The challenges of culture, conduct and reputation

William R Rhodes

It is almost unanimously agreed that changes need to be made to improve the banking culture, but it is important to set realistic and workable targets that support the banking business model.

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THE SCALE OF BANK REGULATORY REFORMS IN RECENT years has been unprecedented. The capital and liquidity positions of many banks have been improved significantly. Yet, public confidence in banks in the US and western Europe remains unsatisfactory. This weakens internal morale in banks, while damaging the ability of some institutions to maximise their contributions to financial intermediation and economic growth.

I have long argued that there needs to be a far more vigorous public discussion about core cultural changes in financial institutions. A deficiency or failure of culture including reputational risk can be as destabilising to an institution as problems of capital or liquidity.

Culture is about behaviour. It is about how individuals and groups act even when they are not being observed. A good culture underpins and is reflected by the actions of a company's employees, a problematic culture will also be reflected in how a firm and its employees perform. The cultural tone of a firm is set by the ways in which those at the top of the organisation act – both the CEO and his or her most senior colleagues – but it must also include middle management and go down to the teller level as well as up to the members of the board of directors. This process also has to be consistently monitored.

The risk management component of creating a good culture always poses challenges to financial institutions – there is a lot of complexity around the interplay between the four major types of risk: credit risk, market risk, operational risk and reputational risk. If managers make serious errors in any of the first three areas, then the reputational consequences are always serious.

The failings in risk management, which are often related to the reach for yield and were a hallmark of the run-up to the 2008 to 2009 financial crisis, did enormous damage to the reputations of nearly all major financial institutions – not just the banks, but also the supervisory agencies themselves.

The high-profile problems of many individual banks, involving record-high fines and settlements, have undermined public trust further, while convincing many regulators and supervisors that there needs to be greater focus on the core issues of banking culture.

These perceptions have emerged clearly over the past nine months, in a series of discussions between bankers and officials around a report published by the Group of 30 (G30) in October 2013, 'A new paradigm: financial institutions boards and supervisors'. Members of the Financial Stability Board encouraged the development of this report, and they have recently supported the idea that the G30 consider writing a follow-up study on banking culture and conduct.

REALISTIC EXPECTATIONS

The original report underscored the point that considering culture together with governance and business strategy is an essential part of forward-looking supervision. Issues of culture, and particularly risk culture, are 'soft' and, correspondingly, often difficult for supervisors to deal with. An important approach would see regular exchanges of views, where supervisors could confidentially share knowledge they have gained from system-wide experiences, while obtaining a deeper understanding of the unique cultural aspects that every bank has.

As my colleagues and I* developed the G30 report, so we recognised that supervisors should not seek to write rules or guidance about culture, but they should set realistic expectations about what can be achieved.

Boards need to be proactive in understanding the culture of their organisation and how that translates and supports their business model. Potential cultural problems need to be identified inside institutions as early as possible and dealt with seriously. Furthermore, boards and management should make sure their compensation system in practice provides the incentives that support the desired culture. As many banks have discovered, a culture that places too great an emphasis on short-term profit-maximisation and risk is one that can damage the financial strengths and the reputation of the bank – and once the reputation of a bank is lost, it is very difficult to restore.

Managers and boards in a number of banks need to place more emphasis in promoting integrity and trust as the guiding principles of corporate culture. The more effective they can be in attaining this goal the more they will strengthen public and shareholder confidence and improve relationships with regulators and supervisors. TB

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**The G30 working group was chaired by Roger W Ferguson, Jr, with vice-chairmen John Heimann, William R Rhodes and Sir David Walker.*

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