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Introduction

Corporate governance has been at the center of every crisis involving U.S. business practices since at least the Armstrong investigation of the insurance industry in 1905-06.[1] Public anger re-emerges after each new revelation of mismanagement, though it varies in degree with the scope of the crisis. Fraud and abuse cases make front-page news, with the media pointing to failures in organizational leadership. Politicians hold hearings, and changes in laws and regulations often ensue. While the public costs of a given crisis are difficult to measure, settlements associated with the lawsuits that invariably follow can be in the hundreds of billions of dollars, as with the 2007-09 crisis. In the aftermath, academics try to isolate the factors that contributed to the crisis. Although it is hard to identify the root cause of a crisis or to fully understand the contributing factors, the focus eventually turns to the effectiveness of governance and how it might be improved. Typical questions include: Were boards forsaking their obligations to shareholders and to the public? What did the boards do or not do? What do we want them to do differently going forward?

Identification of governance problems is an issue for all firms, but it takes on particular significance in the case of financial institutions. Why is this so? First, bank governance—the firms' structure and conduct—is the product of market forces as well as regulatory expectations (Armstrong et al. 2016).[2] Second, finance is a notoriously opaque industry, where appropriate measures of performance and risk are difficult to determine within firms, let alone among outside researchers. Third, the unique governance structure of the financial industry means that, when a banking firm defaults, directors have little or no opportunity to learn from their own mistakes or the mistakes of others in similar positions. In the case of banks, which cannot go through the bankruptcy reorganization process and emerge as the same entity, there is no avenue for directors who have firsthand experience of bank failure to share their knowledge and insights with others. Further, the risk of litigation often acts as a deterrent to information sharing even though sharing insights in such cases could help build a stronger financial system. Instead, regulators are often called upon to fill this void of institutional learning by establishing industry-wide best practices through a multitude of compliance-oriented regulations.

The adoption of new guidelines, however, is likely to be a lengthy process for struggling financial firms, in contrast to the experiences of nonfinancial enterprises in a similar situation. Nonfinancial firms in distress are forced by creditors and large stockholders to make rapid changes to their business models, culture, and governance. Often, the employees with the most influence on culture—the incumbents—are forced out. Thus, a

[1] For a discussion of the Armstrong investigation, see Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* (Princeton, N.J.: Princeton University Press, 1994).

[2] Christopher S. Armstrong, Wayne R. Guay, Hamid Mehran, and Joseph P. Weber, "The Role of Financial Reporting and Transparency in Corporate Governance," Federal Reserve Bank of New York *Economic Policy Review* 22, no. 1 (2016).

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new culture can be adopted to support the new business model. However, in the banking sector, the incumbents of weak banks continue their employment, and so the old culture persists for a while. Regulators and nonsupervisory advocates, including shareholders, citizen groups, and other interested parties, then propose a new culture with the goal of enhancing financial stability. Over time, the banks will try to strike a balance between the old and the new, and culture and governance will slowly evolve. A bank's strategy and the behavior of its employees will coincide in ways not observed before the financial crisis, with the safety and soundness of the bank—at best a minor concern to employees in the pre-crisis world—now the goal of both. The bank will craft new measures of performance and productivity that reflect the priorities of the new culture. Still, the transition to the new culture will be gradual.

Why such a gradual transition? In a world of complete knowledge—or one in which governance is simpler to define—when regulators observe failure, it is straightforward to determine the ultimate cause of that failure, and thus trivial to know which regulatory response is most fitting. Edmonson (2011) offers a useful "spectrum of reasons for failure" that ranges from deviance ("an individual chooses to violate a prescribed process or practice") and lack of ability ("an individual doesn't have the skills, conditions, or training to execute a job") to process inadequacy ("a competent individual adheres to prescribed but faulty or incomplete process").[3] Now, eight years past the financial crisis, it remains frustratingly difficult to untangle these various explanations, as well as the causal or enabling role of governance.

Why did firms that looked well-governed from the outside crumble under stressed market conditions or collapse as a result of outsized bets placed by a few from within the organization? Was their failure a failure of process, policy, or people? Were the risks calculated or accidental? At what level did the governance system break down? Despite our best efforts, we still have very few answers, including to the most important question of all: *What should we do differently this time?* And in our attempt to answer that question, what kind of research and insights could help?

A new approach to the pursuit of financial stability was advanced by Federal Reserve Bank of New York President William C. Dudley at the October 2014 *Workshop on Reforming Culture and Behavior in the Financial Services Industry*. In his remarks at the workshop, Dudley emphasized the role of corporate culture in banking and the importance of a deep understanding of the concept and its application to financial stability. Culture suggests that the way organizations manage themselves has a predictable economic effect, particularly with respect to the financial strength and soundness of the organization. A culture-centric view also focuses attention on employees and human behavior while recognizing the influence of the firm's asset structure and organizational design on performance and risk. The benefits of an effective culture arise in part from the culture's contribution to internal information production and to the flow of this information to the entire organization (bottom-up and top-down) and to all stakeholders, including supervisors, in close to real time. The prompt disclosure of information, in effect, can help unmask the firm's weak spots, whether they are driven by negligence or not.

The literature on the economics of culture, particularly in the banking industry, is small, and identification of key issues in culture and governance marks an important step toward achieving soundness. This special volume of the *Economic Policy Review* is designed to foster a better understanding of corporate culture and governance—particularly as they apply to banking firms—among regulators, investors, researchers, and the interested public. The contributors to the volume analyze the topic from the perspective of several disciplines, including financial accounting, financial economics, and law and regulation. They also summarize and synthesize the literature on vital issues of culture and governance, and identify key areas for future research.

The volume is divided into two complementary parts. The first part, consisting of five articles, introduces the concept of culture and its importance to risk management and financial stability. The articles present a framework for diagnosing and changing culture, describe how corporate culture is transmitted and shaped, explore the importance of taking the optimal amount of risk, and examine the role of deferred cash compensation and bank cash holdings in promoting financial stability. The second part, featuring four articles, takes a closer look at several critical areas of corporate governance: the role of boards of directors, the monitoring function of large outside shareholders, the importance of financial disclosure and transparency, and the relationship between banks' disclosure practices and performance.

In the appendix to the volume, I provide an extensive list of additional questions for future research. These questions extend and augment the important research presented in the volume and should help advance the burgeoning study of the role of culture and governance in banking.

Finally, it should be noted that this volume of the *Economic Policy Review* has been four years in the making. Offering insights in the growing area of financial stability viewed through the lens of human behavior, the volume will assist practitioners and researchers in their efforts to establish a stronger and healthier financial system in the United States and around the world.

[3] Amy C. Edmondson, "Strategies for Learning from Failure," *Harvard Business Review* 89, no. 4 (April 2011).