their speeches, which have been released publicly, emphasized the pressing need for reform across the industry, offered specific ideas for improvement, and highlighted the potential consequences of a further decline in public trust.

Opening Remarks and Keynote Address

During his welcoming remarks, Mr. Dudley explained that he convened the workshop to address an "apparent lack of respect for law, regulation, and public trust [that] persists within some large financial institutions." In his assessment, "the industry is not close to where it needs to be." Failing to address these cultural problems was not an option because unlawful or unethical behavior harms financial stability. He described the workshop as an effort to promote an ongoing, frank, and practical discussion on how financial institutions can materially improve their cultures.

Following Mr. Dudley's comments, Mr. Walker delivered a keynote address on the importance of public trust in banks.[1] The trustworthiness of banks depends, in Mr. Walker's view, on three factors. He described the first two as "hard" ingredients: the financial soundness of individual

[1] For the purposes of this summary, the terms "financial institutions," "firms," and "banks" are used interchangeably.

institutions and of the industry and the resilient functioning of operational processes and systems. These two categories are much improved since the crisis. But he warned that there has been far less improvement on the third ingredient, which some might characterize as a "soft" factor: how financial institutions treat their customers and employees.

Mr. Walker argued that the re-establishment of trust begins with the "clear articulation by the board of the purposes and values to which it commits," adding that "[s]implicity in the message will limit the scope for nuance, but uncomplicated clarity is the better prize." He maintained further that a bank's leadership must, at a minimum:

- Demonstrate publicly its commitment to high ethical standards;
- Promulgate higher standards of conduct to complement traditional compliance functions;
- Invest in additional training;
- Align financial and career incentives with core principles; and
- Measure behavior with a view to promoting accountability.

According to Mr. Walker, the financial services industry has the principal responsibility for improving its culture. One avenue for improvement could be "self-regulatory initiative[s]," such as the Banking Standards Review Council in the United Kingdom (the "BSRC"). Regardless of the particulars, however, he maintained that there is urgent need for change. "Whatever priority was given in the past to the balance between the bank's operating model and its culture, in this new environment the visibility and credibility of the bank's culture is certain to be a clear differentiating factor in overall performance."

Following Mr. Walker's address, the workshop presented two panels. The first focused on the historical development of culture within the industry. The second considered the role of compensation in incenting behavior. After lunch, two additional panels discussed industry-driven reform and the role of law enforcement in shaping culture and behavior.

The following summaries of panel discussions are based on remarks and questions offered by moderators, panelists, and workshop participants. These summaries do not reflect all the views that were expressed at the workshop, but attempt instead to identify key themes in each topic of discussion. No portion of the panel summaries is attributed to a particular speaker. The views expressed herein do not necessarily reflect the position of the Federal Reserve Bank of New York or the Federal Reserve System.

Development of Culture in the Financial Services Industry

The first panel addressed the evolution of culture in the financial services industry over the last three decades. Some observed that a lack of clear values and priorities contributed to cultural and behavioral dissonance, especially in increasingly complex, global institutions. Competing firm objectives—for example, long-term franchise sustainability and short-term financial performance—may have sent conflicting messages to customers and employees. Some noted in particular that increased competition and employee mobility in certain areas of finance spurred an increased focus on short term benchmarks for performance and compensation. This ultimately created a misalignment between compensation practices and long-term sustainability. High employee mobility also had a tendency to displace loyalty to a firm in favor of loyalty to oneself alone or the market segment in which the employee functioned.

The scale and complexity of firms today and the tendency of large institutions to encounter governance gaps was another topic of discussion. For example, a firm with 60,000 employees and a 99.9 percent record of compliance with behavior rules might still have up to 60 employees whose misbehavior could inflict severe harm on the firm and its customers. It was observed that this risk became especially grave if many of these 60 employees were housed within a single business unit with its own micro-culture. The growth of financial institutions also increased management layers, which may have created additional challenges for transmitting cultural values. Some observed that many young employees require guidance on acceptable risk-taking. But in a growing hierarchy, junior personnel had less direct contact with firm leaders, who were more likely to keep the long-term goals of the firm in mind. In addition, some participants noted that as products and services became more complex, some firm leaders lost the ability to understand fully the risks within their business.

By the conclusion of the panel, a consensus emerged around three points. *First*, firm leadership must articulate more clearly the organization's core values and purposes. *Second*, culture could be improved by restoring more direct contact and mentoring between senior leadership and junior staff. *Third*, management should give its sustained attention to culture and behavior. In each of these efforts, firms should emphasize the importance of how a firm and its employees earn money, as opposed to how much money is earned.

Compensation as an Incentive for Behavior

The second panel addressed compensation, which some described as the most powerful lever for influencing behavior. Specific topics of discussion included:

- Optimizing the balance of fixed and variable compensation;
- Incorporating behavioral aspects of performance into compensation policies and practices; and
- Reinforcing, through compensation decisions, the message that how one achieves a financial result is as important as the result itself.

The touchstone for this panel was the alignment of compensation practices with long-term business sustainability. This theme was apparent, for example, in a discussion of the need for tail (or latent) risk to be internalized by firm leadership and material risk takers. Long-term sustainability was also cited as the goal of deferred debt compensation programs and efforts to incent employee loyalty in a highly liquid job market.

Another theme was the importance of performance measurement. Specifically, standardized metrics could help to quantify the judgment and behavior of individual employees and broader changes in firm-wide culture. The former category would be useful in annual performance reviews for employees. The latter would help boards and senior management assess the effectiveness of their communications about firm values. Some suggested that 360-degree reviews, which many firms already use as part of their annual performance assessments, could be a valuable source of measurable information about behavior and culture.

Another topic of discussion was the appropriate means of holding employees accountable for poor behavior. Some observed that coaching to a higher standard might be appropriate in some cases. But more egregious transgressions demand blunt consequences, including material reductions in variable compensation or termination. It was noted that employees witness poor conduct long before senior management becomes aware of it, and wait to see whether there are consequences. If no consequences are seen, employees may mistake poor conduct as acceptable behavior.

Finally, several panelists and workshop participants noted that when it comes to compensation packages, complexity is the enemy of the good. The simpler the overall policy and particular calculations, the easier it would be for individual employees to understand firm expectations, and for senior leaders to gauge the relationship between compensation and the firm's risk profile.

Luncheon Remarks

Over lunch, Mr. Tarullo urged the industry to avoid a "check-the-box" approach to improving behavior. Firms should focus instead on the more challenging task of understanding what employees perceive to be the firm's expectations for conduct. He asked: "Do employees understand their job to be maximizing revenues in any way possible so long as they do not do anything illegal, or do they understand their job to be maximizing revenues in a manner consistent with a broader set of considerations?"

Mr. Tarullo said that although each firm may have its own principles, "some concrete organizational systems are needed for firms to carry into effective action the goals or values that they nominally espouse." He highlighted, as had others in the morning panel discussions, the question of whether a "trading mentality has migrated to other parts of large financial firms, so that . . . the firm has no 'customers' or 'clients,' only counterparties." He also warned that while this "attitude is typical for trading in anonymous markets or with equally sophisticated institutions, it hardly seems designed to engender trust on the part of those who have ongoing relationships with the firm."

In practical terms, firms implement their values through policies of rewards and punishments, he said. Firms must continue and extend the work they have undertaken to adjust compensation systems and other controls, positive and negative, so as to incent appropriate behavior. Mr. Tarullo concluded: "My expectation is that if banks do not take more effective steps to control the behavior of those who work for them, there will be both increased pressure and propensity on the part of regulators and law enforcers to impose more requirements, constraints, and punishments."

Industry-driven Reform

The third panel premised its discussion of industry-driven reform on three observations. *First*, clients and investors recognize cultural differences among financial services firms. It is therefore unwise to dismiss culture as irrelevant to a firm's bottom line. *Second*, the industry should acknowledge that there has been a widespread run on trust, and that unlike clients of banks, the public may view a mistake by one institution as a mistake by the entire industry. *Third*, industry reform efforts should be the topic of constructive dialogue with the official sector.

Participants and panelists observed that a healthy culture demands coordination across all divisions of an institution led by its board and senior management, who articulate and demonstrate standards of conduct. Lasting cultural change would likely require that firm leadership devote sustained attention to a series of efforts, which may have to be repeated over the course of several years:

- Promulgation or clarification of business standards;
- Education of multiple tiers of leadership;
- Direct communication with the rank and file; and
- Measurement of behavior.

Elaborating on these points, some posited that a clear, concise and consistent statement of purpose is a necessary foundation for firm-wide business standards. Regarding training, it was noted that while there is no substitute for direct, personal contact with senior leadership, there are practical limits on the ability of management to engage personally with each employee. To this end, some suggested that board members could play a key role in communicating firm values directly to employees. It was also recommended that an informal network of credible role models within a firm may supplement and reinforce senior leadership's message about culture and behavior. These individuals may not hold senior titles and may include retired leaders. What they have in common, though, is peer respect and effective communication skills.

Some panelists and participants supported a coordinated reform effort among financial institutions. Others cautioned that such an effort would need to overcome suspicions that it was a mere lobbying or public relations initiative, which would further deplete trust in the industry. The BSRC was discussed as a potential model for such collaboration. Panelists also took note of initiatives taken by other industries that had faced public criticism of their conduct.

Another suggested approach to cultural reform was to simulate aspects of investment partnerships at large banking corporations. Such an approach might include flattening firm hierarchies, fostering personal connections among employees of different levels of seniority, and instilling a sense of personal responsibility for the enterprise. Creating proxies of partnership could help to convince all employees that good behavior protects them as well as the firm and is a necessary component in long-term success. Especially among senior management, a greater sense of partnership might help promote joint responsibility for the overall risk taking and broad financial health of the firm.

Finally, panelists and participants observed that employees and stakeholders need to see that firm leadership acts on its stated values. In particular, small deviations from firm values—such as disparaging clients in internal email or chat rooms, or failing to complete compliance training—could be portents of bigger problems to come. Policing minor violations was a delicate task, and would have to balance fear of individual punishment against a culture of inclusion and forthrightness. Some recommended that management share, on an anonymized basis, enough detail about exceptionally good or poor conduct to enable employees to understand what the firm expects from its staff. Ultimately, it was observed that firms need to instill an understanding that all employees share the consequences of poor conduct, and thus share a responsibility to root out bad behavior.

Law Enforcement and Behavior

The workshop's final panel addressed the efficacy of using public prosecutions or enforcement actions to improve conduct. The panelists addressed public criticisms that prosecutors and regulators had been too quick to punish firms instead of the individual employees who participate in misconduct. It was noted that a lower bar for criminal intent could yield more individual prosecutions. There was agreement, however, that a better route to prosecuting more individuals would be for financial institutions to report voluntarily instances of misconduct—great and small—before they are uncovered by regulators or the media. There was further consensus that firms desiring cooperation credit for demonstrating good corporate citizenship must follow through on promises to provide information and adopt necessary safeguards against future misconduct. To this end, it was suggested that firms seeking to avoid or reduce criminal or civil consequences should be prepared to show that their cultures—that is, their stated values and corresponding actions—do not tolerate a cost-benefit approach to compliance with the law.

Throughout the discussion, the panelists emphasized the need for collaboration among regulators, prosecutors, and the industry. For example, investigations of financial crimes committed on more vulnerable or unsuspecting customers are aided materially by bank cooperation in identifying potential frauds and gathering information on suspects. The panelists also noted their willingness to work with the industry to educate employees about detecting and reporting illegal activity, and to assist in gathering facts that could be used to hold individuals publicly accountable for misconduct. Finally, they agreed that establishing a reputation for cooperation with the official sector would, over time, build trust with prosecutors and regulators and would help support the argument that aberrant conduct by a rogue employee may, indeed, be just that.

Concluding Remarks

The workshop concluded with remarks by Mr. Dudley. He emphasized that a healthy industry culture promotes financial stability and that firm leadership has the responsibility to correct poor behavior. "In its simplest form, a strong culture means that individuals who get away with unethical or illegal activities will not have the satisfaction of 'bragging rights' about their actions because there are no congratulations for breaking the law or outwitting compliance. A strong culture will reinforce the simple reward of having done the right thing. A clear conscience can be a powerful reward." He also urged the industry to consider a collective approach to the problem. "I would strongly encourage the largest institutions based here in the United States to work to develop collaborative solutions aimed at improving culture and rebuilding the public trust."

Mr. Dudley offered a number of suggestions on how incentives could be realigned with firm values—in particular, with the public purpose of financial institutions. "Financial firms exist, in part, to benefit the public, not simply their shareholders, employees, and corporate clients." Among these suggestions were:

- An increased use of deferred debt compensation with a maturity period of up to a decade;
- Performance bonds wherein the deferred compensation of senior management and material risk takers would be available for the satisfaction of fines;
- A database that tracks employees dismissed for illegal or unethical behavior; and
- A mandatory ban from both the regulated and shadow banking sectors for any person convicted of a crime of dishonesty while employed at a financial institution.

Finally, Mr. Dudley observed that the primary responsibility for reforming culture and behavior in the financial services industry belonged to financial firms, not to the public sector. However, if bad behavior persists on the scale seen in recent years, "financial stability concerns would dictate that [financial] firms need to be dramatically downsized and simplified so they can be managed effectively." Noting that this consequence would be "both fully appropriate and unattractive," he urged the industry to get to work.