



# **BANKING CONDUCT** AND **CULTURE** *A Permanent Mindset Change*



**GROUP OF THIRTY**

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The Group of Thirty  
1701 K Street, N.W., Suite 950  
Washington, D.C. 20006  
Tel.: (202) 331-2472

E-mail: [info@group30.org](mailto:info@group30.org), [www.group30.org](http://www.group30.org)



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# FOREWORD

## CULTURE AND CONDUCT: A PERMANENT MINDSET CHANGE

Ten years after the global financial crisis, trust in banks remains low.

The industry has devoted significant time and resources to understanding the causes of the breakdowns in culture that contributed to the crisis, and to implementing reforms to address them. Yet throughout the last decade, the industry has continued to be dogged by failures of corporate culture, conduct, and governance.

At the same time, the scope of the issues around culture has grown. The last few years have shown that no geography, size of institution or business unit is immune to the potential negative impact of inappropriate employee behavior, or of the unintended consequences of certain business and human resources practices (such as sales targets and compensation structures). Compounding the internal governance issues are the external factors that have impacted and influenced norms and behavior.

Fundamentally, getting culture and conduct right is not merely a supervisory requirement. It is necessary for banks' and banking's economic and social sustainability.

This report, issued by the Group of Thirty (G30), seeks to support the process of reform in banking culture and conduct that is underway across the industry. Achieving this common goal requires ongoing board and management focus and, to avoid "culture fatigue," needs to become a *permanent, fundamental, and integral* part of how business is *invariably* done rather than being addressed through a series of ad-hoc initiatives.

The report outlines the progress made this far. It identifies eight lessons learned and twelve recommendations for further work and additional focus. In addition, the report highlights future challenges emerging due to changing societal norms, technological advances, competitive dynamics, and macroeconomic trends. We recognize that the sources and scope of culture issues will continue to evolve, and so too must oversight and monitoring of bank culture and conduct.

We hope the G30's multiyear focus on governance, supervision, boards, conduct and culture has supported the collective goals of supervisory and banking communities, and intend this latest study to add meaningfully to the debate on and evolution of best practices in the sector.



**Jacob A. Frenkel**

Chairman, Board of Trustees  
Group of Thirty



**Tharman Shanmugaratnam**

Chairman  
Group of Thirty

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We cannot name but must also thank the hundreds of chairs, CEOs, senior executives, and supervisors who provided their insights through off-the-record interviews during the G30's multiyear focus on bank governance. Without their support, this project and the previous three reports would not have been possible.

No project of this magnitude can be accomplished without the committed effort of a strong team. The G30 extends its deep appreciation to the Project Director, Elizabeth St-Onge, and to Yoonju Kim, of Oliver Wyman, who worked tirelessly toward our goal with diplomacy and tact. We thank them for their contributions to the analysis and formulation of the report.

The coordination of this project and many aspects of project management, Working Group logistics, and report production were centered at the G30 offices in Washington, D.C. This project could not have been completed without the efforts of our editor, Diane Stamm, and the work of Executive Director Stuart Mackintosh and his team, including Desiree Maruca and Peter Bruno of the G30. We are grateful to them all.



**William Rhodes**  
Chair



**Gail Kelly**  
Vice-Chair



**David Walker**  
Vice-Chair



# WORKING GROUP

## STEERING COMMITTEE

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President and CEO, William R. Rhodes Global Advisors  
Former Chairman and CEO, Citibank

**Gail Kelly, *Vice-Chair***

Senior Global Advisor, UBS AG  
Former CEO and Managing Director, Westpac Banking Corporation

**David Walker, *Vice-Chair***

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**Roger Ferguson**

President and CEO, TIAA-CREF  
Former Vice Chairman, Board of Governors of the Federal Reserve System

**Gerd Häusler**

Senior Advisor, goetzpartners  
Former Chairman and CEO, Bayerische Landesbank

**John Heimann**

Founding Chairman, Financial Stability Institute  
Former US Comptroller of the Currency

## PROJECT DIRECTOR

**Elizabeth St-Onge**

Partner, Oliver Wyman

## WORKING GROUP MEMBERS

### **Jaime Caruana**

Member of the Board of Directors, BBVA  
Former General Manager, Bank for  
International Settlements

### **Richard Debs**

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Morgan Stanley International  
Former COO, Federal Reserve Bank of New York

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Former Secretary of State, Ministry of Economy  
and Finance, Spain

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Former Superintendent of Financial  
Institutions, Canada

### **Maria Ramos**

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Member of the Executive Committee, World  
Economic Forum's International Business Council

### **Masaaki Shirakawa**

Special Professor of International Politics,  
Economics, & Communication,  
Aoyama-Gakuin University  
Former Governor, Bank of Japan

## EXPERTS

**Yoonju Kim**, Oliver Wyman

**Stuart P.M. Mackintosh**, Group of Thirty

# ABBREVIATIONS

<b>AI</b>	artificial intelligence
<b>APRA</b>	Australian Prudential Regulation Authority
<b>BEAR</b>	Banking Executive Accountability Regime
<b>BSB</b>	Banking Standards Board
<b>CBA</b>	Commonwealth Bank of Australia
<b>CBRC</b>	China Banking Regulatory Commission
<b>CCAR</b>	Comprehensive Capital Analysis and Review
<b>CEO</b>	Chief Executive Officer
<b>CFPB</b>	Consumer Financial Protection Bureau
<b>DNB</b>	De Nederlandsche Bank, the Dutch central bank
<b>EBA</b>	European Banking Authority
<b>ECB</b>	European Central Bank
<b>ESG</b>	environmental, social, and corporate governance
<b>FCA</b>	Financial Conduct Authority
<b>FCAC</b>	Financial Consumer Agency of Canada
<b>FINRA</b>	Financial Industry Regulatory Authority
<b>FX</b>	foreign exchange
<b>GDPR</b>	General Data Protection Regulation
<b>G-SIBS</b>	global list of systemically important banks
<b>G30</b>	Group of Thirty
<b>HKMA</b>	Hong Kong Monetary Authority
<b>HR</b>	human resources
<b>KPIs</b>	key performance indicators

<b>LIBOR</b>	London Inter-bank Offered Rate
<b>MAS</b>	Monetary Authority of Singapore
<b>MBA</b>	Master of Business Administration
<b>OCC</b>	Office of the Comptroller of the Currency
<b>OSFI</b>	Office of the Superintendent of Financial Institutions
<b>SEC</b>	Securities and Exchange Commission
<b>SFC</b>	Securities and Futures Commission
<b>SIFIs</b>	systemically important financial institutions
<b>SM&amp;CR</b>	Senior Managers and Certification Regime

# EXECUTIVE SUMMARY

This year marks the tenth anniversary of the 2008–09 global financial crisis, an event that renewed focus on banking culture and conduct. In our prior report, *Banking Conduct and Culture—A Call for Sustained and Comprehensive Reform* (2015), we put forth a set of recommendations for banks, their boards and management, and supervisors, and promised to follow up with an update on progress made by the industry. In this report, we focus on two fundamental questions: (1) How much progress has the banking industry made in culture and conduct since the financial crisis, particularly since our last report?, and (2) Where do we go from here? That is, in what areas should banks continue to press on, and what evolving questions should they be mindful of going forward?

In the years following the financial crisis, banks, supervisors, clients/customers, and investors have increased attention on and scrutiny of bank conduct and culture. As a result, banks have endeavored to implement various changes to improve their conduct and culture. And much has indeed been done across the industry. Despite these efforts, however, the banking industry still suffers from a negative reputation, and trust still needs repairing because serious conduct and culture failures continue to occur in many markets. Regaining trust will require persistent efforts across the industry. On conduct and culture, boards and senior management must lead by example.

In addition, a number of industry leaders we interviewed have voiced numerous concerns including (a) lack of faith that the industry has really changed; (b) the potential for conduct and culture fatigue, that is, the potential for employee burnout from all of the culture

and conduct initiatives and desire to get back to business; (c) uncertainty around how new external forces (such as technology and artificial intelligence [AI]) are impacting conduct; and (d) fear that the changes are not fully embedded and won't "stick" in the longer term. A key conclusion is that bank conduct and culture are at the center of a slow, uphill battle for trust.

Our observations of progress in specific focus areas are:

- **MINDSET OF CULTURE:** Banks have shown a clear, rapid, and positive shift in their view of the importance of conduct and culture. But much of the work has been done at the most senior levels of the organization—with “tone from the top” receiving much more focus than “tone from above.”<sup>1</sup> For permanent and ongoing change to occur, banks now need to focus on embedding culture awareness and stewardship at all levels of the organization, with a particular focus on middle management and frontline businesses. Only by making culture stewardship a permanent and integral part of how business is conducted will organizations avoid culture fatigue and backsliding.
- **SENIOR ACCOUNTABILITY AND GOVERNANCE:** Bank boards and senior management have significantly increased their involvement in conduct and culture topics and have reorganized their governance and reporting structures to better oversee these areas. But there is still lack of clarity in many organizations on how the board will champion, oversee, and monitor conduct and culture issues and whether a single dedicated committee of the board is appropriate.

<sup>1</sup> By “tone from above” we mean the signals being sent by an employee’s manager or supervisor. Cultural norms are felt and transmitted most directly by a worker’s immediate supervisors. The worker in a large firm is unlikely to have regular contact with senior managers or their CEO. This is why the task of embedding the desired conduct and cultural norms throughout an institution is so important.

- **PERFORMANCE MANAGEMENT AND INCENTIVES:** Many banks have reviewed their remuneration schemes to integrate cultural and behavioral metrics into performance scorecards. For example, most banks now have balanced scorecards for employee performance management that evaluate both the “what” and the “how.” But many have found that managing via a more balanced view requires management skills that need to be further developed, especially in the middle management layers.
- **STAFF DEVELOPMENT:** Banks have expanded their training programs to help employees better understand expectations of behavior and manage gray zones. Banks are also focused on creating environments of “psychological safety”<sup>2</sup> where employees can speak up, challenge groupthink, and escalate concerns. Diversity and inclusion efforts are also a primary focus as banks look to create environments where decisions are made taking into account broader perspectives.
- **AN EFFECTIVE THREE LINES OF DEFENSE:**<sup>3</sup> Significant work remains in defining and empowering second-line oversight of conduct and culture risks and in designing appropriate audit practices. The most work, however, remains in entrenching culture and conduct risk management practices in the first line. Progress remains slow in embedding understanding, especially ownership of culture and conduct risk in the first line, and much more work will be required on this front to ensure a fully functional three lines of defense.
- **REGULATORS, SUPERVISORS, ENFORCEMENT AUTHORITIES, AND INDUSTRY STANDARDS:** Regulators and supervisors globally have increased attention to, and expectations regarding, conduct and culture, though they continue to grapple with the scope of their role and responsibilities, and whether and how they can support the industry in dealing with culture and conduct issues. Addressing

conduct and culture from a regulatory and supervisory perspective is not a simple matter and requires careful judgement, the fostering of new skillsets, and industry experience.

\* \* \*

After a decade of slow progress and uneven results, industry leaders have reflected on key lessons. The following eight key lessons were repeatedly raised in the interviews by financial sector leaders as they reflected on the lessons learned and the future of banking culture.

1. Managing culture is not a one-off event, but a continuous and ongoing effort that must be integrated into day-to-day business operations.
2. Leadership always matters, and banks must embed conduct and culture messages and expectations from the top down, through middle management down to the teller in their organization. There is increasing awareness that tone from above is as important as tone from the top, and this requires a shift in how managers at all levels of the organization are trained, promoted, and supported.
3. Conduct is not just about purposeful misbehavior, but also unintended consequences from decisions and/or lack of skills and knowledge.
4. Managing culture requires a multipronged approach and the simultaneous alignment of multiple levers, including structural elements such as processes and policies, as well as human elements such as beliefs and attitudes.
5. Diversity must become an imperative for the industry as it improves outcomes for all stakeholders. Diversity in thinking, problem solving, and leadership styles helps organizations achieve better results.
6. While cultural norms and beliefs cannot be explicitly measured, the behaviors and outcomes that culture drives can and should be measured.

<sup>2</sup> Psychological safety is a term coined by Harvard Business School professor Amy Edmondson to mean “a shared belief held by members of a team that the team is safe for interpersonal risk-taking. It describes a team climate characterized by interpersonal trust and mutual respect in which people are comfortable being themselves.”

<sup>3</sup> In the Three Lines of Defense model, management control is the first line of defense in risk management, the various risk control and compliance oversight functions established by management are the second line of defense, and independent audit is the third.

7. Regulation has a limited role to play given that culture cannot be mandated or defined by rules. Regulation can be an effective tool in outlining basic principles (especially related to good conduct), refocusing banks' attention on areas of persistent conduct failure, and providing insights and lessons learned from across the industry. Supervision can play a role in monitoring and providing feedback to banks that can aid the bank board and senior management in addressing culture and conduct issues.
8. Industry-wide dialogue and sharing of best practices are key to restoring trust and strengthening the entire banking industry. The cultural health of the industry as a whole benefits all banks.

\* \* \*

In this report, we also revisit the recommendations made in the 2015 report and reiterate and reinforce guidance for the industry in twelve areas where we believe additional efforts and attention are still required.

**RECOMMENDATION 1.** Bank boards should reevaluate their governance structure to ensure a specific board committee has oversight of the bank's conduct and culture.

**RECOMMENDATION 2.** Bank boards and senior management should work more closely with various business units and geographic and functional heads to strengthen the quality and availability of data and insights needed to manage conduct and culture.

**RECOMMENDATION 3.** Banks should consider the potential impact of outsized incentives in their compensation mechanisms.

**RECOMMENDATION 4.** Banks should remove the link between quantitative sales targets and compensation for sales staff to minimize pressure that can lead to misconduct and help staff prioritize meeting customer/client needs.

**RECOMMENDATION 5.** Banks should explore ways to celebrate role models in behavior, both in business decisions and in individual actions.

**RECOMMENDATION 6.** Bank governance structures must recognize the integral role that middle management plays in embedding cultural reforms and promoting values through lower levels of the organization.

**RECOMMENDATION 7.** Banks should make efforts to promote diversity and inclusion in the workplace in their hiring and staff development practices.

**RECOMMENDATION 8.** Banks should promote an environment of "psychological safety" that encourages employees to speak up and escalate issues or share feedback without fear of retribution; bullying or aggressive management styles must not be tolerated.

**RECOMMENDATION 9.** Banks should establish credibility and enforcement through their disciplinary mechanisms for conduct breaches to ensure employees take these measures seriously.

**RECOMMENDATION 10.** Banks should focus on hiring people who align with the bank's purpose and values as they strive to create the right culture for their organization, recognizing that recruiting is a critical element to creating the right culture.

**RECOMMENDATION 11.** *Given the limited progress to date, this is a reinforcement of our 2015 recommendation:* Banks should persevere in their efforts to shift primary ownership of conduct risk to the first line of defense to ensure conduct risk is truly owned by the business and is effective.

**RECOMMENDATION 12.** Conduct risk oversight roles and responsibilities should be clear across the various second line functions such as Human Resources (HR), Risk, and Compliance.

\* \* \*

Finally, as the industry continues to strengthen its conduct and culture and address outstanding gaps, banks need to anticipate and prepare for new challenges that are emerging. We have identified five areas that remain open questions and present challenges for

banks as they continue on this journey toward better conduct and culture:

1. Ensuring banks do not become complacent about conduct and culture and fully embed a conduct and culture lens in everything they do as a normal part of business
2. Managing the changing sources and scope of conduct issues; recognizing that the pressures on conduct and culture are changing and expectations are evolving
3. Understanding the challenges of putting the customer first and balancing potential conflicts of interest
4. Tackling the industry-wide issue of “rolling bad apples,” that is, individuals with poor conduct records moving from one bank to another
5. Reconciling the appropriate form and level of public disclosures on culture and conduct.

This is a decisive turning point for the banking industry in terms of the journey we are all on in the evolution of the thinking and practices related to conduct and culture. As society and the competitive landscape rapidly evolve, banks cannot afford to be complacent about

their trust and reputational problems. From a competitive perspective, new entrants are quickly moving into traditional banking space and may capture clients (and talent) that would have otherwise been directed to banks. In addition, from a societal perspective, many people believe that banks have an integral role in supporting individuals, businesses, communities, and the economy more widely by providing, in an appropriate fashion, complex products and services that are needed for the financial health of individuals and economies. And, as such, the financial services industry should be held to a higher standard than other industries.

Our journey is complex and the process of change will be difficult both in terms of changing how banks are perceived and positioned within our communities, and in managing the changes that will be imposed on banks driven by external factors such as increasing digitization, evolving customer expectations, and dynamic competitive pressures. A key to success is recognizing that this is a constantly evolving journey rather than an issue that can be addressed once and forgotten about. Embedding culture, reinforcing levers, and aligning conduct and risk management practices with everyday business is a constant and critical process if we are to see a return of trust in banking among all stakeholders.



# INTRODUCTION

This year marks the tenth anniversary of the 2008–09 global financial crisis, an event that put banking culture and conduct under the global spotlight. In the previous installment of our series of reports on this topic, *Banking Conduct and Culture—A Call for Sustained and Comprehensive Reform* (2015), we put forth a set of recommendations for banks, their boards and management, and supervisors, and promised to provide an update on the progress major banks have made in implementing our recommendations. This report provides that update.

We focus on two fundamental questions: (1) How much progress has the banking industry made in culture and conduct (Box 1) since the financial crisis, particularly since our last report?, and (2) Where do

we go from here? That is, in what areas should banks continue to press on, and what evolving questions should they be mindful of going forward? To address these questions, we interviewed a significant number of CEOs, board members, and senior executives at major banks across the globe, as well as a number of supervisory institutions and industry standards bodies. We also drew on other sources including insights from Oliver Wyman’s global practice.

*Over the last decade, bank culture and conduct have received increased attention from bank management and their supervisors, clients/customers, and investors.* Supervisors, regulators, and governments globally have increased scrutiny of culture and conduct issues;

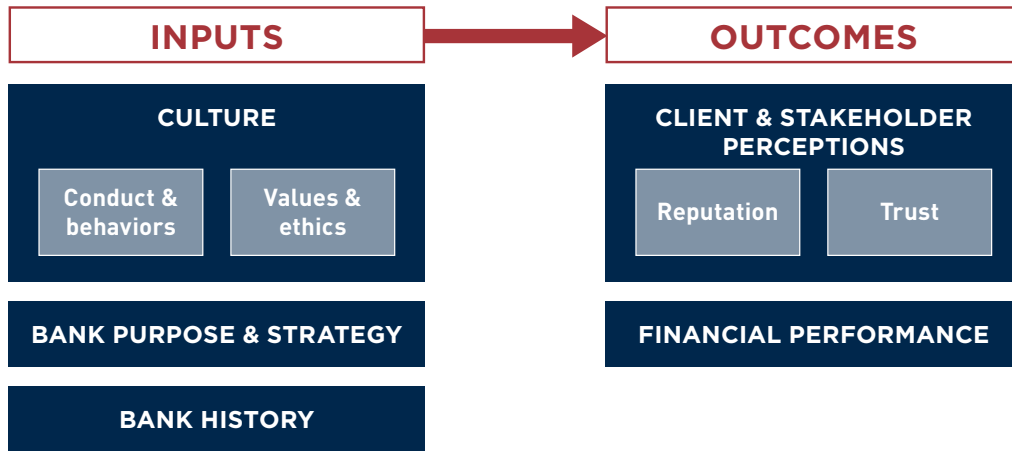
## BOX 1. Definition of culture and conduct

In our 2015 report,\* we defined **culture** as the mechanism that delivers the values and behaviors that shape **conduct** and contributes to creating trust in banks and a positive reputation for banks among key stakeholders, both internal and external.

We used a framework that identifies key factors that determine two broad outcomes for a bank: (a) client and stakeholder perceptions about the bank’s reputation and services, and whether the bank builds trust (among stakeholders including employees, society, government, and supervisors); and (b) financial performance, which rewards shareholders. To achieve these outcomes, the bank starts with its history (client franchise, brand, technology, and financial resources), defines a purpose or strategy for the institution, and develops a unique culture that is the summation of values and ethics, desired conduct standards, and implied behaviors. Figure 1 provides a schematic summary of this framework.

\* Source: *Banking Conduct and Culture – A Call for Sustained and Comprehensive Reform*, Group of Thirty, Washington, D.C., 2015.

**FIGURE 1. Elements of a unique bank culture**



Culture comprises not only conduct and behaviors, but also the bank's values and ethics. While cultural norms and beliefs cannot easily be measured, the conduct and behaviors that the cultural norms encourage or discourage can be. In fact, conduct can and should be observed, monitored, managed, and incentivized. It is important to remember that while conduct and behaviors—that is, what people actually say and do—are the only visible elements of culture, they are directly influenced by the less tangible elements, such as the bank's unspoken rules, ideas, norms, and subconscious beliefs that lie beneath the surface.

Managing culture thus requires understanding visible conduct and behaviors as well as the complex web of influences that lie beneath them.

While conduct can be evaluated as good or bad, culture itself cannot be. **The culture of each firm is unique to that organization and it is not empirically right or wrong; rather, it has to be right for that organization.** In that same vein, firms that have had conduct issues or scandals do not necessarily have an overall bad culture but have elements of their culture that are misaligned with the outcomes the firm is seeking and that are driving undesirable or inappropriate behaviors. That is why it is so important to focus on both the overall culture and all of the elements that comprise culture. Culture is complex and is made up of multiple structural elements (such as processes, policies, organization, and technology) and multiple human elements (such as norms, expectations, beliefs, and values), all of which must be aligned with one another and with the desired outcomes in order for the culture to work for the firm.

since the financial crisis, the banking industry has paid an estimated US\$350 billion to US\$470 billion<sup>4</sup> in penalties (including fines and litigation/settlement charges) for conduct-related matters, evidence that these so-called soft people issues can significantly impact the bottom line. Both institutional clients and retail customers are becoming more focused on bank conduct and culture, driven by highly publicized cases of conduct failures. Senior executives and board members are increasingly expected to demonstrate that conduct risk is understood and managed, and that appropriate discipline and culture are being reinforced.

*As a result, banks have invested significant effort in improving their culture and conduct.* With increasing appreciation of the scope and scale of culture and conduct issues, banks have instituted many changes focused on improving their culture and conduct. These efforts span both formal and informal measures and include:

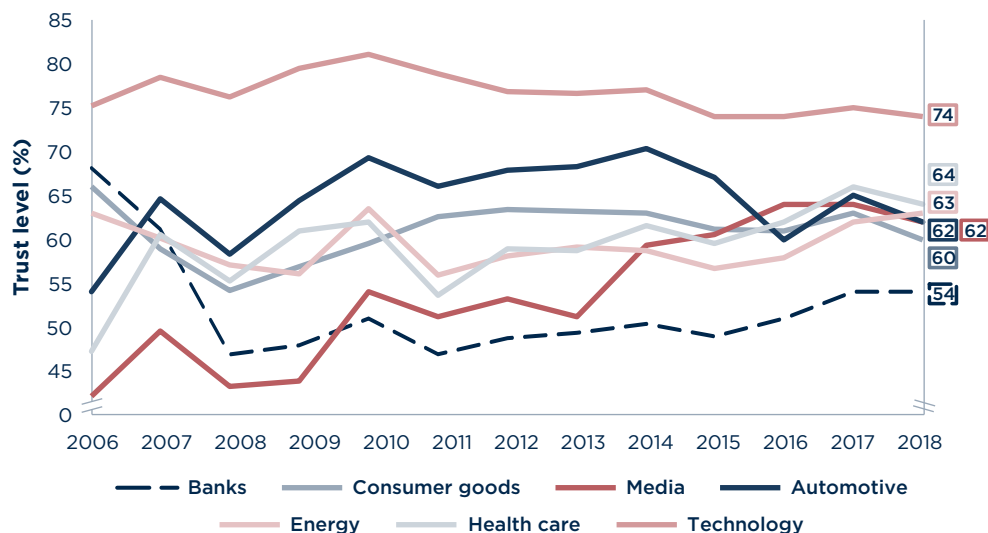
- Refinement and/or re-articulation of bank purpose and values, with subsequent establishment of extensive communication and training programs
- Heightened engagement at the board level on conduct and culture issues

- Modification of compensation and performance management schemes to incorporate not just financial results but also behavioral considerations
- Systematization of the roles of second and third lines of defense in culture and conduct, and a push toward greater ownership of these concerns by the first line
- Changes to business processes, including new product approval and product governance, revised pricing approaches, improved whistleblowing mechanisms, and review of questionable market practices in trading and hedging, all of which are signs that the conduct agenda is beginning to cascade down to the way business is done.

*Despite these efforts to improve conduct and culture, the banking industry still suffers from a negative reputation, and trust still needs repairing.* According to the Edelman Trust Barometer, the banking industry historically ranked among the most highly trusted industries since the end of the World War II; however, trust declined precipitously during the financial crisis, and today remains low compared to other industries and far from recovering to precrisis levels, as shown in Figure 2.

4 Sources: Conduct Costs Project, Good Jobs Project, Oliver Wyman analysis.

**FIGURE 2. Edelman Trust Barometer results by industry sector, 2006–2018**



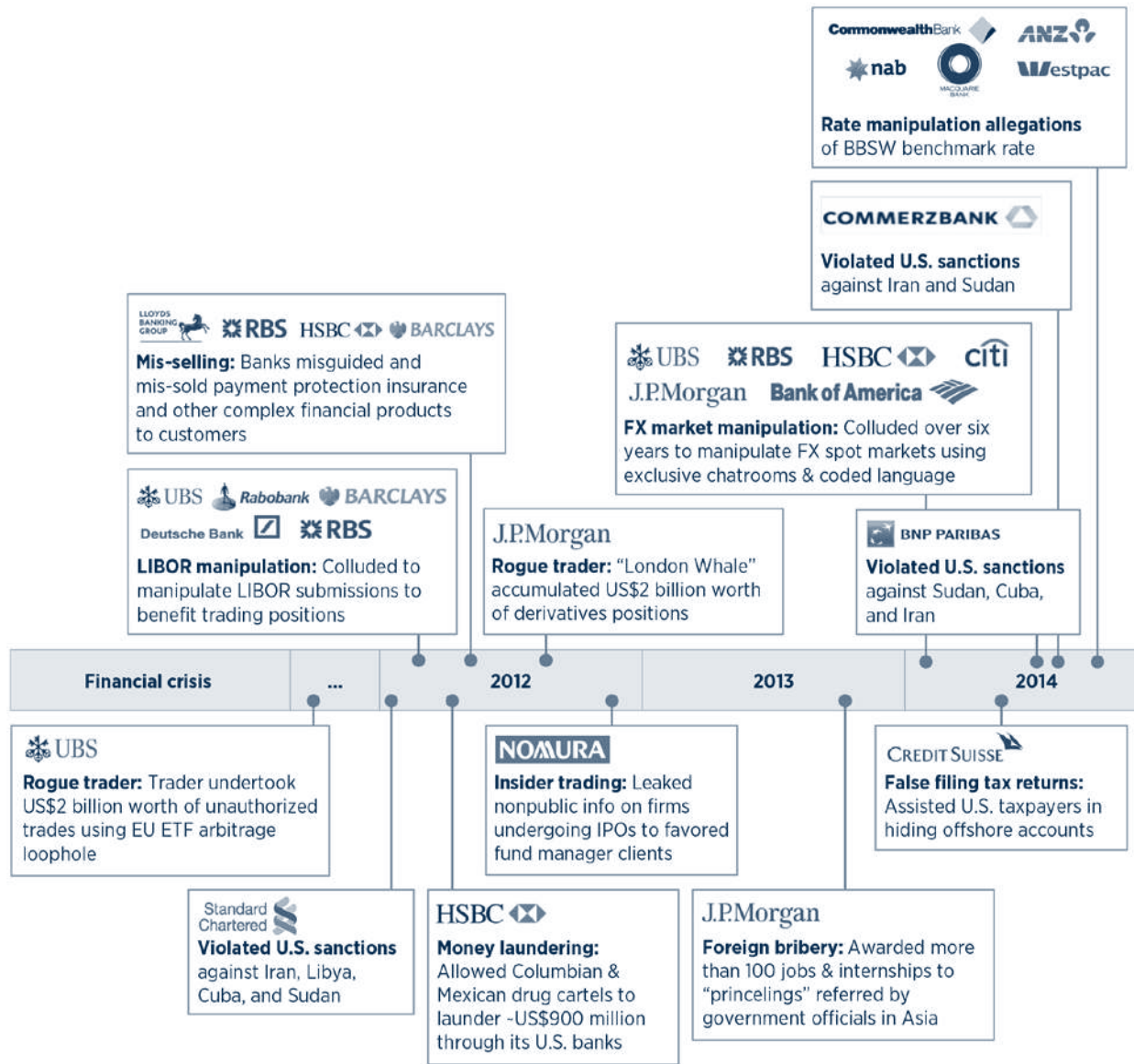
Note: Trust level results are distinguished between two populations: “informed public” (ages 25–64, college-educated, in top 25 percent of household income per age group/country), and “general population” (all population ages 18+). Due to differences in publicly disclosed results by Edelman, years 2006–2011 of this figure show informed public results; years 2012–2015 show a blend of informed public and general population results; and years 2016–2018 show general population results.

Source: Edelman Trust Barometer Archive.

The ongoing stream of conduct scandals, ranging from lapses in customer protection to anti-money-laundering deficiencies to manipulation of market benchmark rates to rogue traders, has called attention to the intimate link between conduct and reputation and continues to take a toll on the banking industry's reputation. The broad spectrum of topics and

geographies of recent scandals (see Figure 3) reveals that conduct is not just an investment banking issue but an “*all banks, all geographies, all businesses potential issue,*” as one banking official put it. It is relevant to all banks globally and to all lines of business within banks. (See Box 2 for the case of Australia.)

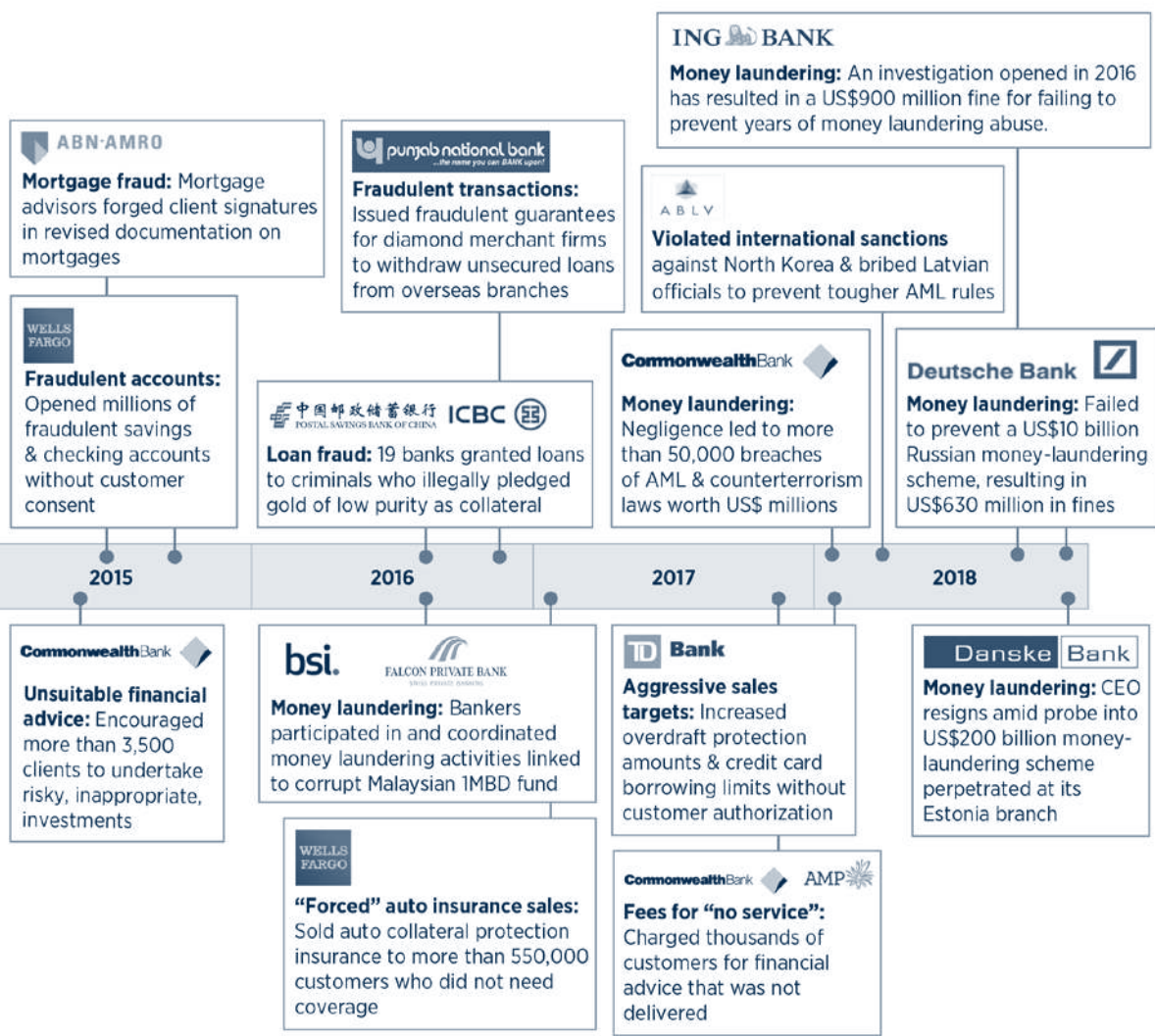
**FIGURE 3. Examples of high-profile and public conduct scandals since the financial crisis**



Note: AML = anti-money laundering; BBSW = Bank Bill Swap Rate; ETF = exchange-traded fund; EU = European Union; FX = foreign exchange; IPO = initial public offering; LIBOR = London Inter-bank Offered Rate; IMDB

While some scandals are institution-specific, the reputational fallout is often not limited to the offending institution but has a contagion effect, impacting other players in the industry. This shows that trust is an industry common good rather than an institution-specific competitive advantage. Further, as scandals are often revealed retrospectively rather than in real time,

the reputational overhang can live on long after the misconduct occurs, sometimes even after the specific issue has been addressed. All this shows that while trust and reputation are easy to lose, rebuilding it is much more difficult. Even as banks continue their efforts to become more trustworthy, becoming trusted again will be a slower process.



## BOX 2. The Australian crisis

As the current situation unfolding in Australia demonstrates, the banking industry remains subject to further serious scandals and fallouts.

In December 2017, Australian prime minister Malcolm Turnbull's government called for the establishment of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry following revelations of years of serious misconduct by Australia's financial institutions. **Since the 2015 G30 report, egregious examples of misconduct have surfaced, affecting one or more of Australia's "Big Four" banks.\*** These include rate manipulation allegations (2015), unsuitable financial advice impacting thousands of clients (2015), weak controls to prevent thousands of breaches of anti-money-laundering/counterterrorism laws (2018), and fees for no service (for example, charging accounts of dead clients) (2018).

These incidents have led to over US\$700 million in penalties and compensation since the 2008 global financial crisis, removal of senior leadership (at CBA and AMP), and numerous legal and criminal investigations. An interim report, released in September 2018, noted remuneration practices and inadequate consequences as having been closely linked to issues of conduct and culture, with more to come pending the final recommendations of the Royal Commission. The executive summary of the Interim Report of the Royal Commission points to greed as a central issue, resulting in "the pursuit of short-term profit at the expense of basic standards of honesty" (p. xix).

Separately, the Australian Prudential Regulatory Authority (APRA) concluded in April 2018 its prudential inquiry into CBA and released a report that outlines key shortcomings in governance, accountability, and culture. While the findings are specific to APRA's review of CBA, the report contains lessons for the industry as a whole, and in fact, other banks are being required to conduct a self-assessment against the specific CBA findings. The key issues outlined in the review include:

- Lack of alignment between banking remuneration practices and frameworks and indicators of good conduct
- Lack of senior leadership and board oversight on issues of conduct and culture
- Inadequate oversight and challenge by the Board and its gatekeeper committees of emerging nonfinancial risks
- Unclear accountabilities, starting with a lack of ownership of key risks at the Executive Committee level
- Paucity or nonexistence of sufficient internal controls.

As next steps, APRA has recommended that the banks design and implement stronger remuneration practices that will align with strong conduct and culture outcomes, and that banks leverage the Banking Executive Accountability Regime (BEAR) to detail international best practices on strengthening conduct and culture.

With the ongoing Royal Commission investigation and pending recommendations, as well as continued revelations of retrospective misconduct among Australia's financial institutions, we anticipate that the Australian banking industry is only beginning its long journey to repair its conduct and culture.

\* National Australia Bank (NAB), Commonwealth Bank of Australia (CBA), Australia and New Zealand Banking Group (ANZ), and Westpac (WBC).

Source: "Why is Australia investigating its banks?," BBC News, February 12, 2018.

*Banks cannot afford to be complacent about their trust and reputational problems, especially in light of emerging competition from alternative providers.*

As Bill Gates presciently put it nearly twenty-five years ago, “banking is necessary; banks are not.” Banks have a small window to figure out how to manage culture and conduct and regain the public’s trust. Without earning trust every day, the continued survival of banks is at risk from displacement by new industry entrants, a growing list that includes fintech start-ups, technology firms, retailers, and telecom companies.

In addition to the risk of client attrition, trust and reputational issues may over time also lead to problems in acquiring and retaining talent. For instance, young millennials continue to be turned off by banks’ reputational problems and are opting instead for other sectors, as seen in the changing career destinations chosen by MBA students post-graduation (Figure 4). Despite a number of high-profile discrimination lawsuits, banks’ efforts focused on improving diversity have been minimally successful, as diverse talent remains deterred by cultures they view as not supportive and attentive to their development and well-being.<sup>5</sup> Further, the shift toward digitization will continue to reveal gaps in banks’ technology capabilities, pressuring banks to compete for talent that is already in high demand by other industries.

This and similar trends may spark concerns about potential talent shortages in an industry that is highly

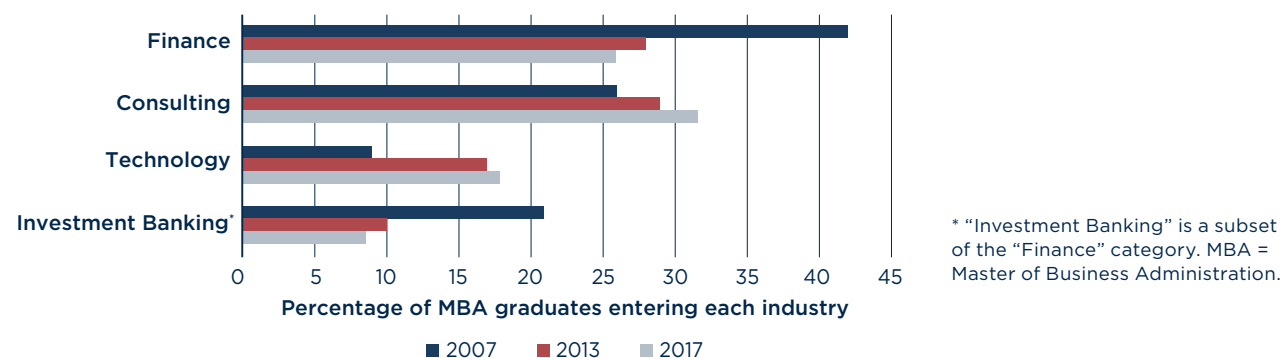
dependent on its human resources as a competitive differentiator.

*Bank culture and conduct are more important than ever, to repair trust and reputational issues and fulfill the role of banks in society.* Sound culture and conduct are critical for banks to be able to play their role in society, and to the stability of the broader financial system. Banks are held to a higher standard than many other service providers given that the services banks provide are viewed by many as a public good that benefits society—that is, intermediating between sources and needs of funds and facilitating transactions throughout the economy—and the effects of failure extend beyond just shareholders, with repercussions for the broader economy. Further, because banking products and services can be complex and difficult to understand, the public expects banks to provide good advice based on expertise and in the clients’ best interest.

And yet, many banks that devote considerable attention to their business strategies and actions spend insufficient time thinking about their purpose and the role they play in society. Despite the trending notion of balancing stakeholder needs and the argument that, over the long run, putting the customer first is the best way to drive sustainable shareholder value, short-term trade-offs often confront banking executives, in which doing what is best for customers may lead

5 “Why Diversity Programs Fail,” Frank Dobbin and Alexandra Kalev, *Harvard Business Review* 94 (7) (July/August), 2016.

**FIGURE 4. Career destinations chosen by MBA students**



Sources: 2007 and 2013 data: “Business education: Banks? No, thanks!,” *The Economist*, October 11, 2014. 2017 data: average employment data from Chicago Booth, Wharton, Harvard, London, and INSEAD.

to less immediate profit or more immediate cost.<sup>6</sup> In such situations, clarity of purpose is critical to enable executives to resist the temptation of near-term gains, and to make decisions for the long run. Banks must understand, reinforce, and internalize their key economic and social purpose and improve their culture and conduct to fulfill that purpose.

Responsibility for ensuring the organization's ability to balance purpose and profit ultimately resides with the board and the CEO. Under the rubric of culture, as with other aspects of business performance, the board should see it as its key responsibility to set the right tone and reinforce the desired culture, and to oversee the bank's efforts to sustain a healthy culture. In addition to the board, the chief executive should have a comprehensive awareness of the overall tone and know what is happening under his or her watch. An expectation that senior management should invariably be aware of every departure from desired behaviors would, of course, be unrealistic, inappropriately implying a reversal of the burden of proof. But it is a specific responsibility of the board and senior management to put in place robust processes to identify and ensure appropriate escalation of behavioral breaches. Such processes should be designed to be auditable and the subject of regular monitoring by internal audit as a key ingredient of the third line of defense.

Despite significant efforts, many still voice concern about the industry's ability to make profound and lasting change. In our interviews, industry leaders voiced several questions and concerns about culture and conduct:

- **Have things really changed?** Skeptics wonder whether true change is possible in an industry that maintains large potential upsides to pushing the boundaries, and point to the example of Wall Street in 2017 recording its highest bonuses since 2006.<sup>7</sup> In addition, despite banks implementing many process and policy changes to mitigate misconduct, culture and conduct have yet to be fully embedded in many banks in how they do business, and conduct issues are still observed in

banks worldwide. Others are concerned about the passage of time dimming the effect of the lessons learned during the global financial crisis, and of the possible return to old practices, especially if interest rates rise, regulation is lessened, and other business conditions improve. As post-global financial crisis regulations are potentially rolled back (in some jurisdictions), firm-level focus on conduct and culture (by the board and senior leaders) must take on even greater importance.

- **Potential for culture and conduct fatigue.** Especially in some geographies where there has been a long-standing focus on conduct and culture problems, we detected some desire to move on and get on with business. Banks cannot think of culture and conduct as separate from business, or as merely soft or HR-specific issues. They *are* business, that is, how business needs to be done and the means by which banks can achieve continued success and sustainability. For culture and conduct initiatives to be successful, they need to become internalized as a way of doing business rather than a program that is created and then ignored. Conduct and culture must be understood by all employees.
- **Shift in relevant management and leadership capabilities.** Many leaders reported that historically, the banking industry managed the business and the people primarily via quantitative metrics (for example, volumes, sales, and profits), which were relatively straightforward to assess. In the context of the increased emphasis on culture and conduct, however, there is greater need for management acumen and skill as banks start to manage not just the "what" but also the "how," which requires much more judgment as well as proximity to and involvement in the daily business operations. Also, driving sustainable cultural change at large organizations requires leadership capabilities that may not have been a focus of development in the past, such as more focus on soft people management skills rather than financial acumen.

<sup>6</sup> Balancing stakeholder needs with putting the customer first ultimately improves company success, so no trade-off between customers and shareholders should exist.

<sup>7</sup> "NYS Comptroller DiNapoli: Wall Street Profits and Bonuses Up Sharply in 2017," Office of the New York State Comptroller, March 26, 2018; <http://www.osc.state.ny.us/press/releases/mar18/032618.htm>.



Finally, creating an environment of psychological safety where all employees feel empowered to be authentic, where diversity can thrive, and where challenging groupthink is encouraged will require greater management skills.

- **Shifting toward a more nuanced and effective style of management.** This is especially difficult in many institutions given the leadership deficit they are facing. In fact, many banks historically promoted their best producers/performers into management roles with minimal regard to ability or interest in managing others (and often without regard to the individuals' values and ethics, sending a powerful message in terms of the organization's priorities). And little time was dedicated to developing management skills. A management role was often considered a reward for a job well done rather than a privilege, obligation, and responsibility to develop others and ensure the long-term sustainability of the firm. Banks are now realizing a leadership gap in middle management layers, with a lack of skill and capacity to manage the "how" of performance, and limited ability to influence and drive team member behaviors. A number of banks that have historically underinvested in the management and leadership capabilities that they require are now investing in leadership development to make up for lost time.
- **Evolving forces on conduct.** While the definition of good conduct will stay the same, the pressure points will change as the market and business models continue to evolve. Banks will be tasked with anticipating and addressing additional scenarios for misconduct that may emerge, such as uncertainty in pricing contracts in the context of the London Inter-bank Offered Rate (LIBOR) transition; new General Data Protection Regulation (GDPR) requirements around data usage, consent, retention, and portability; and risk of embedded bias in automated black box systems and artificial intelligence (AI).
- **Rolling bad apples.** Individuals with poor conduct records move from one bank to another. Can issues truly be resolved and addressed at the industry level if "bad players" can simply move

from one institution to another with impunity? What can the industry do to address this? Are there lessons from other professional industries (for example, legal, medical, engineering) that are applicable? Do laws defending employee rights clash with the industry's ability to protect itself from toxic employees? The industry continues to grapple with these issues within the constraints of privacy and employment laws.

- **Increasing scope for supervisory gaps and conduct arbitrage.** As the thinking of financial authorities around the world continues to evolve on conduct and culture, the divergence in supervisory approaches across jurisdictions is arousing concerns around conduct arbitrage, that is to say large firms seeking to benefit from supervisory oversight in jurisdictions that may be less focused and demanding. Further, Open Banking developments have started to create some blurring of competitive lines across banks, technology companies, retailers, and telecom companies, adding to concerns around fair competition and customer protection.

\* \* \*

This report is structured as follows. Section 1 presents industry progress on conduct and culture since the financial crisis, and particularly since our 2015 report; section 2 outlines the lessons learned; section 3 offers additional, specific recommendations reinforcing our 2015 recommendations; and section 4 explores outstanding questions and opportunities for continued progress in the future.

While this report focuses on banks as our primary audience, we note that non-bank financial institutions (for example, private equity firms, hedge funds, and insurance companies) are also prone to conduct and culture issues that are similar to those of banks. Certain issues may come into particularly sharp focus at these institutions, such as the possibility of outsized financial rewards promoting excessive risk-taking behavior. We hope that, as has been the case with our previous reports on governance and supervision, the leadership and directors of non-bank financial institutions will also internalize the lessons learned and our recommendations. As Box 3 makes clear, conduct and cultural failures are not unique to banks—far from it.

### BOX 3. Not just banks

Examples of corporate misconduct are not limited to the banking industry. Other industries worldwide, including manufacturing, automotive, and high tech, have exhibited various forms and levels of misconduct, especially over the last few years. As in banking, the root causes of misconduct stem from poor corporate cultures, inexperienced or self-absorbed managers, weak internal controls, and lack of safe escalation procedures. These have resulted in billions of dollars in fines, criminal investigations and charges, leadership removal, and loss of customers.

Two industries, in particular, automotive and high tech, highlight the similarities in environmental factors also observed in the banking industry, which led to cultural breakdowns and eventually to misconduct issues.

- **Automotive:** In Germany, in particular, several major incidents of misconduct have emerged from the intentional manipulation of vehicular software to deceive emissions tests. In September 2015, the United States and Germany opened investigations into Volkswagen's/Audi's deliberate rigging of software on 11 million diesel-powered vehicles worldwide between 2009 and 2015, including 600,000 vehicles in the United States, to falsify emissions levels to pass U.S. emissions tests. Investigators further found active approval, engagement, and concealment of this program by the Volkswagen/Audi senior leadership, including then-CEO Martin Winterkorn. Consequently, Volkswagen has faced numerous federal investigations in both the United States and Germany; criminal charges or arrests of senior leaders and managers, including Volkswagen's and Audi's CEOs; and over US\$30 billion in recalls, legal penalties, and settlements as of midyear 2018.<sup>1</sup> In addition, German authorities are investigating similar misconduct at Daimler, which faces a potential US\$4.4 billion fine for illegal software in some Mercedes-Benz models.<sup>2</sup>

It is worth noting that the German car executives concerned received among the highest bonuses in the country.

- **High tech:** The high-tech industry has also struggled with many reputational issues, allegations of misconduct, and loss of business due to actions that negatively impact key stakeholders (that is, customers and employees). In addition, the high-tech industry overall has been plagued by extensive accusations of discrimination and mistreatment of female employees. The examples of cultural failings are rampant. During the tenure of its former CEO, Uber's culture had serious faults and resulted in numerous incidents of misconduct, including deliberately undermining its competitors (for example, booking thousands of fake Lyft rides, spamming Lyft drivers), underpaying its drivers, using technology to deceive law enforcement, applying surge prices inappropriately, and stealing trade secrets from Waymo (the Uber example is also an interesting case of social media turning on a company for its decisions/behaviors, and the #DeleteUber movement showed customers voting with their feet).

In December 2017, Apple admitted to slowing the processors on its older generation iPhones, presumably to sell more batteries or new iPhones. Finally, Facebook has demonstrated significant negligence in managing the privacy of millions of its users' data, as revealed in the Cambridge Analytica scandal in early 2018. Personal

conduct of senior executives is also under scrutiny; in a one-month period in the summer of 2018, three CEOs in the chip industry resigned or were fired for conduct reasons (the companies involved are Texas Instruments, Intel, and Rambus).<sup>3</sup>

### Cross-industry lessons

Upon examination of other industries that have suffered significant and systemic cultural breakdowns similar to those observed in banking, we identify five characteristics that these industries have in common and that might provide insights into characteristics that lead to greater culture risk.

- 1. Lack of diversity:** Industry homogeneity in backgrounds, education, gender, and racial/ethnic composition remains prevalent and can foster groupthink cultures. Such environments limit the number of challenges or alternative opinions required to effectively mitigate poor business decisions.
- 2. Presence of dominant companies:** A few large, successful players dominate these industries and may lead to deprioritizing culture, given that these companies have been able to attract customers and talent due to their dominant brands.
- 3. High dependence on specialized skills:** High-quality, well-educated candidates with specialized knowledge are critical in these industries. As a result, such individuals can often take on an outsized organizational role in their influence and decision making and make it more challenging to fire such highly valued individuals even in the face of egregious behaviors or inappropriate decisions. Distorted views of individual's contributions can also lead to the cult of personality in many of these firms.
- 4. Misaligned incentives:** Performance and remuneration schemes are often aligned with quantitative or financial targets, which can inadvertently prioritize decisions that lead to misconduct. In addition, average annual wages for positions in these industries tend to be significantly higher than mean annual national wages; for example, in the United States, the mean annual wage for financial analysts and advisors is 107 percent higher than the U.S. mean annual wage across all industries, and the mean annual wage for computer- and tech-related jobs is 77 percent higher than the U.S. mean.<sup>4</sup>
- 5. Ineffective leadership and management skills:** Board members, senior leaders, and middle management of fast-growing and highly successful firms may overestimate their own and their company's capabilities and be ill-equipped and too inexperienced to recognize potential risks and complexities of their operating and revenue models. Hubris caused by a high degree of success can also cause individual leaders to believe their capabilities and decisions are unassailable and they start to believe their own rhetoric.

1. "Audi CEO Rupert Stadler arrested in Germany," CNN Money, June 18, 2018.

2. "Germany threatens Daimler with 3.75 billion euro fine over emissions-Spiegel," Reuters, June 1, 2018.

3. "Texas Instruments CEO Resigns After Code of Conduct Violations," Maria Armential and Eliot Brown, *Wall Street Journal*, July 17, 2018.

4. "National Occupational Employment and Wage Estimates," U.S. Bureau of Labor Statistics, Washington, D.C., May 2017.



## SECTION 1.

# ASSESSMENT OF INDUSTRY PROGRESS

Our 2015 report outlined key recommendations for improving conduct and culture, across both the *what* and the *how* for banks to challenge their cultural foundation:

- **THE WHAT.** Banks should specify their cultural aspirations through a robust set of principles, and fashion mechanisms that deliver high standards of values and associated conduct consistent with the firm's purpose and broader role in society.
- **THE HOW.** Banks should work to fully embed the desired culture through ongoing monitoring and perseverance, drawn from four key areas: senior accountability and governance, performance management and incentives, staff development and promotion, and an effective three lines of defense.

Our specific recommendations are summarized in Table 1.

**TABLE 1. Summary of 2015 recommendations**

AREA	RECOMMENDATIONS
<p><b>1</b>     <b>Fundamental shift in the overall mindset on culture</b></p>	<ul style="list-style-type: none"> <li>a. Banks should look at culture and look to achieve consistent behavior and conduct aligned with firm values, as key to strategic success.</li> <li>b. Banks should reinforce the messages in their actions and in their internal communications.</li> <li>c. Banks' behaviors and conduct should be open to constructive internal challenge.</li> </ul>
<p><b>2</b>     <b>Senior accountability and governance</b></p>	<ul style="list-style-type: none"> <li>d. Oversight of embedded values, conduct, and behaviors should receive regular attention in boards' agenda setting, given sensitivity to reputational risk.</li> <li>e. Board charters should include responsibility for oversight of values and conduct.</li> <li>f. Boards should build a reputation, values, and conduct risk tolerance dashboard to aid in their evaluation of cultural issues.</li> </ul>

AREA	RECOMMENDATIONS
<p><b>2</b>     <b>Senior accountability and governance</b></p>	<ul style="list-style-type: none"> <li><b>g.</b> If the Chair and CEO positions are not split, boards should ensure that the lead independent director spends adequate time in the effective challenge role to the CEO on values and conduct issues.</li> <li><b>h.</b> The CEO and Executive team should be highly visible in championing the desired values and conduct, and face material consequences if there are persistent or high-profile breaches.</li> <li><b>i.</b> The CEO should ensure that there is a thorough process that reviews the bank's brand and reputational standing.</li> <li><b>j.</b> Asset owners and third-party fund managers should tell boards directly that they consider effective governance and accountability to be a priority cultural matter for the firm and investors.</li> </ul>
<p><b>3</b>     <b>Performance management and incentives</b></p>	<ul style="list-style-type: none"> <li><b>k.</b> Compensation and promotion processes should ensure reflection of desired behaviors, including consequences for weak management oversight or willful blindness.</li> <li><b>l.</b> A comprehensive set of indicators is needed to monitor and assess the adherence of individuals and teams to firm values and desired conduct.</li> <li><b>m.</b> Individual review and assessment of senior executives by the senior leadership and CEO is required.</li> </ul>
<p><b>4</b>     <b>Staff development and promotion</b></p>	<ul style="list-style-type: none"> <li><b>n.</b> Banks should buttress first-line skills and ensure that frontline management and leadership are properly trained in how to conduct judgment-based staff evaluation and deal with identified breaches.</li> <li><b>o.</b> Banks should develop programs for staff across all areas of the bank that regularly reinforce what the desired values and conduct mean in practice.</li> <li><b>p.</b> Institutions should formulate and implement a system-wide values and conduct evaluation process for internal promotions and external hires.</li> </ul>
<p><b>5</b>     <b>An effective three lines of defense</b></p>	<ul style="list-style-type: none"> <li><b>q.</b> Staff and management in the business (first line of defense) should shoulder the largest responsibility for judging whether behavior is in line with the bank's values and desired conduct.</li> <li><b>r.</b> Banks should allocate clear second-line ownership to Compliance or Risk Management functions and ensure that the designated function is on the Executive team.</li> </ul>

AREA	RECOMMENDATIONS
<p><b>5</b>     <b>An effective three lines of defense</b></p>	<ul style="list-style-type: none"> <li>s. Banks should provide assurance to all employees that reports of wrongdoing in the workplace will be taken seriously and confidentially without reprisal. Banks should challenge the conventional wisdom on legal impediments and ensure that robust penalties and appraisal processes are in place.</li> <li>t. Staff rotation between control and business functions may be beneficial and help develop the desired firm-wide cultural mindset.</li> <li>u. Banks should ensure that the third line of defense is robust, has operational independence, is suitably staffed, and has a clear mandate to examine adherence to standards.</li> </ul>
<p><b>6</b>     <b>Regulators, supervisors, and enforcement authorities</b></p>	<ul style="list-style-type: none"> <li>v. Regulators should carefully consider the limited effectiveness of promulgating rules related to values and conduct.</li> <li>w. Conduct-of-business and prudential supervisors can, however, gauge the effectiveness of board and management processes that generate tangible oversight and change in values and conduct.</li> <li>x. Conduct-related assessment should be embedded into the core supervisory work, rather than developed as an “add-on” task or objective.</li> <li>y. Industry-led standard-setting initiatives should be encouraged.</li> </ul>

This chapter reviews the progress the banking industry has made on conduct and culture since the financial crisis, particularly since our last report in 2015, with a specific focus on the recommendations above. Before we begin, two caveats:

- It is not possible to holistically grade progress at a global level, given the (sometimes very) significant differences by geography and by each individual institution; for larger banks, progress may even differ across businesses, offices, and teams. For example, banks in markets directly impacted by the financial crisis (for example, the United States, the UK, and Europe) experienced an immediate spotlight on culture and conduct and have been on this journey for a decade, while banks in markets that escaped the financial crisis relatively unscathed (for example, Australia) have only more recently begun to focus on the issue. In many of the areas

assessed, we observed significant gaps between the leaders and laggards, with some institutions having made significant improvements while others still operate under the perception of “*it would never happen to us.*”

- While progress in terms of inputs/efforts can be easily observed, whether and how these inputs/efforts actually impact outcomes is difficult to prove. Even a reduction in conduct breaches over time cannot be considered a conclusive indication of improvement, as seen by the number of conduct scandals that persisted for many years and only recently have come to light.

Given these considerations, we focus on the efforts and inputs of banks to improve culture and conduct, and we attempt to provide a range of views on progress across the industry.

That the industry mindset on culture has evolved was a point of unanimous agreement across all our interviews. There is now collective appreciation of the importance of culture and conduct, and the need to improve. But tangible industry progress has been slow, especially as the bar for good conduct continues to rise and the public continues to expect more from banks, and as levels of transparency (especially due to social media) increase. While a number of individual firms have made headway in implementing changes to formal and informal elements of culture, the industry as a whole continues to struggle to embed culture in a more fundamental manner, and to conclusively demonstrate the effects of these changes. Moreover, there is a growing gap between firms that are applying a holistic, multipronged approach with active board-level engagement and firms that continue to focus more narrowly on misconduct management and compliance as the solution to cultural issues.

Two relatively recent incidents in particular have attested to the seriousness of the continuing cultural and behavioral leadership and managerial deficit, one regarding Wells Fargo in the United States and one regarding Commonwealth Bank of Australia (CBA). Wells Fargo, considered an industry leader in cross-sell metrics and praised for having successfully navigated the financial crisis, saw a series of high-profile scandals erupt in succession from late 2016 that revealed serious cultural failings such as flawed incentives and excessive sales pressures, a pattern of corner-cutting and unethical behavior, and inaction by senior leadership. CBA, the largest financial institution in Australia and a bank respected for its history of financial success and technology innovations, also underwent a succession of scandals and was found in a 2018 prudential inquiry to harbor critical cultural shortcomings, including a sense of complacency; utilizing only a reactionary approach to exposed risks; insularity; and pursuit of consensus at the expense of constructive challenge and accountability.

In some ways, these cases shook up the industry in each market more than other cases because they were so unexpected; these were institutions with stellar reputations that had weathered the financial crisis relatively unscathed. They were also considered solid traditional banking institutions with a community focus. These scandals proved that conduct issues

are not limited to investment banking and can in fact permeate conventional retail and wealth management banking activities. As one senior industry member stated, it is when the institution is successful, growing, and well-regarded that senior leadership must be most vigilant against the “*tyranny of success*,” extreme overperformance vis-à-vis competitors, and the temptation of willful blindness.

Unfortunately, major conduct failures continue elsewhere, further underscoring this is not predominantly an Anglo-Saxon matter. For example, the Danske Bank US\$200 billion Estonia-Russia money-laundering scandal has shown that whistleblowing cannot be overlooked and should always be carefully and swiftly investigated by senior management with the oversight of and reporting to the board. Likewise, a money laundering scandal at ING led to a US\$900 million fine earlier this year. The Punjab National Bank US\$2 billion fraud has also highlighted conduct and oversight weaknesses in India’s state-owned banks. Finally, the reported conduct failure at Goldman Sachs related to 1MDB, drives home that a focus on conduct and behavior is essential to all firms.

## MINDSET OF CULTURE

Since the financial crisis, culture and conduct concerns have risen in prominence at many banks, representing a clear shift in the mindset of culture. Most banks by now have re-articulated their core values (which are unique to each bank, but commonly include concepts such as customer/client centricity, integrity, and internal collaboration) in a Code of Conduct or similar document and have made efforts to repeatedly communicate these throughout their organizations (including implications of personal and company behaviors and expectations related to the firm’s values).

Banks have taken various approaches to communicate values throughout their organizations. One CEO personally reviews important bank-wide communications to increase visibility of the bank’s values and ensure alignment with the organization’s culture. Other banks have set up regular town halls and focus groups to promote dialogue on values and create venues for constructive challenge. A number of institutions have developed interactive training and



role-playing to further clarify and entrench the values and expectations.

Despite significant progress in formal intention, frameworks, and communications, the degree to which these values have been embedded in the day-to-day behaviors of employees has yet to be determined. While “tone from the top” is appropriately focused on conduct and culture matters, it is unclear if this has flowed throughout the organization and whether employees at all levels, and especially in the front lines, have fully internalized how this will change how they do business. Much opportunity also remains in working with middle management layers to ensure that tone from above properly reflects the message and intent from the top, and that employees are not in a position where they feel a conflict between what they hear from senior leadership and what they are required to do on a day-to-day basis.

Accurately understanding and measuring changes in culture on the ground remains challenging (especially in large, multi-geography and multi-business-unit banks), and will require banks to continuously monitor whether the formal shifts in their mindset of culture have translated to changes in the day-to-day conduct and behaviors of their employees.

Banks need to ensure that the inclusion of behavior and conduct within their mindset and approach toward business is permanent, and to view the process underway as a fundamental shift in how they do business rather than a program or set of initiatives. Many leaders interviewed shared the concern that as the crisis and scandals are put behind us, the lessons might be forgotten and a return to old practices might occur.

## SENIOR ACCOUNTABILITY AND GOVERNANCE

### Board responsibilities and involvement

With the increased public scrutiny on conduct and culture, and greater expectation for Boards to be fully informed of and involved in such issues, ignorance is no longer an acceptable excuse. In fact, on conduct issues and risk taking, many directors are asking themselves “*how do we really know?*” and are putting

in place measures for greater involvement and insights into the company culture.

The banking industry overall has stepped up board-level involvement on these topics. Prior to the crisis, only one-third of global systemically important financial institutions (SIFIs) had a dedicated board-level financial risk committee,<sup>8</sup> and boards rarely (for example, once a year or sometimes even less frequently) dedicated attention to culture and conduct topics, leading to a deficit in expectations and guidance for senior executives on such issues. Today, conduct and culture discussions account for a meaningful share of board agendas, and as observed by industry participants, the increased board involvement represents not just lip service but tangible improvement.

The specific form of implementation varies across banks. Some boards have co-opted existing, more broadly mandated committees (for example, Risk Committees); some banks have newly established dedicated subcommittees on culture and conduct topics; and still others have opted for multiple overlapping committees to exercise joint oversight over these issues.

Our prior recommendation to split Board Chair and CEO roles has been executed to varying degrees. Many U.S. banks persist in a combined role. Wells Fargo notably shifted to a split model driven by shareholder pressure in the aftermath of the conduct failure and scandal, and Citigroup has announced they will continue to split the Chair and CEO roles. While the splitting of roles does not on its own guarantee elimination of misconduct (scandals have occurred in banks with split roles), it nonetheless is good governance practice and facilitates checks and balances between board and executive leadership.

### Board-level conduct management reporting

Developing management and board-level conduct management reporting has been a major area of focus for many banks over the last few years, in response to regulatory and senior management pressure. Many banks are in the process of creating and refining their culture (and often also ethics) dashboards, often leveraging data and information that is already

8 “BSB Blog: Sir David Walker on Banking Conduct and Culture,” David Walker, Banking Standards Board, May 24, 2018; <https://www.bankingstandardsboard.org.uk/bsb-blog-sir-david-walker-on-banking-conduct-and-culture/>.

collected across the organization, and now collating and analyzing these indicators through a culture lens for the first time. There is general agreement on the value and importance of such dashboards, though the approaches vary in the type, amount, and granularity of indicators. Results are often examined by a variety of factors including geography, business unit/function, tenure, and employment level, to identify subcultures, discrepancies, and pockets of issues existing today and appearing over time.<sup>9</sup>

The trend analysis across both leading and lagging indicators has been used effectively in a number of institutions, but many organizations still struggle with shortcomings in their reporting abilities. The challenges reported by banks include:

- **DATA QUALITY AND AVAILABILITY:** The required data are not available and take time to build (requiring capability enhancement or new roles and responsibilities), and/or available data are of poor or variable quality. Data must also enable reporting and metrics at the right level of detail and granularity to be able to identify localized declines or weak areas. Management must be able to slice and dice the information in order to spot, highlight, and investigate specific or localized issues. Greater advances in technology and AI are starting to enable greater monitoring and analysis capabilities.
- **APPLICABILITY:** Defining standardized metrics across businesses and geographies that are meaningful and can be aggregated remains a challenge.
- **RELEVANCE AND EFFECTIVENESS:** Existing metrics provide useful but limited insights in isolation, and relationships between variables and trends need to be considered. Also, banks continue to struggle to develop forward-looking measures and test outcomes, and given the fact that available metrics are often asymmetrical, they remain focused on reporting misconduct rather than conduct more broadly (including positive measures of conduct).
- **USEFULNESS:** Conduct and culture reporting in many institutions is a relatively new exercise and will require practice to get right. Many banks are

still struggling with how to best use the data and metrics to trigger action or achieve goals of better managing conduct risk. Interpreting the data and translating it into actionable insights is a work in progress at many banks we interviewed.

Monitoring and measurement will always be difficult, but this should not dissuade firms from the exercise, as they can continue to develop and adjust their tools over time.

### Modeling behavior

Banks increasingly recognize the importance of leading from the top (“tone from the top”) and the need for senior management to consistently set concrete examples of desired behavior for the organization to follow. While tone from the top can materialize in various ways, a few best practices have emerged in recent years.

First, leaders can ensure that their communications throughout the bank are consistent, clear, and relatable, (for example, clearly explaining key decisions, how they fit with the firm’s overall strategy and culture, and how the decision is relevant to employees). Second, leaders can demonstrate the desired behavior by living it on a daily basis and exhibiting it in how they act within the firm, with employees, and with customers and clients. Examples matter, and those set by a firm’s leadership are key to embedding culture. One CEO set a strong tone early in their tenure by rejecting a business opportunity that was not aligned with the company’s culture, even though it resulted in a significant loss of business and profits for the company. Third, leaders can and should model desired behaviors by expressing (and, more importantly, demonstrating) a genuine desire to receive and respond to feedback. At one bank, the CEO, upon finding that a culture issue raised by an employee had not received attention in a timely manner, proffered a personal apology for the delay.

Finally, bank leadership can tangibly demonstrate they are in the same boat with employees by taking responsibility for the consequences of difficult actions or outcomes. For example, the CEO at one bank took a voluntary 40 percent pay reduction upon unveiling

<sup>9</sup> See Section 2 Lessons Learned for additional information on how banks are approaching culture and conduct measurement and reporting.

a plan to cut staff numbers and instituted long-term incentive plans with compensation deferred for multiple years.

Senior leaders sharing their own dilemmas and scenarios of when they faced difficult and ambiguous decision making also helps in both defining the expectations and making leaders more approachable.

### Role of asset owners and third-party fund managers in influencing the board and management focus on culture and conduct

- Asset owners and shareholders are beginning to increase pressure on banks with regard to culture and conduct, and in a number of interviews, CEOs

spoke about actively engaging key shareholders in a dialogue about their firm's culture. Investors, on the other hand, still feel it is difficult to have a true voice in the process given the diffuse nature of the investor community; that is, they rarely speak with one voice (see Box 4).

- The Wells Fargo scandals revealed the extent of increasing investor attention on these topics: not only did they incite vocal reactions from activist investors, demanding improved governance and changes in board membership, but the resulting record US\$60 million senior executive claw-backs were made possible by prior activism in 2013 by New York City's pension funds to enable claw-backs in the event of misconduct.<sup>10,11</sup>

10 "Citi, Wells broaden exec pay clawback policies, *MarketWatch*, March 13, 2013; <https://www.marketwatch.com/story/citi-wells-broaden-exec-pay-clawback-policies-2013-03-13>.

11 Clawbacks (especially ones due to public/investor demands) should be seen by the industry as a last resort measure. The industry should strive to achieve effective upfront compensation assessments rather than after-the-fact remediation.

## BOX 4. The investor view

As companies in the banking industry (and in other industries) face increasing conduct issues, and have incurred significant financial costs (fines, lawsuits, lost business), we have seen investors increasingly paying attention to the softer issues beyond financial results. A number of bank CEOs reported to us that they have started engaging directly with large investors to discuss their culture—and the potential impact of strategy on culture and conduct. For the first time, we included interviews with large institutional investors in our report, the key findings of which are described below.

Investors we interviewed care about the culture of their portfolio companies from two perspectives: (a) they look for a board that is independent and strong, while also being appropriately involved in understanding how the business is run; and (b) they look for sustainability, which requires both strong financial results and positive outcomes for all stakeholders, not just shareholders.

Board culture: The investors we spoke with look at the corporate culture but also, importantly, at the board culture. While the two are related, they are not the same. Assessing the board culture enables investors to understand the effectiveness of the board in representing and defending the interests of shareholders. Elements that they look at include:

- Diversity of board members (such as experience, background, and gender)
- Culture of accountability within the board
- Ability to dissent and have differing views from the majority
- "Chumminess" of the board with the CEO.

Investors also assess how well the board understands the culture of the firm and how the culture drives ability to achieve desired results. One investor we spoke with said that while boards have become more involved in discussions with management about culture, many directors are still unable to fully articulate or describe the company culture. From the investors' viewpoint, there appears to be room for improvement in terms of boards' understanding, involvement in, and influence on corporate culture.

**Culture as a driver of sustainability:** While investors focus on returns, there is an increasing recognition that “soft” factors such as culture can make or break a company. Financial returns are necessary but not sufficient; returns can be wiped out by one event. Culture failures not only lead to hard costs (fines, lawsuits) and financial losses, but scandals and reputational issues put management in a crisis mode, which detracts from their focus on business growth and revenue generation. A sustainable business model must include a focus both on financial results and on addressing the interests and well-being of all stakeholders. As one institutional investor stated: “It is not a choice between profit or purpose—we are long-term investors for our clients and that requires our portfolio companies to pay attention to both profit and purpose.”

The challenge, of course, is that even today, the markets put significant focus on quarterly earnings, which can lead to business decisions and actions that maximize short-term financial results over other priorities. One institutional investor told us that the market needs to start thinking long term rather than in quarterly results, “but the market is not good at pricing the value of having sustainable results: there is value in good culture and good corporate citizenship but we call these the nonfinancial elements because we don't know how to price sustainability.” This investor looks carefully at environmental, social, and corporate governance (ESG)\* elements as they believe these provide forward-looking insights. Financial results report on historical performance, but the ESG elements provide predictive insights into an organization's health, and therefore continued ability to perform.

While asset owners have the potential to significantly influence boards and management to focus on culture as a driver of long-term sustainability; the greatest impediment remains the diffuse nature of the investor community and of their interests. Even the largest institutional investors rarely have significant ownership in any one company, and it can be difficult for them (on their own) to influence board/management agendas. Aside from specific scandals that can cause investors to align their interests, shareholders in any one company often have very diverse goals and may seek divergent outcomes. The asset owners we interviewed spoke about the need for the investment community as a whole to better align on the importance of culture and governance as drivers of sustainable financial results.

\* Note: The ESG elements are the three main areas of focus in measuring the sustainability and ethical impact of an investment in a company.

## PERFORMANCE MANAGEMENT AND INCENTIVES

Many banks, particularly in the UK and Europe,<sup>12</sup> driven by recent Financial Conduct Authority (FCA) and European Banking Authority (EBA) guidance, have reviewed their remuneration schemes, and incorporated cultural and behavioral considerations into performance scorecards, most notably at senior management levels. Banks are at varying stages of formalizing these measures, cascading them to middle management levels and below, and ensuring consistent application. While some banks are beginning to report cases of significant compensation adjustments resulting from the adoption of balanced scorecards for performance management, many banks still weigh the “how” element lower than the “what.” In practice, it is much easier to evaluate direct results than behaviors, and difficult to penalize high performers who do not fall in line with cultural expectations. Nonetheless, boards and management must take this step, and be willing to terminate employees for conduct breaches when necessary.

Recent years have seen cases of conflicted remuneration models that incentivize overly aggressive sales behaviors that resulted in harmful outcomes for customers. A number of individual firms have removed sales-focused incentives for frontline staff, opting instead for alternative measures such as those based on team goals and customer satisfaction outcomes. One bank shifted compensation away from paying based on profitability metrics to paying commission based on a service provided to the customer. For the commission to be paid, the client must be aware of and happy with the service (a third party is employed to collect client satisfaction key performance indicators [KPIs]). Another bank shifted to a three-pronged performance evaluation for all staff: (a) performance in job, (b) effectiveness of behavior, and (c) results on personal stretch goals.

This transition in compensation structures has not been without friction, with some banks experiencing initial sales declines, and others needing to experiment

with alternative performance measures to achieve the right balance between incenting good conduct and achievement of strategic goals. The changes in incentives will also require efforts in other areas, such as reeducating staff to better assess customer needs and make suitable recommendations, and introducing new service tools and routines for frontline staff.

Another challenge of transitioning from purely results-based compensation to a balanced-scorecard compensation structure is that it requires insight into how employees perform their role. This means that managers must have enough time and management acumen to understand what actions and decisions are required in different circumstances and whether the employee did in fact exhibit these behaviors. Also, because compensation is such a blunt (and limited) instrument for influencing behavior, organizations that value the “how” as much as the “what” need to minimize reliance on compensation as a management tool. Compensation has a role to play, but more important is the role of leadership. One institution we interviewed trains managers to look for real-time coachable moments to drive employee behaviors rather than only ex-post compensation measures.

A number of leaders we interviewed, while agreeing about the need to change compensation structures, also pointed to the limited impact on culture this change will have if done in isolation. In fact, compensation is often a by-product of its environment rather than a driver. Whenever there is misconduct, there are almost always issues with incentive design. However, one must ask whether the incentives drove the undesirable behavior or the incentives are an indication of the wrong mindset, which is ultimately responsible for the behavior.

To be credible, the shift toward a balanced performance management culture also requires willingness and courage on the part of leadership to deal with high performers (from a purely results perspective) who display toxic behaviors. When management unevenly upholds standards of behavior, it sends a powerful message to all team members of what is important in reality regardless of the stated values.

<sup>12</sup> In Australia, APRA released an updated remuneration framework and set of standards; see “Information Paper: Remuneration practices at large financial institutions,” Australian Prudential Regulation Authority, Sydney, April 2018. Specifics on implementation and outcomes are not yet available.

Banks have also become more willing to act on and publicize breaches of conduct, and some have signaled when conduct failures have led to terminations, which, when done, sends a very strong firm-wide message. Whereas in the past poor behavior from a strong producer may have been overlooked, banks today have much lower tolerance for bad behavior and have stated that they are even willing to forego revenue opportunities (for example, withdraw from certain deals or businesses) where necessary in favor of maintaining a strong culture.

Banks are also beginning to weigh the potential benefits of using breach of conduct incidents and terminations as teaching moments, against the potential risks of running afoul of privacy, confidentiality, and employment law. Some banks are choosing to explicitly communicate such narratives, while others rely on informal grapevines and collective consequences (for example, heavier scrutiny of activities) imposed on teams of the offending individual or individuals to spread the message internally. A number of senior industry executives pointed to the disconnect between regulation and societal expectations on the one hand, and employment and privacy laws on the other. Dealing rapidly and forcefully with egregious breaches of conduct can be difficult, especially in certain jurisdictions with strong employee protection. In the current climate of social justice campaigns and activist investors, ethical and legal considerations need to be aligned.

## STAFF DEVELOPMENT AND PROMOTIONS

Training programs on conduct and culture have expanded in size and scope at most banks, often focusing on defining specific expectations around behavior and helping employees understand how abstract values and principles specifically translate into day-to-day responsibilities and expectations. This is a very important element of driving behavior; historically, while banks had value and mission statements, there was very little guidance for employees to translate high-level statements into *“what does this mean specifically for me in my everyday job to be able to live up to the expectations of the institution?”* Banks are applying

a variety of scenario-based/role-playing/industrial theater approaches and using a combination of live and web-based mechanisms to deliver content. As one industry leader put it, *“we need to map the culture to the practical,”* providing actual examples of how the culture must be lived. Another area of training is around the grey zones where judgment is required. Banking is a complex business where rules and policies are not possible (or even desirable) for every situation. A principles-based culture requires that employees also have the knowledge, skills, and tools to face the multitude of decisions in ambiguous and complex situations where the right answer is not obvious.

At the same time, some banks have seen that the increased level of training on all aspects of conduct can have a numbing effect on staff, where employees start to tune out and training has the opposite effect than intended. It is important to have the right training for the right people at the right time and to target the training and not push everyone through everything.

Conduct screens are also increasingly being applied to promotion and external hiring decisions. Some banks have stepped up their hiring practices to better assess new recruits’ alignment with the organization’s purpose, values, and expectations on behavior; examples include conduct interview questions, ethical screening, and various forms of personality assessments.

Recent years have also seen active investment in surveillance technology at banks (see Box 5), typically beginning with capital markets businesses but increasingly broadening in scope to other areas. The focus at the cutting edge is on making better use of available data with advanced analytics, bringing together disparate analytical outputs (for example, communications/trade/voice surveillance, social media scanning), and exploring additional analytics to detect or predict potential conduct events (for example, reputational/sentiment analysis, network analysis, cluster analytics). While the technology is rapidly evolving to support such capabilities, the ethical questions around the acceptable degree and level of employee monitoring remain. With increased monitoring capabilities, banks need to carefully balance the need to manage conduct with the need to provide employees with some level of privacy and trust.

## **BOX 5. Use of machine learning for culture and conduct surveillance by supervisors**

Both banks and supervisors have recently started to look at the use of advanced technology (that is, AI and machine learning) to support conduct risk management through automated surveillance techniques.

Culture and conduct surveillance establishes what normal or expected behavior is for a company/function/role, and then analyzes relevant data to identify behaviors that are not in line with the norm. This objective of identifying patterns and anomalies in behavior is an ideal application for machine learning models. For example, clustering algorithms are effective in identifying patterns, trends, and correlations in large bodies of data such as account openings and sales performance. In addition, natural language processing techniques can be used to extract sentiment and meaning from chat logs and call transcripts to identify employee misbehavior or trends in customer complaints.

While not without some controversy (related to privacy and intrusiveness), the technology is advancing rapidly and there are numerous benefits to automating the monitoring, comparison, and analysis of behavior patterns. Indeed, individual companies have experimented with and are starting to implement such capabilities. Supervisory bodies are also exploring how these capabilities could be used to address their goals of ensuring safety and soundness.

Assuming supervisors can collect the necessary data at the appropriate granularity and frequency from institutions, they could apply machine learning techniques to monitor culture and conduct at the industry level and across institutions on an ongoing or near real-time basis. However, even though such applications are feasible in theory, the practical reality is much more challenging.

The initial practical challenge is the collection of the necessary data in a consistent manner across institutions. However, bigger concerns and challenges arise after the data are collected. These include establishing baseline behavior, setting thresholds and triggers, drawing meaningful comparisons given the complexity of institutions and differences across institutions, engaging institutions to investigate potential issues, and the treatment of false positives. The other overarching issue, particularly from the perspective of supervised institutions, is the potential negative consequence of big brother influence on employees created by the ongoing monitoring of employee behaviors and actions.

The potential to use machine learning by supervisors for industry-wide culture and conduct surveillance is real, given that the technology already exists, and the data already reside within individual institutions. The benefits are numerous and include rapid identification and remediation of bad behavior and systemic issues; reduction of manual, siloed, and costly monitoring processes at institutions; and understanding of the cultural health of the industry (similar to how other industry-wide exercises such as Comprehensive Capital Analysis and Review [CCAR] help supervisors understand the financial health of the industry). However, the practical challenges are significant and likely prohibitive at this point. Overcoming these challenges would require a concerted effort and collaboration between supervisors and the industry to ensure that the potential benefits of this new generation of surveillance methods outweigh the downsides.

## AN EFFECTIVE THREE LINES OF DEFENSE

An effective three lines of defense is the area of greatest challenge and least progress to date. The shift of ownership of conduct and culture initiatives to the first line (where it belongs) has been slow. Banks are beginning to improve clarity of second-line oversight of conduct and culture risk, though a standard model has yet to emerge; the specific setup varies by bank size, complexity, and risk management approach. At many banks, second line teams are often still responsible for driving conduct initiatives, focusing on the development of frameworks and standards, piloting, and initial stages of implementation. In terms of the third line of defense, while some banks have started to establish culture audit practices, many banks still struggle with the best way to audit what can feel very intangible. Given this is a relatively new area of focus, banks are in the process of working through a maturity curve to understand the risk and develop a common taxonomy and frameworks.

The biggest gap we observed in the effective implementation of the three lines of defense for conduct risk management is that in many banks it still appears to primarily be a second line focus area. As with all other risks, to be properly managed, it needs to be owned by the first line and embedded in all business processes. It is especially important for the first line to be deeply aware of and accountable for conduct risk management given that conduct by its nature is how you do business. A conduct risk lens needs to be explicitly applied to all business activities including new product approvals, pricing guidelines, customer complaint handling, and evaluation of new transaction/business opportunities. Where it has been a focus by regulators and banks, some progress has been made. For instance, as the UK FCA notes in its “5 Conduct Questions” April 2018 Industry Feedback report,<sup>13</sup> for the polled companies,<sup>14</sup> nearly all frontline business areas have taken full ownership for conduct risk and related change and development programs. There are, however, firms that were slower to make this shift and continue to lag behind their peers.

In addition to ensuring that the first line firmly owns conduct and culture risk management, banks have also struggled with the organizational placement of the second line conduct oversight and control responsibility. Many banks have shifted the responsibility for second line oversight across a number of functions in order to find the right fit. Common organizational placements are Compliance, HR, Risk (directly under the Chief Risk Officer), Operational Risk, and Enterprise Risk Management. Each of these has its own set of benefits and challenges:

- Compliance is probably the most natural fit given that it has the expertise, experience, and discipline for surveillance and monitoring of employee activity. However, some banks are starting to worry that it may restrict the view too much with a focus on laws and regulations. Conduct is about what should or should not be done, rather than on what can or cannot be done.
- HR has the benefit of being able to integrate conduct management into the broader talent management life cycle from hiring to termination. Banks with close HR involvement in conduct initiatives have benefited from the ability to closely embed culture and values into various HR processes, including performance evaluations, incentives structures, and external recruiting. The downside is that as HR in some banks plays a first line role in many of those activities, its second line abilities may be restricted (in fact, in a number of banks, HR is considered a first line function). Another potential limitation is that in many institutions, HR does not have the same organizational power as the Risk function, nor does it have the proximity to the daily business that Compliance and Risk have.
- Placing conduct management in the Risk function directly under the Chief Risk Officer can be effective, especially in institutions that have experienced significant conduct issues, as it elevates the importance of the function and senior management line of sight. However, as an ongoing business-as-usual

<sup>13</sup> “5 Conduct Questions” Industry Feedback for 2017 Wholesale Banking Supervision, Financial Conduct Authority, London, April 2018.

<sup>14</sup> Per the report, a sample of approximately 30 firms.



structure, this can lead to a siloed approach to conduct risk management.

- Operational risk management is a natural fit for many institutions that have defined conduct risk within the operational risk taxonomy and structure. Given that operational risk covers people, process, and technology risks, conduct risk can be viewed as an extension of those risk types. The downside is that operational risk is such a broad and still evolving area of risk management that conduct risk may get lost in the fray and not receive the attention it needs.
- More recently, some banks have moved conduct risk management under enterprise risk. This can make sense for several reasons: it is closely linked to reputational risk, it requires a holistic understanding of risks across the enterprise, and it entails significant reporting effort for the board and senior management. The downside is that the Enterprise Risk Teams in many banks may be too small and not have the capacity to undertake oversight of such a pervasive risk type.

Furthering the dilemma on the organizational placement of second line conduct risk oversight is that many institutions do not yet have full clarity on whether conduct, culture, and ethics should be managed as one integrated function, or separately.

While the industry has not defined one agreed model for second line oversight of conduct and culture, there are two guiding principles that should be observed:

- Whichever function is selected as the responsible second line, it needs to be clear. While all the groups listed above likely have a role to play in the oversight and governance of conduct and culture, there needs to be clarity on roles and responsibilities; that is, which function is taking the lead and which functions are tasked with contributing input (and the type of input) need to be explicitly stated. The risk responsibilities, policies, and appetite statements also need to be aligned.
- Whichever team is given second line oversight and governance responsibility also needs to be given proper power for conduct initiatives to have teeth.

Banks are also starting to further their thinking in terms of the third line's role in the management of culture and conduct. A number of banks have explicitly structured culture audit processes, and in some cases, institutions have established audit teams specifically focused on culture auditing.

While second line placement is important for an effective conduct risk management program, most important for the long-term and permanent success of culture and conduct efforts is ownership by the frontline business. Progress has been slow in embedding ownership of conduct risk in the first line, often due to a lack of understanding or experience by the first line management and/or the view of culture and conduct as a soft HR issue rather than a business imperative. Due to lack of first line ownership, some banks have seen first line responsibilities slip to the second line, which in turn rendered ineffective the second line's role of independent challenge. This is often due to the lack of clarity of how this risk should be defined and managed. It cannot be overstated that ultimately, ownership and oversight for conduct and culture risk management needs to be owned by the Board, the CEO, and the heads of the business units. Defining conduct risk, incorporating it into the risk appetite statement, and developing risk identification and auditing processes are all still very much a work in progress. For instance, many institutions are still struggling with the classification of conduct risk: is it its own risk type or a subset of another risk such as operational risk? As with all other risk types (credit, market, and operational and reputational risks), the methodologies and practices will mature over time. Formal risk management routines will need to be agreed and adopted for the effective functioning of the three lines of defense.

## REGULATORS, SUPERVISORS, ENFORCEMENT AUTHORITIES, AND INDUSTRY STANDARDS

Regulators and supervisors across the globe have increased attention to and expectations regarding conduct and culture. Examples include:

- **UNITED KINGDOM:** The FCA has been a driving force, issuing the Fair and Effective Markets Review

in conjunction with the Bank of England and Her Majesty's Treasury, and implementing regulations for benchmark rates, foreign exchange (FX) remediation programs, and the Senior Managers and Certification Regime to increase individual accountability and governance via banks' senior leadership.

- **EUROZONE:** European regulators have dialed up scrutiny of conduct issues, for instance, with the ECB/EBA releasing conduct-related guidelines on governance arrangements and remuneration policies, and the De Nederlandsche Bank (DNB, the Dutch central bank) conducting examinations focusing on topics such as decision making, leadership, and communication. Further, the ECB updated its Manual for Asset Quality Review in June 2018, incorporating the implications of International Financial Reporting Standard 9 (IFRS 9)<sup>15</sup> and increasing the importance of bank business models focused on investment services. Also, as part of its Internal Capital Adequacy Assessment Process, DNB has stated they will devote particular attention to strategic risks to banks, including the gradual deterioration of a business model.
  - **UNITED STATES:** There has been increased focus on culture and conduct from the Federal Reserve Banks, the Office of the Comptroller of the Currency (OCC), the Financial Industry Regulatory Authority (FINRA), the Securities and Exchange Commission (SEC), and the Consumer Financial Protection Bureau (CFPB). In particular, the Wells Fargo sales practices scandal led the OCC to launch a multi-phase industry-wide review. In his June 2018 speech, "Now is the Time for Banking Culture Reform,"<sup>16</sup> Federal Reserve Bank of New York president and CEO John Williams expressed a sense of urgency in addressing banking culture, and the *"need to ensure that bank management and boards are exerting strong and effective leadership with robust governance. That means holding management and boards*
- of directors to high standards in terms of culture and conduct."*
- **CANADA:** The Financial Consumer Agency of Canada (FCAC) launched a business practices probe, focusing on bank employees' obligation to obtain customer consent and provide proper disclosure about fees and costs when selling new products, and the Office of the Superintendent of Financial Institutions (OSFI) launched a review of domestic retail sales practices. The FCAC's related report,<sup>17</sup> released in March 2018, noted insufficient controls at Canada's largest banks to mitigate the risk of mis-selling and breaching market conduct obligations.
  - **AUSTRALIA:** The Banking Executive Accountability Regime (BEAR) is seeking to improve standards of behavior and accountability, and the Banking Royal Commission is currently investigating incidents of misconduct. The Interim Report of the Royal Commission is critical of regulators, and in its final report, due in February 2019, is likely to recommend that they be accorded additional powers. In May 2018, the Australian Prudential Regulation Authority (APRA), released its review of Commonwealth Bank of Australia's frameworks for governance and accountability,<sup>18</sup> noting *"CBA's continued financial success dulled the senses of the institution, particularly in relation to the management of nonfinancial risks."* As a result, the APRA applied a \$1 billion Australian dollar add-on to CBA's minimum capital requirement.
  - **HONG KONG:** The Securities and Futures Commission's (SFC's) Manager in Charge regime aims to increase accountability of senior management and managers of key/control functions, while the Hong Kong Monetary Authority (HKMA) recently released a framework for fostering sound culture at banks.

15 IFRS 9 was promulgated by the International Accounting Standards Board and addresses accounting for financial instruments. It covers the classification and measurement of financial instruments, impairment of financial assets, and hedge accounting.

16 Now Is the Time for Banking Culture Reform: Remarks given at Governance and Culture Reform Conference, Federal Reserve Bank of New York, by John C. Williams, President and CEO of the Federal Reserve Bank of New York, June 2018.

17 "Domestic Bank Retail Sales Practices Review," Financial Consumer Agency of Canada, Ottawa, March 20, 2018.

18 "Prudential Inquiry into the Commonwealth Bank of Australia (CBA) Final Report," Australian Prudential Regulation Authority, Sydney, April 2018.

- **SINGAPORE:** The Monetary Authority of Singapore (MAS) has drafted proposed guidelines on individual accountability and conduct via banks' senior leadership.
- **CHINA:** The China Banking Regulatory Commission (CBRC) has published Conduct Management Guidelines for banks, designed to facilitate reporting of improper conduct in banks. The process is designed to establish norms for long-term monitoring and inspection of bank practices. The People's Bank of China has also underlined the importance of conduct and culture for the leadership of major banks via its support for the G30 recommendations.

Financial authorities recognize that culture and conduct supervision represents a departure from historical, often quantitatively based prudential supervision, and are grappling with what that means in terms of the skills and capabilities of their staff and their traditional approaches, and their own internal culture and practices. A consensus view has yet to emerge on whether outside organizations that have traditionally focused on quantitative measures of bank health can, without hands-on experience, truly assess the culture of the banks they supervise and add value to a culture review.

In our interviews we heard significant differences of opinion in terms of the role regulatory agencies can play. On the one hand, culture is so intimate and unique to the strategy and values of a specific institution, it is hard to imagine any external party being able to engage productively in an assessment of the culture. On the other hand, numerous scandals and conduct issues have shown that insiders can miss signals of cultural deterioration, and management could benefit from external, unbiased inquiry. Some regulators have taken an optimistic view on this and are experimenting with alternative approaches. For example, DNB has hired psychologists to observe and analyze culture at banks, and the Monetary Authority of Singapore is building up AI and data analytics capabilities.

An important differentiation in determining the role supervisors should adopt in this space is the difference between conduct and culture. Given that conduct

risk management is based on observable behaviors, it may lend itself to a clearer supervisory assessment. As Box 6 shows, in recent years, supervisory authorities in a number of countries have recognized this and reinforced managerial responsibility for conduct and conduct failures with accountability regimes.

Culture, on the other hand, is intangible and ubiquitous; as such, it requires deep understanding of the strategy, operating model, and values of the organization. In other words, conduct can be assessed as right or wrong, whereas culture is not objectively right or wrong, it can only be assessed in terms of its alignment to the strategy and values of the institution.

In some markets, discussions on conduct and culture have moved beyond individual bank efforts to collaboration across multiple players in the industry, including tools and practices that are shared more broadly. Examples include:

- **The Banking Standards Board** in the UK conducts an annual assessment across banks on culture and conduct topics, providing participating banks with useful benchmarking on how they are doing relative to peers.
- **The Fixed Income, Currencies and Commodities Markets Standards Board** has developed actionable standards on behavior and statements of good practice that have been well received by industry participants.
- **The Financial Stability Board** has since 2015 been coordinating international efforts around a work plan to reduce misconduct risk, most recently publishing a toolkit for firms and supervisors to strengthen governance frameworks. The tools focus on mitigating cultural drivers of misconduct, strengthening individual responsibility and accountability, and addressing the "rolling bad apples" phenomenon.
- **The Bankers' Oath** in the Netherlands is a legally required ethics statement and code of conduct holding bankers to standards of good behavior. To date, it has been taken by 87,000 Dutch bank employees.<sup>19</sup>

<sup>19</sup> "The Banker's Oath," Tuchtrect Banken, Amsterdam; <https://www.tuchtrectbanken.nl/en/the-bankers-oath>.

- **The Global Banking Education Standards Board** recently announced standards for ethics education and training for professional bankers, with plans to develop further standards in both general banker competency and on the capabilities required in credit products.

## BOX 6. Holding managers accountable

First introduced in 2016 by the UK Financial Conduct Authority, Accountability Regimes already cover or will cover many major financial centers and financial business models. These regimes are a direct response to a call to amend professional standards and the culture of the banking sector following a perceived lack of personal responsibility for management failings in the financial crisis.

The UK Senior Managers and Certification Regime (SMCR), introduced a statutory duty of responsibility for a defined set of senior individuals in a firm to demonstrate that they have taken reasonable steps to prevent prudential and conduct failures. The regime has been recognized by many as a key driver of cultural and behavioral changes in senior managers in banking. The SMCR was originally established for deposit takers and later extended to include investment firms and insurers and focused clearer articulation of senior roles, responsibilities, and accountability, as well as individual consequences extending to legal prosecution and sanction in the event of breaches by the firm.

Accountability Regimes have since emerged in several other jurisdictions including Hong Kong Manager-in-Charge (MIC), effective October 2017; the Australian Prudential Regulation Authority's BEAR (Banking Executive Accountability Regime) effective July 2018; and most recently the Monetary Authority of Singapore's proposed Individual Accountability and Conduct Regime and guidance from the US Federal Reserve Bank.

In designing and implementing these regimes, supervisors need to have a clear view of the intended outcomes of an Accountability Regime, and design a regime that adheres to those outcomes, taking lessons learned from established regimes such as the FCA SMCR. Special attention should be paid upfront to consider potential unintended consequences and design standards and principles that allow for flexible application where appropriate.

Firms themselves should avoid a pure compliance-based "tick-box" approach when responding to Accountability Regimes and ideally use such regimes as an opportunity to drive and build on strengthening leadership behaviors and overall culture in the organization, ensuring that employees have the resources and support to discharge their duties. Firms that need to respond to regimes in multiple jurisdictions will need to align on approaches, and navigating the minefield of unintended behavioral consequences will be key for both firms and supervisors.

## SECTION 2.

# LESSONS LEARNED

**A**s the banking industry reflects on the last decade, and culture and conduct efforts gain additional maturity, our research has revealed eight key lessons.

- 1 Managing culture is not a one-off event, but a continuous and ongoing effort that needs to be constantly reinforced and that must become a permanent way of doing business.
- 2 Leadership always matters; conduct and culture must be embedded from the top down throughout the firm, starting with the board and senior management but also importantly including middle management.
- 3 The scope of conduct management is shifting from misconduct to conduct risk management more broadly.
- 4 Managing culture requires a multipronged approach and the simultaneous alignment of multiple cultural levers.
- 5 Ten years out from the financial crisis, there is strong recognition that a more diverse set of views and voices in senior management will lead to better (and more sustainable) outcomes for all stakeholders.
- 6 While cultural norms and beliefs cannot be explicitly measured, the behaviors and outcomes that culture drives can and should be measured.
- 7 Regulation has a limited role in rule setting and mandating culture.
- 8 Restoring trust will benefit the industry as a whole; as such, industry-wide dialogue and best practices sharing are important elements in the journey toward a stronger and healthier banking sector.

A discussion of each of these lessons follows.

**LESSON 1.** Managing culture is not a one-off event, but a continuous and ongoing effort that needs to be constantly reinforced, and it needs to be permanent (see Box 7). Banks need to not only find ways to keep culture discussions from becoming stale or repetitive, but also to ensure that culture efforts are responsive to potential changes in the desired outcomes themselves as the industry evolves (for example, digitization). This is particularly important as changes to conduct and culture are further embedded throughout the organization. It is also important to remember that culture is not (and should not be) static; it will evolve as the business evolves, customer needs change, and competitive forces modify. As such, the firm must constantly and deliberately adapt culture to align to a changing strategy and business conditions. Constant nudges and reinforcement of expectations are needed in everyday life as training alone is not enough to shift behavior.

**LESSON 2.** Leadership always matters. Conduct and culture must be embedded from the top down throughout the firm, from the board to senior management and through middle management down to the teller, and through all business units and geographic locations.

First and foremost, the board needs to be aware of and involved in defining and guiding the culture. The board's role is to define purpose of the organization and ensure that all business levers are aligned with that purpose. Strategy, communications, policies, processes, and practices must all align with the desired culture, and the board must oversee that alignment.

Senior leaders need to involve middle management to further articulate and reinforce firm values and intended behaviors in their respective areas of oversight. The day-to-day realities of frontline staff are most profoundly impacted by their immediate manager rather than by the CEO or other senior executives. As such, leadership modeling must flow all the way through the organization and cannot only be seen at the senior levels. This is especially difficult for large, multi-geography and multi-business-unit banks. A direct manager that does not model the values of the firm can easily undermine any example or message communicated by the CEO; as such, many banks are shifting away from focusing mainly on tone from the top, to tone from above. While the tone and direction

of the culture message needs to be consistent across all leaders, it also needs to be flexible enough to be aligned with the different styles of each leader.

**LESSON 3.** The scope of conduct management is shifting from misconduct to conduct risk management more broadly. Conduct is not just about purposeful misbehavior driven by an employee's desire for personal gain or to meet performance targets (for example, rogue traders); rather, it should be considered more broadly. For example, a bank's decisions—in the form of such things as business targets, product design, and automated processes—can sometimes have unintended consequences and harm clients, customers, and/or colleagues even in the absence of bad intentions.

In many institutions, conduct has been defined to include intent, negligence, and failure of judgment. The definition is also broadening to cover all stakeholders, having shifted from only market and customer impact to also include harm to colleagues. In this context, rather than just focusing on how to reduce bad conduct, it may be useful to consider the mirror image question of how to promote good conduct that aligns and furthers the organization's purpose and values. It is also important to consider the full potential consequences and implications of all business decisions.

**LESSON 4.** Managing culture requires a multipronged approach and the simultaneous alignment of multiple cultural levers. Culture is not empirically good or bad, but it must be right for the organization based on its values, strategy, and business model. And the various levers of culture must be aligned with the desired outcomes. Cultural levers include structural elements such as policies, organization, processes, and technology, as well as intangibles such as tone from the top, beliefs, and perceptions.

Embedding culture is not about changing specific cultural levers in isolation, but about achieving alignment throughout, that is, a clearly stated (and believed) purpose that flows into strategy, policies, behaviors, governance models, processes, performance measurement, and incentive schemes. Tone from the top and leading by example are necessary for initiatives to have credibility, but they are not sufficient. Processes and structural elements are also critical for enabling messaging to cascade uniformly and effectively throughout the organization, especially for larger banks. Small

changes in everyday decisions ultimately add up to big changes over time. Implications of this lesson include:

- Along the lines of “every organization is perfectly designed to get the results it gets,” a bank’s various culture elements are a reflection of its true (which may differ from its stated) values and priorities. Banks should think carefully about how each culture element came to be designed/implemented/perceived in its current form, and make necessary adjustments to ensure that it is aligned with the organization’s desired values and priorities.
- Beyond articulating purpose and values, banks need to provide practical, actionable guidance to help staff make decisions. This means clear communication of expectations, and concrete, relatable examples around behavior in real-life situations that employees may face. While values and principles provide direction, on their own they are often too abstract to be directly useful in gray-zone situations. This can be best achieved through tailored trainings across levels and more open communication from senior leadership.

## BOX 7. Lessons from other industries

Banks can learn from other high-risk, asset-intensive industries that have worked for years to embed responsibility for managing behaviors throughout the organization. Examples include the following.

**Oil and gas:** Companies have established specific guidance on behavior (for example, Shell’s “Life-Saving Rules”) that sets clear expectations on acceptable vs. unacceptable behavior. Also, firms use a buddy system to encourage employees, upon observing non-compliant behavior by peers, to intervene with each other without the need to escalate the issue up the management chain. This helps create an environment of trust and psychological safety where employees look after the well-being of the firm and of each other. Banks could consider applying similar approaches to clarify behavioral expectations and foster a speaking-up culture. A speaking-up culture could also mean speaking out to a colleague through mentoring and coaching rather than only via escalation measures.

**Medical devices:** “Hazard analysis” (also known as risk analysis) is a mandatory step in the design of medical devices, to consider the possible consequences of inadvertent misuse by the customer, and to mitigate those hazards so that the customer is not harmed. Such analyses, applied to banking and other financial products, could help banks think more rigorously about product features, even those commonly taken for granted, and build in appropriate safeguards against potential customer misuse.

**Pharmaceuticals:** Healthcare professionals abide by a philosophy of “right patient, right medication, right time”<sup>\*</sup> to ensure patient safety and reduce errors in drug administration.<sup>\*\*</sup> A banking analog (for example, articulated as “right customer, right product, right need”) of this philosophy could help guide retail sales staff in recommending appropriate products for customers, reduce mis-selling incidents, and ultimately improve customer satisfaction and outcomes.

<sup>\*</sup> Some versions also specify, for example, right dose, right route, right reason, right documentation, and right response.

<sup>\*\*</sup> While considered a useful rule of thumb, this is not a foolproof guideline; see “The Five Rights: A Destination without a Map,” by Matthew Grissinger, *P&T* 35 (10) (October): 542, 2010; <https://www.ncbi.nlm.nih.gov/pmc/articles/PMC2957754>.

**LESSON 5.** Ten years out from the financial crisis, there is strong recognition that a more diverse set of views and voices in senior management will lead to better (and more sustainable) outcomes for all stakeholders. Many of the industry leaders interviewed pointed to group-think as a contributing cause of the behaviors leading to the financial crisis and many of the scandals that have occurred since.

Diversity in thinking, problem solving, and leadership styles will help organizations achieve better results through greater questioning, challenging, creativity, and innovation. Diverse leadership teams can also help employees (especially diverse employees) feel safer in raising concerns and escalating issues.

Many leaders stated that their institutions have recently placed greater focus and importance on hiring, retaining, and empowering diverse employees. These leaders recognize that successful, innovative, and learning organizations are ones that are diverse—at all levels of the organization. As one senior industry leader stated, *“everything changes for the better when you have critical mass of women in the C-Suite and the Boardroom.”*

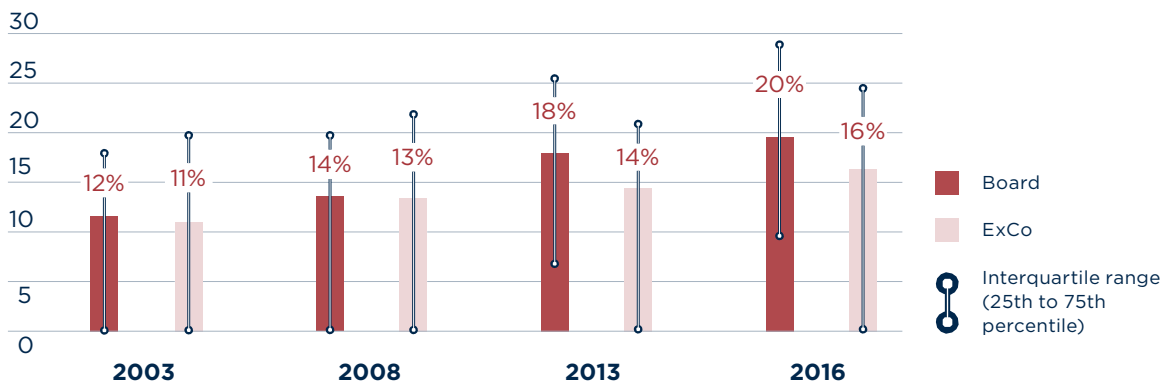
But results on this front are slow, and achieving truly diverse teams (especially at the senior levels) will require intentional and ongoing effort. A 2016 study by Oliver Wyman showed that while slight improvement is being made in terms of female representation in the C-Suite and the board, the numbers are very low and only marginally improving (see Figure 5).

Recent analysis of the financial sector by Mercer shows that women are significantly better represented at the support staff level than at the senior manager or executive level. In addition, the proportion of women decreases at each level as we move up the hierarchy; they are hired at a lower rate than men at all levels except for senior manager; they are less likely than men to be promoted to the next level across all levels of the organization; and they exit at higher rates than they are being hired at all levels, and even more so at manager level and above. This is a troubling picture. Global firms in other industries do not display such large skews.

In addition, gender disparity in pay is gaining attention as an issue in the banking industry, as recently highlighted in the UK but holding true globally. While some of this disparity can be attributed to issues with equal pay for equal work, the fact that women hold fewer senior, highly paid positions than men is typically a larger source of disparity. Such imbalances can create culture issues such as bullying, harassment, and other behaviors that can negatively impact clients.

One Bank Board Chair interviewed rightly stated: *“As human beings, we are not wired to seek out diversity; the natural order is to be drawn to those who are like us. And for too many years, cultural fit has been used in hiring and promotion decisions as a proxy for ‘is just like me.’”*

**FIGURE 5. Percentage of board and Executive Committee (ExCo) members in major financial services organizations who are women**



Source: Oliver Wyman analysis of organization disclosures across 381 financial services organizations in 32 countries (“Women in Financial Services,” Oliver Wyman, New York, 2016).



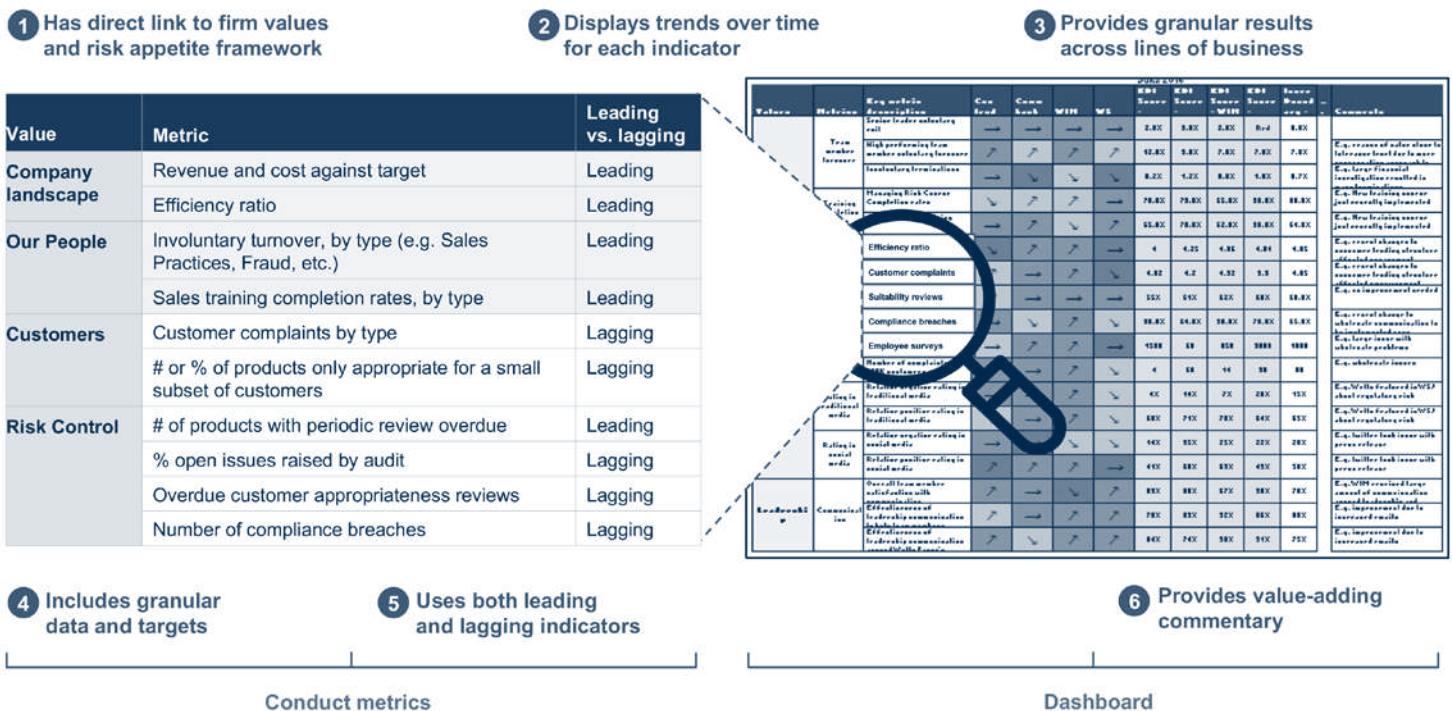
**LESSON 6.** While cultural norms and beliefs cannot be explicitly measured, the behaviors and outcomes that culture drives can and should be measured. Banks are at various stages of trial and error to determine what the right metrics are and how to use them. While measuring culture is a challenging task, it is also a necessity. Leadership’s ability to confidently and objectively state that the conduct of individuals across the organization is in line with their strategy, core principles, and desired goals requires a set of indicators that can support their statements. To maintain a healthy culture and detect conduct issues before they become a significant problem, management needs to be able to observe and track behavior through meaningful and objective metrics. This is especially true for larger organizations that span numerous geographies and business lines, and can host a myriad of subcultures that differ significantly. In addition, banks need to measure and report on culture and conduct because only by measuring them will banks be able to shift their focus away from purely quantitative financial metrics (for example, revenues, volumes, profits) to an understanding of how their actions and decisions align to their values.

Culture also needs to be measured and monitored because it is not constant; culture can and should evolve over time and be influenced by a number of factors including company strategy, hiring, growth, acquisitions, and external drivers such as evolving customer needs or technology advancements. Without effective measurement, leadership cannot determine whether this evolution is progressing in a desirable direction.

Deriving metrics from company values is a multistep process that requires organizations to look inward and answer some challenging questions starting with values, identifying stakeholders and outcomes for each, and then articulating desired behaviors and translating them into observable metrics. Following this, banks will need to embark on a data exploration and analysis effort to make sure that the data needed for the desired metrics are available or can be readily collected. Several tools, including internal surveys, audits, and customer assessments, are particularly useful in gathering data for given metrics.

There is no silver bullet for measuring and reporting conduct and culture, but several key design principles are critical to building a culture dashboard that provides useful and actionable insights, as shown in Figure 6.

**FIGURE 6. Design principles for conduct and culture measurement**



The more mature banks in terms of culture and conduct reporting provide the following lessons learned:

- The report should focus on metrics that are meaningful to the purpose and value of the firm. Also important in metric selection is having both leading and lagging metrics: the forward-looking metrics are key to identify what might happen rather than only reporting on what did happen.
- To be truly valuable, the metrics should be seen over time and analyzed as a trend rather than a single number or point in time. In addition, the analysis should not just look at individual metrics in isolation but rather assess how the data interact. Metrics from across strategy, governance, HR, service, operations, product, sales, and clients should come together to form the full narrative on culture and conduct.
- The details are critical, and the board and senior management should focus on the anomalies, exceptions, and the tail, given that in the summary view, the issues can be buried and lead to a false sense of complacency.
- The report should include commentary and explanation of the data, and the reporting operating model should also include the ability to do further analysis and investigation where needed. With culture and conduct reporting, the metrics do not identify issues per se; rather, they identify where to look for potential issues. The metrics don't tell you what went wrong, they just tell you where to look. In that same vein, as banks refine their approach to selecting and calibrating metrics, they often struggle with many false positives. Getting the right metrics and inferring the right insights will take time and should be piloted/tested over a period of time.
- The reporting should focus on conduct rather than narrowly on misconduct. When banks start down the culture and conduct measurement path, many focus their efforts on misconduct—*intentional* actions that are clear breaches of policies. However, culture and conduct reporting should also include outcomes driven by *unintentional* behaviors and unintended consequences, such as flawed product design that does not meet customer needs. Furthermore, to provide a truly comprehensive and

balanced view of company culture and conduct, the scope of measurement should cover *positive* conduct and associated indicators such as employee volunteer hours, employee satisfaction survey results, sustainability efforts, and social impact investments.

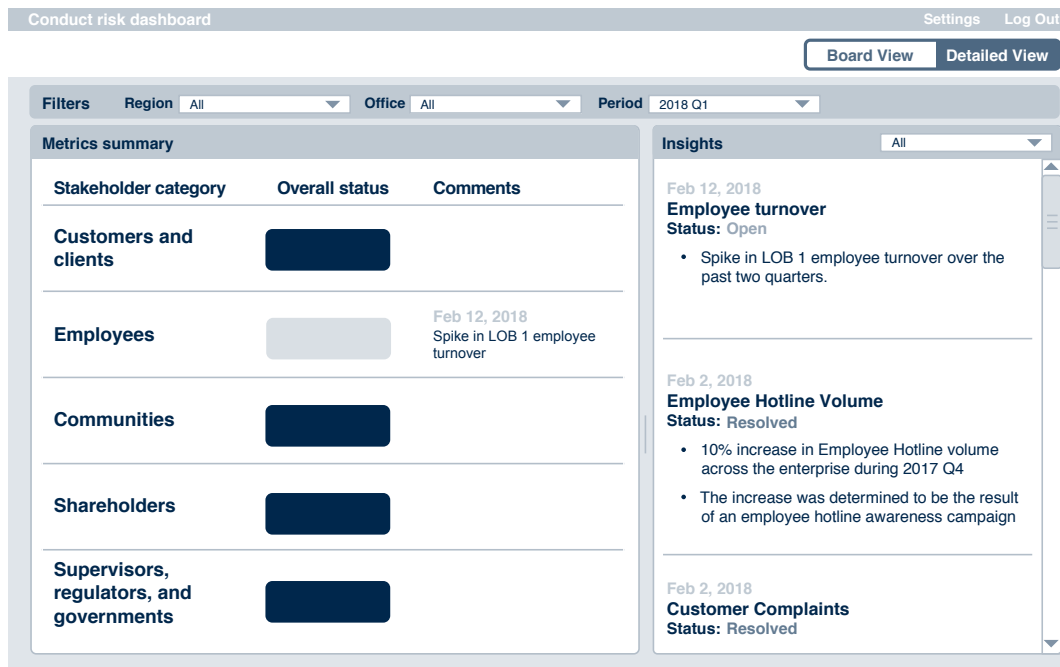
- The reporting tool should be flexible and provide multiple views, levels of granularity, geographic focus, and types of metrics needed to meet the needs of multiple audiences (for example, the board, senior management, business heads, and various second line functions). A number of institutions are starting to develop dynamic web-based reporting views (Figure 7).

**LESSON 7.** Regulation has a limited role to play given that culture cannot be mandated or defined by rules; that is, good culture cannot be regulated into existence. A number of industry leaders raised concerns related to the potential downsides of overly prescriptive regulation, such as encouraging a box-ticking response, undermining the clarity of the message that culture is a matter for banks' boards and executives, creating a mindset of outsourcing good judgment, and forcing disengagement from activities that may expose banks to future financial penalty. Having said that, regulatory agencies *are* responsible for safeguarding the safety and soundness of the financial services industry. As such, these agencies cannot be excluded from the dialogue and monitoring.

The industry continues to explore effective approaches to regulation and supervision; while there is not yet a consensus view, agreement is beginning to emerge in some areas, including:

- **REGULATION:** Regulation can be an effective tool to focus banks' attention on specific and tangible areas of persistent conduct failures (for example, conflicts of interest, risk incentives, and customer protection), in such cases clearly outlining basic principles while leaving room for banks to own and drive the specifics of implementation. The approach of principles-based regulation has recently proven effective in two areas: increasing accountability of senior leadership (FCA's Senior Managers and Certification Regime [SM&CR]) and aligning remuneration policies to drive better

**FIGURE 7. Sample conduct and culture dashboards: Board view and detailed view**



Source: Oliver Wyman.

## BOX 8. Skills and capabilities required of regulators

To effectively assess banks and assist them in effecting lasting conduct and culture changes, supervisors themselves will need to evolve in order to be properly equipped with the right skills and capabilities. As one senior industry leader stated, *“a supervisor would not undertake the review of a financial model without financial modeling expertise; how can they engage in dialogue and review of culture without the skills in behavioral drivers?”*

Supervisory teams should be composed of experienced individuals who understand banks' business models and strategy, and can engage in judgment-based, forward-looking discussions with boards and senior executives about conduct matters. These teams must be adept at leveraging new types of assessment methodologies and be able to identify potential issues and behavioral outliers in a constructive and well-intentioned manner. Further, supervision of conduct and culture will involve greater resources and time commitment relative to traditional supervisory activities, requiring ongoing dedication, careful planning, and a deeper understanding of each bank's business model and strategy.

Over time, some supervisors may find themselves needing to reassess their internal governance structure, operating model, and rules of engagement. It goes without saying that there should be no conduct issues among those tasked with evaluating conduct. Finally, supervisors should consider leveraging additional expertise from external experts (for example, behavioral scientists, governance experts) to bolster the quality of assessments and strengthen supervisors' knowledge and capabilities going forward.

conduct (FCA/EBA guidance on remuneration). Regulatory bodies can also outline requirements in terms of claw-back practices, including defining the appropriate time period for deferrals and claw-backs, which may be too short in some cases today.

The various senior accountability regimes seen in some jurisdictions are one way regulation has impacted bank culture. While the specifics differ, increasingly supervisors are incorporating individual accountability for breaches of conduct in the mandate of their senior management regimes. These are leading to changes in the roles and responsibilities of senior leaders and directors, and are also affecting how banks recruit, appoint, train, and compensate their most senior leaders. It is of course also having a direct impact on the mindset and actions of these individuals and on how they carry out their responsibilities on a daily basis (that is, they are more involved in and aware

of the activities and decisions being carried out in their organizations). See Box 8 for a discussion of the skills and capabilities required of regulators.

- **SUPERVISION:** Supervision has an important role in engaging in a dialogue with the industry and holding up a mirror to the institution. Supervisors can ask questions of the board and management to ensure an appropriate focus on culture and conduct topics, and can also share industry best practices and learnings. It is important that supervisors share culture insights that they have gleaned from their work across multiple institutions and in their dialogue with regulatory bodies from around the world.

Supervisors can also help in anticipating future sources of potential misconduct given their broader industry-wide view. Trust, transparency, and open dialogue between banks and supervisors will be critical to allow for this, and to enable early intervention to prevent serious issues before they materialize.

- **SYSTEMIC ISSUES:** Systemic issues such as the “rolling bad apples” problem cannot be addressed by individual bank efforts and require collective response across the industry and regulatory/supervisory bodies.<sup>20</sup>

**LESSON 8.** Restoring trust will benefit the industry as a whole; as such, industry-wide dialogue and best practices sharing are important elements in the journey toward a stronger and healthier banking sector. The banking industry in major markets should seriously consider mechanisms of collaboration (for example, through industry standards organizations) to develop cross-industry comparisons regarding their progress on culture and conduct. Even though culture is unique to each institution, collaboration and comparisons can benefit the industry by providing banks with a view, considered by some to be more honest than that collected in-house, into their own culture relative to those of peers. Further, such benchmarking results can provide banks with an objective basis for introspection and constructive challenge, guarding against overconfidence in their own approaches.

The Banking Standards Board (BSB) in the UK provides a good example of this industry-wide collaboration. Established in 2015, the BSB is a private, nonregulatory, membership-based organization open to any bank in the UK. The BSB has provided UK banks with an open forum to share and aggregate best practices on conduct and culture. One of the cornerstone

pieces of work achieved and published annually is the BSB Annual Review, which assess current and year-over-year changes in behavior, competence, and culture in UK banking, and identifies key best practices from member banks. Though only its second report, the 2017 Annual Review received over 36,000 responses of input across 25 UK banks, which highlights the keen interest and active participation on the part of UK banks in critically evaluating their own firm’s practices and collaborating with and supporting other banks in identifying changes in conduct and culture.

The Fixed Income, Currencies and Commodities Market Standards Board also provides good examples of behavioral patterns evident in misconduct in its July 2018, *Behavioural Cluster Analysis* study.<sup>21</sup> The publication provides a practical toolkit to identify the root causes and relevant behaviors that underlie market misconduct. The study has identified 25 patterns, which can be categorized into seven categories of behavior: Price Manipulation, Circular Trading, Collusion & Information Sharing, Inside Information, Reference Price Influence, Improper Order Handling, and Misleading Customers. The study finds that there are a limited number of patterns that repeat themselves, are jurisdictionally and geographically neutral, occur across different asset classes, and adapt to new technologies and market structures. This study also demonstrates that conduct issues are a long-standing and constant struggle that management must vigilantly monitor and mitigate. (See Box 9).

<sup>20</sup> Although this must be done within the constraints of local legislation and employee protection laws.

<sup>21</sup> “Behavioural Cluster Analysis, Misconduct Patterns in Financial Markets,” Fixed Income, Currencies and Commodities Markets Standards Board, London, July 2018.

## BOX 9. Training for lasting behavioral change

Many banks struggle to change their culture because they fail to address the issue of behavioral change. Training for behavioral change is not a linear process, but an iterative process, with potential loopbacks to allow adjustments and learning. People change their behavior gradually and on an individual basis, as behavior is embodied in the person. That is, in the moment of action, an employee doesn’t always think about his or her behavior, but rather simply behaves according to subconscious patterns. Changing these behaviors is not possible in a one-off training or coaching session, but rather requires repeated

rewiring of new patterns and suppressing old ones over a series of reinforcing experiences, often an awkward and difficult process, until the new patterns move out of the conscious mind into the subconscious and become behaviors.

Neuroscience research suggests that driving behavioral change relies on cycles that ensure new behaviors stick, starting with a diagnostic to develop a plan of action, then engineering a shock to raise awareness of target behaviors and actions, followed by nudges (ideally every eight or so days), seeking to affect the subconsciousness associated with the change, and finally closing out to reinforce behavioral change.

While there is no one-size-fits-all process of behavioral change, there are typically five stages: **awareness** (becoming aware of the new behaviors and need to change), **nudging** (starting to experience the impact of the new behaviors), **reinforcing** (frequent repetition of new behavior delivers consistent feedback), **sustaining** (reinforcing structures help embed the change), and, finally, **impact** (positive results appear on both a business and personal level).

A well-designed training program comprises not just the initial training sessions, but also interventions in subsequent months that help reinforce the behavioral intent. Banks should look for ways to incorporate such interventions in order to fully reap the benefits of the investment they make in their training programs.

## SECTION 3.

# RECOMMENDATIONS

This report finds that the banking industry has made a significant effort to improve culture and conduct, and has unearthed several valuable lessons in the process, though there is still more to be done. While our 2015 recommendations continue to be relevant, we present the following additions and reiterations. To make the recommendations more tangible and practical, we have included anonymized examples of how some banks have made progress on the various recommendations.

### SENIOR ACCOUNTABILITY AND GOVERNANCE

**RECOMMENDATION 1.** The board should reevaluate its governance structure to ensure one specific and dedicated board committee has oversight of the bank's conduct and culture. Effective board oversight matters, and it is needed to ensure that the embedding and sustaining of the desired culture remains a permanent feature of doing business. This requires:

- Setting the right tone
- Devoting time to culture and conduct matters
- Being satisfied with the tone set by the CEO and senior leadership
- Periodically reviewing how conduct breaches are dealt with
- Watching for signs about the effectiveness (or ineffectiveness) of the bank's work to put in place and sustain the desired culture.

In addition to the dedicated culture committee, the board as a whole must also devote appropriate time and attention to culture and conduct topics. If the specific structure varies from what is recommended in this report (that is, overlapping oversight across multiple board committees rather than a dedicated committee for culture), there must be sufficient communication among the committees to ensure alignment on priorities and initiatives. There is significant risk of dilution and dispersion of responsibility for the governance of something as broad as culture. Therefore, we believe a dedicated board committee is best to ensure focused attention and accountability.

Boards should actively incorporate culture and conduct into their agendas, benchmarking their initiatives and process against the industry and holding management accountable for outcomes aligned with the bank's values, and protecting the bank from short-termism imposed by shareholders or markets. The board should also provide a conduit of direct access for escalation and whistleblowing. (The recent Danske scandal underscores the importance of whistleblowing and escalation processes.)

One of the most effective ways for board members to understand the culture of the organization and its many manifestations is to visit functions and business units. This will provide them with first-hand observation of the behavioral atmosphere. Within limits set by the law, board members should be encouraged and expected to visit business units and functions to gain first-hand impressions of attitudes and behaviors through, so to speak, kicking the tires. Such visits can additionally provide valuable tangible affirmation to employees of the priority assigned by the board to

the bank's culture alongside its business performance. While board member visits into the operations do involve some risk of stage-managing, the ability to discern, and not be misled, is a key requirement of today's director.

*Bank A holds "culture sessions" every one to two months to promote understanding of values, with both the CEO and Chairman in attendance. At these sessions, every business/country is asked to identify three practical initiatives to embed values into practice, collectively amounting to hundreds of such initiatives across the bank. Each business/country manager is then given ownership of these initiatives and is personally accountable for the outcomes at the following session.*

**RECOMMENDATION 2.** Bank boards and senior management should work more closely with various business units and with geographic and functional heads to strengthen the quality and availability of data and insights needed to manage conduct and culture. Boards and senior management should ensure that robust and relevant processes are in place to identify and report on departure from desired behaviors and conduct. Boards should demand and review comprehensive dashboard information and ensure the findings and insights become part of the regular board discussions. Such processes should be auditable and subject to internal audit scrutiny in the same way as other key aspects of the business. Getting regular granular data across a range of areas, for example, including customer complaints and whistleblower activities, will allow boards and management to test the extent to which culture is embedded in the organization. In addition, bank leadership must better define forward-looking, relevant, and effective metrics and ensure alignment with reporting to identify emerging risks and manage conduct progress.

*Bank B conducts a quarterly sentiment assessment, over a random sampling of employees. They present 50 words related to culture attributes, half positive and half negative, and 10 of which are related to outcomes specifically*

*pursued by the bank. Employees are asked to choose 10 words that best describe the culture; results are then compared against the pursued outcomes.*

## PERFORMANCE MANAGEMENT AND INCENTIVES

**RECOMMENDATION 3.** Banks should consider the potential impact of outsized incentives in their compensation mechanisms. Progress has been made on aligning compensation to culture and conduct; however, the fact remains that certain business lines are still compensated largely based on the risks they take, which are incentivized for potential gains, versus limited sharing of potential losses. No matter how well designed an incentive mechanism is, when the magnitude of the potential prize gets very large, it can dominate over other concerns such as firm values and ethics. Banks should incorporate nonfinancial performance measurements (for example, conduct, customer outcomes, assessment against firm values) into their remuneration schemes, and ensure that serious shortfalls in such areas can result in material reductions in compensation, career progression and, where necessary, termination.

*Bank C started a journey about two years ago to rethink the concept of management, which included exploring the science and discipline of people management. The bank recognized that, historically, in order to reward high performers, they were promoted to managing successively larger groups of people. But not all high performers have the skills or inclinations to be strong people managers. The bank developed separate tracks for promotions, recognizing both high-performing individual contributors as well as strong people managers. In addition, the bank developed a stronger curriculum for management development and has deployed a team of HR professionals whose role it is to provide support to middle management levels in the everyday challenges and decisions that present themselves in the management of people.*



**RECOMMENDATION 4.** Banks should remove the link between quantitative sales targets and compensation for sales staff to minimize pressure that can lead to misconduct and help staff prioritize meeting customer/client needs.

A number of shocking scandals, in the United States, the UK, and Australia, for example, have highlighted how linking employees' pay to sales target incentives can distort their behavior, engender highly problematic subcultures within firms, and produce terrible outcomes that are disastrous to reputation and damaging to customers.

Perhaps the most egregious recent case involves Wells Fargo. In 2016, U.S. regulators revealed that the bank's employees created approximately 3.5 million fake bank and credit card accounts as the employees sought to hit unrealistic sales targets linked to their pay and performance targets. Whistleblowers had largely been ignored. The firm admitted to firing 5,300 employees over the course of several years, but the board and management still failed to swiftly recognize clear signs of cultural and conduct failure until the bank was hit with US\$1 billion in fines from the Consumer Financial Protection Bureau. In 2018, U.S. regulators demanded changes to the board of Wells Fargo.

**RECOMMENDATION 5.** Banks should explore ways to celebrate role models in behavior, both in business decisions and in individual actions. This includes both individuals (for example, enabling employees to send "thank you notes" to peers who have demonstrated outstanding behaviors) and business decisions (for example, turning down transactions that may be economically attractive, but are not aligned with the bank's purpose or values). While the industry's focus on incentives has so far generally centered on negative consequences to reduce undesired behaviors, positive reinforcement for desired behaviors can often be more effective in driving cultural change. In fact, in one institution, the focus on bad conduct outcomes had the unexpected consequence of instilling paralysis; people were more focused on avoiding the negative than on achieving the positive. The institution has since shifted its focus to enabling and celebrating positive outcomes. Effective positive reinforcement should focus not just on rewards, per se, but should specify

which of the organization's values were demonstrated in each particular instance.

*Bank D has instituted a program in which about 100 senior staff throughout the organization were appointed as ambassadors for culture. Ambassadors participated in a three-day training session about gray areas in decision making and were then tasked with the responsibility to report out on culture issues and relay the training techniques and information within their respective units. Bank D runs two-hour interactive workshops in groups of seven or eight people, which employees are using to share knowledge and speak up on issues.*

*Bank E runs a weekly two-hour Executive Committee meeting within each business unit. The last 10 minutes of every meeting are devoted to having one person within the team (typically at a junior level) who has exemplified company values present to the group on how their behavior represented the bank's values. Bank E has seen tremendous impact from this due to the high visibility of these presentations and the concrete, practical nature of experiences shared.*

## STAFF DEVELOPMENT AND PROMOTIONS

**RECOMMENDATION 6.** Bank governance structures must recognize the integral role that middle management plays in embedding cultural reforms and promoting values through lower levels of the organization. Senior leadership, tone from the top, and leading by example are key to success. However, cultural reform must also be embedded in middle management and go right to the front line via middle management. Bank middle managers increasingly face greater and new expectations and demands, such as effective business management, strong client management, and clear moral decision making. Banks should look after the well-being of their middle management and equip them with the skills, training, and resources to meet a multitude of disparate expectations, develop into

exceptional leaders, and continue to support cultural changes within their banks. A number of institutions we interviewed have implemented programs specifically focused on supporting and developing middle management. Examples include dedicated HR support for middle management, peer group discussions and training, and scenario-based training with senior leaders.

Middle managers have an important role to play in promoting values and ensuring their teams uphold such values. Middle management is also a critical lynchpin in dealing with emerging influences on culture given that they are closest to the daily operations. For instance, as banks increase their levels of digitization and adoption of AI, the way work is performed and services are delivered to clients will be profoundly affected and will lead to changes in behaviors, expectations, and culture. Direct supervisors will need to play a large role in ensuring that ethical standards are maintained as the culture shifts to adapt to new capabilities and norms. The ability of middle managers to share concrete real-world examples and expectations can have a powerful effect in making culture and conduct issues really resonate with their teams. It is important for senior management to provide the tools, capabilities, and expertise for their middle managers to navigate the complexity of managing in today's environment,

*Bank F instituted a new bank-wide ritual of “service huddles.” Teams across the institution come together on a frequent basis (some teams huddle once per week and others three to four times per week) to discuss key aspects of their service promise, including reiterating their purpose and key goals. The huddles last about 15 minutes. The teams discuss an aspect of service that is applicable to their particular team function and discuss what it means, how it can be improved, and what the impact is. Team members share positive stories of service as well as ways they are challenged. The firm believes that storytelling is a powerful mechanism for team members to mutually reinforce why we’re here and what we’re about.*

*Bank G enrolls its client-facing employees in “dilemmas training,” recognizing that dilemmas frequently occur in decision making. Examples include how to deal with a borrower who becomes ill and unable to work, and hence cannot repay the loan on time. Bank G has outlined a seven-step process for employees to follow in such cases (for example, “Who are the stakeholders?”, “Do we have all the information we need?”, “What will you do?”, “How do you feel about the decision?”), including encouraging employees to reflect on the decision made.*

**RECOMMENDATION 7. Banks should make efforts to promote diversity and inclusion in the workplace in their hiring and staff development practices.**

Banks should strive to reflect the makeup of societies in which they operate and remain mindful of potential issues that imbalances in power and compensation can create within the organization. Championing and supporting diversity matters because it creates stronger institutions.

In the organizations we interviewed, and across the industry overall, we see a general recognition that a diverse workforce has numerous business benefits and fosters better decision-making processes and outcomes. And diversity delivers to the bottom line. As such, banks are rightly focused on diversity initiatives and hiring results, but retaining and promoting diverse talent remains a significant challenge for the industry as a whole. Banks are realizing that having diverse employees is not enough; employees need to be fully engaged and empowered. Many are failing to achieve the truly inclusive environment required to optimize the benefits of diversity.

*Bank H uses reverse mentoring, in which focus groups are held where more junior women and diverse employees meet with mid- to senior-level leaders to discuss a “day in the life” and the specific realities and challenges they face. The leaders are present to listen; they are meant to understand the stories shared with them, but not problem-solve. This creates greater*

*trust across the organization and also engenders awareness, understanding, and empathy within the dominant group.*

*Bank I has established focus groups for female employees to meet with female members of their Board of Directors to discuss the realities and challenges they face as women in the workforce. The female board members first share their stories to create an environment of trust so the female employees will open up. Select senior leaders and HR representatives attend in a listening role to learn about the facets of their culture that work and where issues need to be addressed.*

*Bank J adopted role-playing with reverse roles. Employees are brought together to role-play common workplace unconscious biases (for example, a man frequently interrupting or speaking over a woman in a meeting). But the roles are played out by the other gender. For instance, a man is in the role of the person being interrupted in the meeting. This training serves two purposes: it increases awareness and understanding of the impact of the behaviors, and enables a discussion about the implications and impact of destructive behaviors rather than about gender roles and stereotypes. The training involves discussion of positive vs. destructive behaviors and removes the sensitivity and controversy that a discussion focused on gendered behaviors and roles can cause.*

**RECOMMENDATION 8.** Banks should promote an environment of “psychological safety” that encourages employees to speak up and escalate issues or share feedback without fear of retribution; bullying or aggressive management styles must not be tolerated. Formal mechanisms such as hotlines and escalation channels are only part of the answer, and while banks should ensure effective operation of these channels in identifying and escalating issues, these need to be complemented by other, softer avenues of dialogue to

be truly effective. Examples include holding frequent forums for communication (for example, weekly town halls), avoiding excessive focus on mistakes and/or allocation of blame, and responsively following up on any issues raised within a reasonable time window. The importance of responsiveness cannot be overstated; employees will only raise concerns if they feel that their voice will be heard and that their concerns will be addressed in a timely manner and without retribution. Arming managers with the capability and skills to differentiate and handle cases of honest mistakes vs. cases of misconduct is also important to preserve employee well-being and safety.

*Bank K has instituted a practice of selecting weekly key topics and having teams meet to discuss them. The topics cover all aspects of the business and can cover broad themes such as operational excellence, cost management, client satisfaction, and innovation. The teams meet for 20 minutes and discussions are structured. They first discuss why the selected topic is important to their team and then identify five concrete actions to drive results related to the them. Then each person identifies what they can do to achieve the desired outcome. Team members are held accountable. These team discussions on the key topics happen at every level including with the CEO and 12 direct reports who meet weekly, and make commitments to each other to help drive improvements in the selected topic areas.*

**RECOMMENDATION 9.** Banks should establish credibility and enforcement through their disciplinary mechanisms for conduct breaches to ensure employees take these measures seriously. Banks should also take steps to ensure fairness of treatment by, for example, setting in advance the recommended outcomes by type and severity of breach, and collectively reviewing cases (allegations, findings, and consequences) on a regular basis. Consistently applying the standards, regardless of business performance, is also critical (for example, not turning a blind eye to high performers who act with

impunity). There is also a careful balancing act in being tough on misconduct while not creating a culture of fear or intolerance of honest and reasonable mistakes (see Box 10). To innovate and develop new capabilities, individuals need to feel safe. A fear culture will foster cover-ups and stifle innovation and ambition. Firms will need to balance the desire (and need) to innovate with mitigating unintended negative outcomes.

*Bank L has taken a hardline approach against conduct that is not aligned with its purpose and values. In one instance, a senior director whose relative, in another role at the bank, committed a serious breach of rules, instructed that relative's manager not to take action against the breach. The CEO, upon learning of this, determined that all three employees involved must be terminated, including the relative's manager, who had served the bank for 30 years. The CEO sent an email to all 100,000 employees announcing that the three people had been dismissed.*

**RECOMMENDATION 10.** Banks should focus on hiring people who align with the bank's purpose and values as they strive to create the right culture for their organization, recognizing that recruiting is a critical element to creating the right culture. This may involve changes to the interview process, such as equipping interviewing staff with tools to assess candidates' behavioral competencies and sense of ethics. Many of the leaders interviewed also discussed the challenges they face in fully assessing candidates' past behaviors and ethical practices given privacy and employment laws in many countries that may prohibit or impede prior employers from disclosing full details. Within the boundaries allowed by the laws, banks will need to further their assessment of the culture and ethical fit of potential employees.

At the same time, banks must also be careful that cultural fit is not used as a mechanism to perpetuate lack of diversity by justifying hiring only the individuals who fit in with the majority and whose thinking

aligns with groupthink. In this new world, the fit of candidates should apply to alignment of values rather than alignment of thinking and experience.

## AN EFFECTIVE THREE LINES OF DEFENSE

**RECOMMENDATION 11.** *Given the limited progress to date, this is a reinforcement of our 2015 recommendation: Banks should persevere in their efforts to shift primary ownership of conduct risk to the first line of defense to ensure conduct risk is truly owned by the business and is effective.* Even though centralized second line functions may incubate conduct initiatives at the start, as with any other risk, conduct risk needs to be owned by the business to be truly effective. Banks must ensure their processes to manage conduct risk are as well-defined and established as with other types of risks (such as credit risk). This includes defining conduct risk, incorporating it into the risk appetite statement, and developing risk identification processes. It also includes defining appropriate audit procedures for culture and conduct reviews.

**RECOMMENDATION 12.** Conduct risk oversight roles and responsibilities should be clear across the various second line functions such as Human Resources (HR), Risk, and Compliance. Organizational clarity is required in terms of responsibility for monitoring, measuring, controlling, and reporting. One function needs to have primary accountability for each of these roles with other second line functions contributing to the oversight. There need to be explicit processes for the identification and proportionate escalation of behavioral mishaps and failures. And these processes need to be audited, as with any other key process in the organization. Banks also need to ensure that the second and third lines of defense have enough power in the organization and enough resources and training to effectively review first line actions, and provide independent review and challenge of these actions, including implementing necessary changes in personnel management.

## BOX 10. A cultural balancing act

**Striking the right tone and achieving a balanced culture is difficult. It is important to have zero tolerance for misconduct but not create a culture of fear of honest and reasonable mistakes.** Doing so requires a firm to create a culture of accountability but not of fear or extreme risk aversion; and to develop a principles-based environment, rather than (only) rules-based governance (that is, employees do what *should* be done, not what *can* be done).

Leadership is critical in setting the tone here, encouraging team members to take risks (within reason), to innovate, and to challenge themselves to grow and try new things. This also means that leaders have to accept that mistakes will be made and to respond to team member mistakes in an appropriate manner. Otherwise, employees will be paralyzed and unwilling to try anything new, and/or will try to hide their mistakes when they occur. Successful organizations are not ones that achieve operational perfection; rather, they are ones that recover quickly from errors and that also institute a culture of learning, where mistakes are discussed, and lessons learned are internalized. As one industry leader said, *“You are not defined by your mistakes, you are defined by how you deal with them.”*

One director interviewed spoke about experience in service industries, and said, *“in human capital-intensive industries, mistakes are inevitable. You have to accept that in large, complex organizations, hundreds of things can and will go wrong each day. The key is to find out quickly what those are and to remediate them immediately. At my previous firm, we had a concept of ‘instant recovery’: identifying mistakes, assessing their impact, and remediating them quickly.”* This means the firm needs a culture where employees are constantly looking for potential issues; mistakes are discussed without fear and with a learning mentality; and there is accountability, ownership, and empowerment to address the issues.

An important key to successfully achieving this balance is for the organization to have clarity on what mistakes it will tolerate and which ones it will not. The institutions that have achieved this spoke about basing tolerance on several factors:

- Level and experience of the employee who made the mistake (greater tolerance for more junior individuals)
- Impact or potential impact of the mistake (including financial, reputational, or regulatory impacts)
- Self-disclosure (higher tolerance if the employee identifies and discloses his or her mistake)
- Frequency (low or no tolerance if the same mistake is made multiple times)
- Role of the employee who made the mistake (some roles require greater levels of innovation and/or judgment while others are more rules or procedures driven).



## SECTION 4.

# AN EVOLVING JOURNEY

Achieving good conduct and culture is an ongoing journey. While banks have made progress on many fronts, the industry must remember that culture stewardship is a journey, not a destination. Banks cannot assume they are done; those banks that have invested substantial effort and made significant progress must especially guard against the temptation to declare victory. Culture is shaped (for good or bad) each and every day and requires constant and intentional shepherding.

Culture continues to evolve with changing societal norms, technological capabilities, competitive dynamics, and macroeconomic trends. There are several areas that remain open questions for the industry going forward, which are discussed below.

**1. Will banks be able to guard against becoming complacent about conduct and culture,** and sustain focus alongside other issues (such as growing the business, dealing with a portfolio of nonperforming loans, and being innovative and competing against nontraditional players) that may seem to be more urgent and of higher priority? A recent Fixed Income, Currencies and Commodities Markets Standards Board study of 390 cases of misconduct in financial markets over 225 years in 26 countries shows that, left unchecked, the same patterns of behavior will repeat themselves over and over again.<sup>22</sup> These findings affirm that, to be sustainable, addressing the issue in the long term will require constant vigilance and integration of

culture priorities into day-to-day business practices. It is imperative for banks to understand that culture and conduct are inextricably entwined with business priorities; they are how those priorities are achieved, not a dichotomous, either/or decision.

**2. In the future, the sources and scope of conduct issues will change.** Digitization is increasing speed in banking and will have a significant impact on the business model and strategies of banks. One institution we interviewed referenced the radical change in how they serve clients; only 12 percent of their total transactions now occur in the branches. As technology continues to advance and banks continue to increase automation of their processes and workflows, banks must be mindful about managing potential unintended consequences of such technology, beyond just the behaviors of the humans. For instance, a loan approval algorithm may have bias built into it (for example, learned from data); an automated customer service chatbot may behave erratically (see Box 11). Also, the evolving ecosystem of providers and increasing scope for outsourcing relationships mean that banks will need to think carefully about conduct that impacts the customer, including beyond their organizational boundaries. Staying competitive in a world of increasingly rapid change will require agility, but how should banks address the corresponding pressure on culture and conduct?

<sup>22</sup> “Behavioural Cluster Analysis – Misconduct Patterns in Financial Markets,” Fixed Income, Currencies and Commodities Markets Standards Board, London, July 2018.

## BOX 11. Managing machine conduct risk

Machine learning applications have the potential to transform how financial institutions interact with and serve their customers. From sophisticated chatbots that provide customer support to recommendation engines that can discover unmet client needs, machines can allow institutions to deliver value to their customers in new ways. As a result, the industry is heavily investing in machine learning, and experimenting with a long list of use cases that may allow them to make better and faster decisions, operate more effectively and efficiently, and build competitive advantage through the better use of data and analytics.

However, rapid innovation and experimentation come with new risks that need to be accounted for and managed to ensure new technology is being developed and implemented in a responsible manner. When thinking about machine learning applications, the risks that are most salient for institutions tend to be the model risk (for example, errors in the math behind the machine), technology risk (for example, issues with code or hardware), and cyber risk (for example, loss of data to authorized parties). But as machines take on tasks that are traditionally done by humans, interface directly with customers, and have a growing impact on customer's financial well-being, they are starting to pose another kind of risk that traditionally would not be assigned to machines, and that is conduct risk.

Even though machines have the potential to create value for customers, they also have the capacity for misconduct. Unfair credit decisions, mis-selling of products, and inappropriate segmentation of customers are just a few examples of how applications of machine learning that already exist today can unintentionally harm customers in the absence of proper governance and risk management frameworks. At this rate of investment and innovation, AI will soon be deeply embedded across financial institutions, but most organizations have yet to take steps to address the conduct risk implications of machines.

Institutions that are experimenting with or implementing self-learning technology should determine how machine conduct risk fits within their existing risk taxonomy, and proactively take steps to establish a governance framework and accountability mechanism for managing the risks associated with machine learning. As a first step, institutions should identify all machine learning applications currently in production, under development, or considered for future development, and identify the potential sources of machine conduct risk arising from these applications.

A key question to ask at this step is, "are we using or planning to use machine learning applications that will interact with or can impact our customers in any way?" Once the landscape of machine conduct risk is well understood, institutions can determine the appropriate roles and responsibilities to manage the risk across various functions (for example, conduct risk management, model risk management); develop policies and procedures to manage the risk (for example, procedures for monitoring machines for conduct risk and escalating issues); and identify any other changes that should be made across people, process, and technology, such as hiring talent well versed in machine learning.



- 3. Is there such thing as going too far in putting the customer first?** As banks shift their focus from transactional metrics toward customer (and other stakeholder) outcomes, and broaden the definition of misconduct from intentional foul play to potential unintended consequences, banks may find themselves asking this philosophical question. Banks must of course know their customer, but consider the example of a customer who uses a certain product or feature in ways not intended by the bank. If negative consequences result, are they due to the customer's own making or to the bank's failure in anticipating the potential misuse? How should banks respond to customers who request products or features that do not benefit their financial well-being? Banks should use their purpose and values statements to inform their answers to these questions, and their target placement on the caveat emptor vs. caveat venditor<sup>23</sup> spectrum.
- 4. Rolling bad apples.** While proposals have been put forth to create an industry-wide register of repeat offenders of poor conduct, the issue is complicated by privacy concerns and the still nascent approaches to ascribing responsibility of conduct failures to individuals. Confidentiality and

employment practices and laws also significantly constrain what can be done in this space, especially in certain countries with strong employee protections. Within the constraints of the laws, banks will need to continue building out HR practices to protect themselves and the industry from repeat ethical offenders. This is an area in which cross-industry collaboration will be critical; still more work needs to be done and, if necessary, legal changes should be considered in order to identify people engaging in egregious behavior, including cases of sexual harassment (see Box 12).

- 5. Questions also remain regarding appropriate forms of public disclosures on culture and conduct topics.** As mentioned, a number of external stakeholders, including investors, community members, and the media, have focused greater attention on the culture of organizations and the insights this provides into the long-term sustainability and viability of the business. There are also questions on how the markets might someday be able to assign a value to intangibles such as culture. After all, everything else we value in business is closely tracked and measured; why not culture? Perhaps we will reach a point when disclosures of culture and conduct metrics

<sup>23</sup> Buyer beware vs. seller beware.

## BOX 12. Conduct with colleagues and in personal lives

In the context of the ongoing #MeToo campaign around the world, banks should take seriously employees' behaviors toward each other. Senior bank leadership must take the lead in clearly condemning and addressing behaviors that do not align with bank values and encourage affected individuals and bystanders to speak up about such incidents. One bank interviewed stated that they cover legal fees for employees who are victims of sexual harassment within the workplace.

Further, good ethics and conduct standards cannot be limited just to the workplace, considering that the bank's reputation is not immune to egregious outside conduct of individual employees. Serious incidents in employees' personal lives\* should warrant investigation—and consequences, where appropriate—in the workplace.

\* "Morgan Stanley knew of a star's alleged abuse. He still works there," Emily Flitter, *New York Times*, March 28, 2018; <https://www.nytimes.com/2018/03/28/business/morgan-stanley-douglas-greenberg-financial-adviser.html>.

becomes as much standard practice as disclosures of financials. Finally, banks must understand that the need to pursue either profit or purpose is a false dilemma, and that both goals need to be pursued in tandem and must be aligned for an organization to be successful (see Box 13).

As the G30's work on conduct and culture has underscored, a constant focus on conduct and culture throughout the firm is a business imperative and is essential to the long-term success and sustainability of the firm. The notion that there is unresolvable tension between the pursuit profit and a focus on the firm's purpose, both individually and within society is false.

### **BOX 13. The false dilemma**

In the past, company leadership and investors often believed they had to decide between pursuing profit or pursuing purpose. Historically, the industry focused on profit drivers over company purpose, as profit was synonymous with viability and growth. However, this mindset creates a false dilemma: both profit and purpose must be pursued together to drive the long-term sustainability of an organization. While banks certainly need profit to drive success and growth, purpose is also required to ground a company in its values and create a sustainable, healthy culture. As seen with the multitude of examples of misconduct in banking, lack of focus on purpose has serious organizational and financial implications.

A number of industry leaders and organizations are trying to create a greater focus on and appreciation of long-term indicators of corporate and financial health. For instance, FCLTGlobal, a nonprofit organization that advocates for a long-term focus for business and investment decision making, and its 42 member organizations, which include several financial services institutions, have committed to several actionable organizational changes to renounce a short-term focus, including increased use of long-term-oriented metrics, more transparency in capital allocation decisions, and identifying incentives for long-term shareholders. While significant progress still needs to be made, simple changes, such as revisiting and reaffirming mission statements and firm values, are key first steps to strengthening a bank's culture and sense of purpose.

## SECTION 5.

# A FINAL WORD

Ten years on from the global financial crisis, for banks and the banking industry the repair of trust is a work in progress, and the reform process is still underway.

The provision of financial services requires the trust of customers, first, because of the complexity and scope of the products, and second, because of the importance of these products for the well-being of individual clients/customers, to the public, and to society as a whole. There is also no doubt that trust is difficult to earn, easy to lose, and even more difficult to regain. Client trust is a privilege that banks must earn every day through each of their thousands of actions and decisions. What is in doubt, however, is how profoundly the industry is willing and able to change to ensure that trust can be built and maintained in a continuous fashion.

Fundamentally, the issue is simple. It is about doing the right things in the right ways—always. The execution, however, can be tricky, even with the best intentions. Historically, the industry has focused on delivering transactions; as such, the structures, processes, incentives, and management were built around the delivery of transactions to customers.

Today, banks that continue to emphasize transactions are being asked to refocus on delivery of value to

customers. This will require a shift from a distribution model to a relationship model. Consistently delivering customer value also requires institutions to adopt a stakeholder view. Only when positive outcomes are achieved for all stakeholders, including the public and community, employees, shareholders, customers, and vendors, can customers be assured that their best interests will be met.

A value- and outcome-based culture may require fundamental shifts in the operating, business, and revenue models of many banks in order to embed these tenets in a sustainable and ongoing manner.

To conclude, it is imperative that banks continue to recognize that the focus on conduct and behavior, on bank culture by boards, senior management, front-line employees, and supervisors, must be an ongoing journey rather than an initiative that can be completed and set aside. In 2018, most banks are embarked on this journey, and many firms recognize that the repair of trust must rest upon carefully constructed and monitored conduct and cultural norms. We close by emphasizing that this must be a permanent mindset change for the industry, if we are to successfully deliver for society as a whole and weather future challenges and risks.



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