



BANKING CONDUCT and CULTURE

*A Call for Sustained and
Comprehensive Reform*



G30

GROUP OF THIRTY

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TABLE OF CONTENTS

Abbreviations	4
Foreword	5
Acknowledgments	7
List of Working Group Members.....	9
Executive Summary.....	11
Chapter 1: Definition of culture and proposed framework.....	17
Chapter 2: Assessment of bank and supervisor progress	27
Chapter 3: Recommendations for banks, regulators, and supervisors	45
Appendix 1: List of previous BCBS, FSB, and G30 reports.....	57
Appendix 2: Intended outcomes and supporting behaviors for industrial and financial corporations, recommended by indexes and regulators.....	60
Appendix 3: Bank roadmap for achieving desired values and culture	61
Appendix 4: Supervisor roadmap for assessing conduct and culture	64
Bibliography	67
Group of Thirty Members 2015	69
Group of Thirty Publications	73
BOX	
Box 1. Standards vs. Rules.....	25
FIGURES	
Figure 1. Elements of a unique bank culture.....	18
Figure 2. “Average bank” performance, 2009–2014	21
Figure 3. “Average bank” conduct and credit costs, 2009–Q4 2014.....	21
Figure 4. Comparative trust of selected sectors	22
Figure 5. Word cloud of words and themes found in the value sets of the thirty-nine banks examined.....	28

ABBREVIATIONS

BCBS	Basel Committee on Banking Supervision
CEO	Chief Executive Officer
CSR	Corporate Social Responsibility
D-SIFIs	Domestic Systemically Important Financial Institutions
FSB	Financial Stability Board
G-SIFIs	Global Systemically Important Financial Institutions
G30	Group of Thirty
HR	Human Resources

FOREWORD

Banks and banking rely on trust. And while trust takes years to establish, it can be lost in a moment through failures caused by problematic ethics, values, and behaviors.

Events that precipitated the global financial crisis and the subsequent issues that have emerged have revealed a multitude of cultural failures. This report recognizes that problematic cultural norms, and sub-cultures within large banks, have caused widespread reputational damage and loss of public trust. These events have been economically costly to firms in terms of fines, litigation, and regulatory action. The cultural failures also came at a cost to the public, directly in some cases, and in terms of lost bank lending capacity. Banking plays a crucial economic role across the globe, providing support for growth, employment, and our collective future prosperity. A lot of work has begun in banks to deal with issues of conduct and behaviors, but there are important gaps in implementation, and there is a need to sustain and reinforce these efforts to achieve lasting results.

Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform is the third G30 study and the culmination of several years of work focusing on the governance challenges faced by the world's largest banks, their boards, their management, and the supervisors who oversee the health of the financial system as a whole, and the economic sustainability, strength, and integrity of the individual firms themselves.

Research for this report began in the fall of 2014, led by a steering committee comprised of co-chairs Roger W. Ferguson, Jr. and William R. Rhodes; and

vice chairs Gerd Häulser, John G. Heimann, and David Walker. They were supported by ten other working group members and observers. More than seventy interviews were conducted (on a nonattribution basis to encourage candor) with senior supervisors, board members, Chairs, CEOs, and senior members of management in many of the largest, most complex global and domestic banks in sixteen countries. Interview participants illuminated how individual firms embed desired values, ethics, and behaviors that collectively constitute culture, how they champion strict adherence to ethical values and punish unethical behavior, the challenges they face, and which approaches appear to work and which do not.

A great deal rests on a firm's culture. As the title of this report makes clear, improving and embedding desired conduct and cultural norms is a long-term process that requires a sustained effort. The public can be served and individual firms can prosper in the long term only if they are trusted entities operating for the broader benefit and with the support of their customers and society at large. The banking community as a whole needs to repair the damage done by failures in culture, values, and behaviors, and should tackle the challenge with renewed vigor and purpose to achieve tangible improvements in outcomes and reputation.

The research pursued for this report shows that some firms are further along on the cultural journey, while others have barely begun or are trying but failing to achieve change. Regardless of where a firm stands, this report provides actionable advice to boards, management, and supervisors that we believe is applicable across cultural and geographic boundaries. The

report addresses the “soft” yet very hard-to-get-to issue of bank culture by building on existing foundations of values and conduct-of-business practices. It does not define one good or one bad culture, or propose further regulation to govern culture. Rather, it identifies approaches, processes, and examples of good practice that exist in other sectors, the banking industry, and within individual banks that should be the foundation of a sustained industry-led response. Drawing on the seventy interviews conducted, the report offers recommendations for an industry-led response in key areas, including the overall mindset on culture, the need for senior accountability and governance processes, performance management and incentives (compensation), staff development and promotion, and an effective three lines of defense; and identifies specific ways regulators, supervisors, and authorities can contribute effectively.

The report is the product of the G30 Steering Committee and Working Group and reflects broad

agreement among the participants.¹ While the focus of the report is on systemically important banks, the observations and recommendations have wider application in the banking industry and, we believe, more broadly in the financial industry as a whole.

The mission of the Group of Thirty is to deepen the understanding of international economic and financial issues, to explore the international repercussions of decisions taken in the public and private sectors, and to examine the choices available to market practitioners and policymakers. This report continues that crucial mission. We call on the leaders of the financial community to assign high priority and urgency to strengthening conduct and culture and, in so doing, to draw on our recommendations as signposts of good practice, and as part of a comprehensive series of reforms. We believe there should be a review in approximately twenty-four months of the progress made by major banks in implementing these recommendations.



Jacob A. Frenkel

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Group of Thirty*



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¹ Members participated in their personal capacities and did not represent their individual public or private sector institutions.

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On behalf of the Group of Thirty (G30), we would like to express our appreciation to those whose time, talent, and energy have driven this project to a successful completion. We would like to thank the members of the Steering Committee and Working Group, who guided our work at every stage and added their unique insight. The intellect and experience brought to the table by the ten members and observers of the Working Group on the important subject of bank culture was essential to our collective success.

No project of this magnitude can be accomplished without the committed effort of a strong team. The G30 extends its deep appreciation to Project Director, Davide Taliente, and Dominik Treeck, Tristan Adams,

and the many members of the team at Oliver Wyman who worked so hard to interview scores of leaders from across the globe. We thank them all for their contribution to the analysis and formulation of the report, which builds so effectively on the G30's earlier work on this subject.

Finally, 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 Corinne Tomasi and Stephanie Tarnovetchi of the G30. We are grateful to them all.



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EXECUTIVE SUMMARY

“Pursue a straightforward, upright, legitimate banking business. Never be tempted by the prospect of large returns to do anything but what may be properly done under the National Currency Act. ‘Splendid financiering’ is not legitimate banking, and ‘splendid financiers’ in banking are generally rascals or humbugs.”

– Letter of guidance to bankers from the U.S. Comptroller of the Currency,
December 1863

This report addresses the governance challenges facing the world’s largest banks, their boards, their management, and the supervisors who oversee the health of the financial system as a whole, and the economic sustainability and strength of the individual firms.

Banks and banking today stand in disrepute. Poor cultural foundations and significant cultural failures were major drivers of the recent financial crisis, and continue to be factors in the scandals since then, exacerbated by staff with questionable conduct and values who move from bank to bank with impunity. Unhealthy cultural norms, or subcultures within large banks, including in some cases criminal behavior, have hurt the public, caused reputational damage and loss of public trust, and have been financially costly in terms of fines, litigation, and regulatory action; economically costly to society at large; and have been a major distraction for both senior management and boards. Banking is, in 2015, at a low point in terms

of customer trust, reputation, and economic returns, and steps must be taken to reverse this.

A SUSTAINED FOCUS ON CONDUCT AND CULTURE IS NEEDED. There must be a sustained focus on conduct and culture by banks and the banking industry, boards, and management. Firms and their leaderships need to make major improvements in the culture within the banking industry and within individual firms.

Restoring trust in banking is a public trust and economic imperative, and is the bedrock of a safe and effective financial system. Banks need to restore the primacy of serving customers to help them achieve their financial goals, and of serving the communities and economies in which they operate. Many leaders and banks are already engaged in this important endeavor. They need to continue this focus because addressing culture and repairing trust go hand in hand and are a prerequisite for sustainable economic returns and—in the medium term—a source of competitive advantage.

Answers to the cultural challenges facing banks and banking do exist. Indeed, workable solutions are being implemented by banks across the world. This report identifies shortcomings but also good practice, and makes a series of recommendations for boards, management, and supervisors, which can be applied and drawn upon by leaders as they seek to address culture in their firms.

DEFINE THE DESIRED CULTURE. A major sustained improvement in culture can be achieved and secured by focusing on values and conduct that are the building blocks of culture.

Focusing on values and conduct is a more practical approach, since these are observable and measurable, can be specified as principles embodied in bank standards and linked to incentive structures, and can be explicitly linked to broader stakeholder objectives. Desired values and conduct should be evident in the tone from the top, and the voices of the middle manager should be heard in an echo from the bottom and should, in short, infuse the entire organization and its businesses. Desired values and conduct should be reflected in the daily habits and practices of employees—how they work; how they are evaluated; who is hired, promoted, and rewarded; and how employees act when managers are not present and when matters of personal judgment arise.

Achieving and sustaining a vibrant culture that is understood, internalized, and celebrated by everyone in the firm is difficult. Forming and sustaining a culture is a constant process requiring commitment, perseverance, and continuous focus and monitoring by the board and management.

Broadly speaking, the “what to aspire to” is in place. Most banks have made bold assertions on cultural aspiration in terms of expected values and refreshed or strengthened codes of conduct.

But banks are still failing in implementation. A comprehensive framework is needed to deliver a more effective set of actions and powerful monitoring.

There appear to be systemic weaknesses in embedding these values and codes of conduct in employees’ lives and the ways of doing business within firms. Banks that recognize that embedding a desired culture is core

to their business model and its economic sustainability appear to achieve greater success in internalizing the desired culture. Those firms that are reactive and defensive find embedding culture a more difficult task. The latter tend to view values and conduct changes as a means to minimize future redress, fines, and additional enforcement actions, rather than as structurally important to the firm’s long-term success and viability. This view is misguided.

BANKS SHOULD CHALLENGE THE WHAT AND THE HOW OF 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. A key challenge is to identify and manage behaviors in “grey zones” in which adherence to conduct and values principles and standards is a matter of judgment, not a matter of clear-cut legal requirements. Just because it is legal does not mean it is right.

1. Most banks should aim for a fundamental shift in the overall mindset on culture. If not there already, banks should shift the implementation approach to “this problem is core to our business model and fixing it is key to the economic sustainability of the institution,” raising the bar for CEO and Executive team leadership, visibility, and appetite to consistently take difficult internal sanctioning decisions (ensuring material consequences in terms of both termination of implicated management and employees, and significant compensation adjustments). Sanctioning must affect those with oversight responsibility, including the CEO, for any new issues that arise, and include those who exercise willful blindness.

- a. Banks should look at culture, and achieving consistent behavior and conduct aligned with firm values, as key to strategic success, rather than a separate work stream or add-on process to respond to short-term public, regulatory, or enforcement priorities.

- b. Banks need to reinforce the messages in their actions and in their internal communications.
- c. Banks' behaviors and conduct should be open to constructive internal challenge. Banks need to have processes that welcome and can deal with self-identification or escalation of issues.

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.

2. Senior accountability and governance. Boards should ensure that oversight of embedding values, conduct, and behaviors remains a sustained priority, with the primary responsibility resting with the CEO and Executive team for ensuring that the “tone from the top” has a clear and consistent “echo from the bottom.”

- a. The high sensitivity of Boards to reputational risks should be harnessed to ensure that oversight of embedding values, conduct, and behaviors receives regular attention in their agenda setting.
 - b. Board charters should include responsibility for oversight of values and conduct. Unless the board can commit sufficient time and attention to these matters, the task should be delegated to a dedicated committee of the board, accountable to the board. Boards should report on their oversight of conduct and values, and institutional investors should more seriously weigh these factors in their assessment of likely long-term success.
 - c. Boards should build a reputation, values, and conduct risk tolerance dashboard to aid in their evaluation of cultural issues.
 - d. 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.
 - e. Boards should ensure that the CEO and Executive team are highly visible in championing the desired values and conduct, and that they face material consequences if there are persistent or high-profile conduct and values breaches.
 - f. The CEO should ensure that there is a thorough process that reviews the bank's brand and reputational standing with the full scope of internal and external stakeholders to recommend any corrective or strengthening initiatives to the Executive team.
 - g. 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.
- 3. Performance management and incentives.** Banks should ensure that their performance management does not reward individuals who do not meet a threshold of acceptable behavior in alignment with firm values and conduct expectations. This includes meaningful and consistent compensation adjustments (for example, bonus reduction or elimination, claw backs) in the event of identified failures. This requires use of a meaningful balanced scorecard approach based on objective criteria.
- a. Improve compensation and promotion processes to ensure they take account of desired behaviors, including consequences for weak management oversight or willful blindness. The processes should ensure that misconduct and violation of bank culture come at a meaningful price for those responsible for such behavior (for example, reduced compensation, termination, career limitation). Management and all staff should be made aware that unacceptable behavior and transgressions will engender appropriate disciplinary action.
 - b. Develop a comprehensive set of indicators to monitor and assess the adherence of individuals and teams to firm values and desired conduct.

- c. Implement individual review and assessment of the top 200 to 400 most senior executives (in Global Systemically Important Financial Institutions [G-SIFIs] or Domestic Systemically Important Financial Institutions [D-SIFIs]) by the senior leadership and CEO. For smaller banks, the number would be smaller, but many more than just executive committee members who report to the CEO.

4. Staff development and promotion. Banks should continue to establish robust processes to explain and regularly reinforce to staff what is expected of them.

- a. Buttress first-line skills and ensure that front-line management and leadership are properly trained in how to conduct judgment-based staff evaluation on desired values and conduct and dealing with identified breaches. Examples from the bank's own experience (both positive and negative) can be powerful.
- b. Develop programs for staff across all areas of the bank, tailored to the bank's circumstances that regularly reinforce what the desired values and conduct mean in practice. Changing behaviors is a developmental program that cannot always be achieved through "standard" training, and requires the involvement of senior leaders who champion the effort.
- c. Formulate and implement a system-wide values and conduct evaluation process for internal promotions and external hires. These send strong messages about what the bank values in practice.
- d. Emphasize diversity (cognitive, gender, racial, background) throughout the bank as a key contributor to improved values and conduct and sustained behavioral change.

5. An effective three lines of defense. All employees and all levels of management should adhere to values, conduct, and behavioral expectations. Business line management—the first line of defense—should

shoulder primary responsibility for delivering the desired values and conduct, with the second line setting standards, monitoring, and providing advice to the first line. The third line should be robust and mandated to test adherence to the stated standards.

- a. Staff and management in the business (the first line of defense) should shoulder the largest responsibility for judging what behavior is or is not in line with the bank's values and desired conduct. This will be a significant change for how many think of their role and purpose.
- 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. The designated function should seek input from all other relevant functions as necessary (for example, Human Resources). Remuneration levels in these functions need to be sufficient to attract high-quality individuals who can command the respect of the business. The designated second line needs to develop skill sets and priorities to be better equipped to deal with difficult judgments on values and behaviors and act as a more effective advisor to the first line.
- c. Boards and management should implement systems that provide assurance to all employees that if and when they report wrongdoing that they witness in the workplace, their complaints will be taken seriously and confidentially and they need not fear reprisals. This will require clear policies, escalation procedures, and protection for internal flag-raising or whistleblowing.
- d. Banks should challenge the conventional wisdom on legal impediments—that too often lead to "no action" being recommended by internal legal teams—and ensure that robust penalties and appraisal processes are in place. These should include staff or management termination and compensation adjustments. Employers should ensure that full due diligence is completed on past employment history of

potential new hires. In addition, authorities may need to consider launching a registry; but there are considerable legal hurdles to achieving this within and across jurisdictions

- e. Staff rotation between control and business functions may be beneficial and help develop the desired firm-wide cultural mindset.
- f. Banks should ensure that the third line of defense (that is, the audit function) is robust, has operational independence, is suitably staffed, and has a clear mandate to examine adherence to standards.

6. Regulators, supervisors, and enforcement authorities. Addressing cultural issues must of necessity be the responsibility of the board and management of firms. Supervisors and regulators cannot determine culture, but supervisors should have an important monitoring function.

Supervision has a strong complementary role in improving the banking culture. Supervision is not regulation, which is rule making and which has a limited role in the area of values, conduct, and culture. The Supervisory Function and agencies need to be provided with sufficient resources to perform this monitoring role. Given appropriate resources, senior staff supervisors can add value by sharing best practice insights with executive management and the Board, with specific emphasis on testing whether internal governance and checks and balances are in place as set out in “the how” recommendations above. This does not imply grading institutions on their culture, but it does imply sharing perspectives on whether “the how” is being effectively pursued relative to market best practices.

Progress is being made by prudential supervisors and banks on risk culture, but more is needed. The recommendations presented in the previous G30 report, *A New Paradigm: Financial Institution Boards and Supervisors*, about enhanced constructive interaction between supervisors and boards, progress in assessing governance, and having appropriate supervisory skills and resources, continue to be relevant.

Recommendations for regulators, supervisors, and enforcement authorities:

- a. Regulators should carefully consider the limited effectiveness of promulgating rules related to values and conduct.
- b. 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. It is possible for supervisors to have enough information to credibly identify serious problems institutions are not addressing. Supervisors should challenge the board and senior executive on how they oversee, understand, measure, and manage the problem. This should allow for early intervention by the supervisor to have the institution rectify serious deficiencies through a variety of informal and formal tools.
- c. There is a marked difference among authorities in the balance between ex ante supervision and much more heavy use of after-the-fact enforcement and introduction of specific rules. We find that conduct-related prevention, using a range of informal and formal supervisory tools, backed up by robust enforcement, can produce a better outcome for society. To rectify what now amounts to a supervision deficit in some jurisdictions, authorities should ensure that conduct-of-business supervision has sufficient focus on early intervention to prevent issues before these materialize or magnify in severity. Supervisory teams would benefit from an injection of experience and behavioral skillsets to provide more powerful insights and benchmarking evidence to banks. This assessment should be embedded into the core supervisory work, rather than developed as an “add-on” task or objective. In addition, enforcement authorities should review the tilt toward actions against entities rather than individuals, to ensure the desired incentive effects are being achieved.
- d. Industry-led standard-setting initiatives should be encouraged. Industry bodies tasked with strengthening codes of conduct and creating transparency on implementation progress should be welcomed. Such bodies should not duplicate, but rather complement, conduct-of-business agencies.

CONCLUSION

The prescription set out in this report sets out three critical mechanisms for achieving the cultural transformation that banking and the banking industry has embarked upon. The first—which we view as a bare minimum requirement—is the enforcement of black letter law: there are multiple, complex issues relating to proportionality and accountability of individuals vs. institutions that require careful consideration by enforcement agencies. The second, which is the main focus of this report, is a Board- and Management-led

sustained embedding of substantially improved culture and values, with supervisory monitoring. The third is a competitive effect that should—in time—create competitive advantage for firms that have demonstrably better cultures and conduct, with respect to client reputation and the ability to attract and retain skilled staff and attract investors. The desired cultural shift will require leadership, persistence, and consistency to overcome years of entrenched behaviors and attitudes, and to ensure that the changes are lasting rather than ephemeral, or merely short-term window dressing.

DEFINITION OF CULTURE AND PROPOSED FRAMEWORK

A major improvement in the culture of banks is now a matter of economic necessity and sustainability, and is an imperative for regaining society's trust. We propose a comprehensive framework of decisive actions by bank boards and management, so that the values and desired conduct banks now espouse are consistently and reliably reflected in their behaviors.

Culture is defined as “the ideas, customs, and social behavior of a particular people or society.” Culture is the glue that binds individuals to an institution; it creates a consistent framework for behaviors and business practices. Culture is what people do when no one is watching.

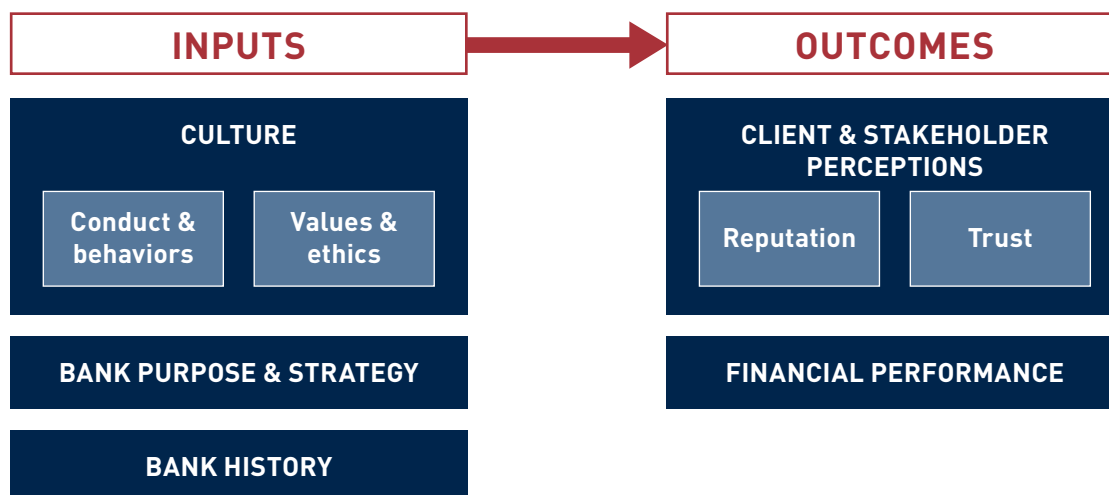
What good or bad culture means for the conduct of bank executives might seem intuitive; however, how culture affects other critical factors such as trust, reputation, values, ethics, purpose, mission, and conduct is not as straightforward as one might think. This is because the concept of culture is amorphous. We need to identify and understand how culture is transmitted—that is, what the transmission mechanisms are that help embed the desired values and behaviors in banks, both large and small.

We define culture as the mechanism that delivers the values and behaviors that shape conduct and

contribute to creating trust in banks and a positive reputation for banks among key stakeholders, both internal and external.

We use 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. This is summarized schematically in figure 1.

FIGURE 1. Elements of a unique bank culture

A bank with a weak or undesirable culture (or sub-cultures) will damage both its reputation and industry trust. There are three reasons for this.

First, culture shapes how employees feel about their jobs and the industry they work in, and affects how motivated staff are and the way they work (their efficiency, job satisfaction, retention, and so forth).

Second, culture has a major effect on public perception, and hence shapes the reputation of an individual bank and of the sector more broadly.

Third, cultures can develop that undermine the values and goals of senior management, thereby reducing the effective control a Board and its management have over the firm and its employees.

Culture is the principal determinant of the perceptions of customers and stakeholders, which include bank employees, and is the critical element that needs to be addressed in order to fix the mistrust that afflicts the industry and individual banks. The importance of fixing the internal reputation and trust is self-evident; most external perceptions are formed through interactions with bank staff.

By shaping behaviors, culture can be used to influence people throughout the bank to ensure their actions are consistent with the bank's values, requirements, and guidelines.

Lack of trust and confidence in the banking sector creates material costs to society. Fixing culture in banking is now a public trust—as well as an economic—imperative.

Without a culture that insists on high standards of values and conduct, it is difficult to generate and sustain trust and reputation, which are the bedrock of a safe and effective financial system.

Trust is the bedrock of an effective financial system; it is built through the summation of individual bank reputations. Most successful financial innovation through history has relied on methods or institutions to encourage trust among market participants.

Cavalier culture and the ensuing abuse of trust were important causes of many of the major financial crises in the last two centuries. British journalist Walter Bagehot described it succinctly by identifying the cause as the public's "blind capital"—capital invested by investors mistakenly trusting promises from unscrupulous financial institutions and intermediaries of high-return investments—flooding into speculative investments.

Poor cultural foundations were a significant driver of the 2008–2009 financial crisis (in common with many past crises). Behaviors that do not meet banks' desired values and conduct continue to be a problem.

Over the last two decades, there has been an erosion of the trust in banks and in their perceived trustworthiness by their clients. Customers for whom caveat emptor was inappropriate were increasingly treated as counterparties to whom the bank owed no loyalty or duty. Asymmetry of information between banks and their customers was exploited. There was widespread slippage in standards of customer and client service in a number of jurisdictions of which boards, senior managements, and regulators were in many cases largely unaware.

Work by the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), and the Group of Thirty (G30) has highlighted how poor cultural underpinnings weakened the resilience of the financial system in the lead-up to the 2008 crisis. Since the 2008–2009 crisis, ethical and cultural lapses have continued to be exposed. There are three broad categories of cultural failings:

- **A culture of individualism and short-termism.²**

As in many other industries, banking is a talent-based industry with deep technical expertise. Certain financial institution customers tend to be less financially literate, and therefore there is scope for client mistreatment due to product opacity and advantages gained through relative financial knowledge. As banking transitioned from acting primarily on behalf of the client as an agent, to also acting as a principal—that is, on its own behalf—and banks became counterparties for the vast majority of financial transactions, the scope to benefit from this asymmetry in knowledge and information grew. Remuneration models further compounded the problem by encouraging individualism and short-termism.

This culture was a key driver of many of the unsound and inappropriate values, behaviors, and practices observed, and of the imprudent and excessive risk that was seen. This has led to significant conduct fines and other legal and enforcement actions, which have affected the banking sector over

the last few years. In this environment, management has struggled to keep in check increasingly complex and large firms, with employees across the globe, who were sometimes pursuing their own short-term individual goals, at odds with those of the firm.

- **A weak risk culture.** Analysis of risk models prevalent before 2008 highlighted the danger of overreliance on quantitative techniques that were vulnerable to methodological and data flaws. These risk models were not failsafe tools, particularly in an environment in which the search for regulatory arbitrage exists. Moreover, regulators focused their attention on the mechanistic elements of risk management, as opposed to the interpretative/management intervention parts. These two factors led to a weak risk culture, with management underinvesting in the checks and balances required to deal with the inherent uncertainty of risk models. With ineffective checks and balances, and compensation models that did not reflect the underlying risks taken, risk takers were able to increase leverage and trading activities to systemically unsustainable levels.

- **A weak culture of oversight among Board members.** As stated in two previous G30 reports,³ complex financial institutions require sound governance that hinges on Boards, in their positions as designated fiduciaries and overseers of the institution, being suitably equipped to oversee and challenge the choices made by management. In the lead-up to the 2008–2009 financial crisis, Boards in certain banks allowed their management to take decisions and actions that ultimately led to poor outcomes for the firms' employees, customers, shareholders, and the wider economy. Boards had neither sufficient expertise nor the ability to effectively challenge management strategies. And Board decisions suffered from self-reinforcing groupthink and herd behavior.

The G30's reports identified a number of further Board weaknesses, including a common

² Short-termism as used here refers to an excessive focus on short-term results at the expense of long-term interests of the firm.

³ *Toward Effective Governance of Financial Institutions* (2012), and *A New Paradigm: Financial Institution Boards and Supervisors* (October 2013).

underestimation of the time commitment required in serving on a board; a lack of risk and/or financial institution experience; a lack of understanding among the Board of the firm's strategic position and of the competitive and regulatory landscape; the inefficiency and unsuitability of joint chair/CEO roles; and Boards that did not engage frequently enough with their relevant supervisors.

In addition, many boards were not sufficiently focused on the importance of the firm's culture, and of its application or failure of application or embedding within different parts of the firm. Boards did not, in general, fully understand the importance of values and behaviors as the keystone in the governance process. Here, too, again, checks and balances did not exist or were inadequate and exploited by management and senior staff.

In addition to these cultural failings within the banks, some supervisors failed to keep up with market developments and were not in a position to assess the extent of risk management or risk governance weaknesses in the banks they supervised and to act in a timely way to have banks strengthen them.

The magnitude of conduct fines, litigation, and related costs is now causing bank valuations to slip, as well as uncertainty and discounting. The current punitive tilt of the judiciary and regulatory authorities and the relentless political pressure are unlikely to diminish unless there are demonstrable improvements in conduct and culture.

Repairing reputation and trust need not be financially costly; and even if there are short-term costs, the long-term benefits are real, since they underpin the sustainability of the firm. A bank needs a minimum level of trust and reputation in order to generate economic returns. A bank with exceptional trust and reputation may generate poor returns in the short run, due to various factors including those required to achieve best-in-class external perceptions, but this enhanced trust and reputation should deliver returns over the longer run, and are in any case necessary for the sustainability of the firm.

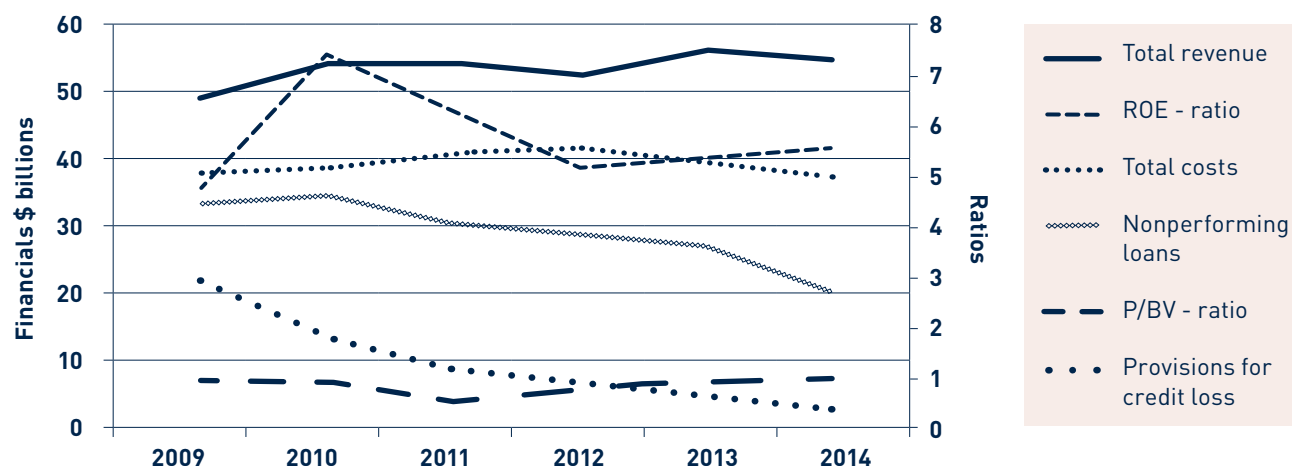
Establishing causality between culture and firm performance is difficult, but there appears to be some correlation. Aspects of culture are related to

organizational efficiency. Cameron and Freeman (1991) found the effectiveness of an organization to be related not to cultural "strength," but to cultural "type." More recently, Shahzad et al. (2012) found organizational effectiveness to be related to the alignment of individual cultures with that of the management and firm. Denison and Mishra (1995) found culture to be correlated to employee satisfaction and overall firm performance, but not to sales growth and profits. In summary, although the exact nature of the relationship is still being debated, making positive changes to a firm's culture will, we believe, have a net positive effect on the performance of the business.

What is clear for the banking sector is that the bad outcomes implied by poor culture are a matter of medium-term economic sustainability due to the sheer magnitude of financial and economic costs borne by the sector. Conduct fines and litigation-related losses have become a material source of losses for major banks.

At the time this report was drafted, cumulative fines for the largest global banks exceeded US\$300 billion since the financial crisis (McLannahan 2015). The extent to which these losses are becoming a prudential issue is illustrated by the US Federal Reserve's 2014 Comprehensive Capital Analysis and Review exercise (US Federal Reserve 2015), which revealed that operational risk losses for 25 US banks amounted to about US\$150 billion over nine quarters, the majority of which related to litigation losses and were comparable to the credit losses incurred by the banks. In part driven by these losses, bank returns are well below expected return-on-equity hurdles, and average valuations are well below historical standards. Conduct fine and litigation costs are likely to continue rising. The unpredictability of those costs, and other regulatory capital requirements, are key drivers of the uncertainty in current bank share values.

Major banks are struggling to achieve acceptable returns to shareholders. Figure 2 shows key performance metrics for the "average" bank in a sample of major global banks from 2009 to 2014. Return on equity has been in the 5 to 7 percent range, below cost of capital for most firms, despite credit losses improving significantly over the time period. Key drivers of this weak performance have been conduct-related

FIGURE 2. “Average bank” performance, 2009–2014

SOURCE: Company annual reports, Oliver Wyman analysis.

NOTE: ROE = return on equity; P/BV = price-to-book value

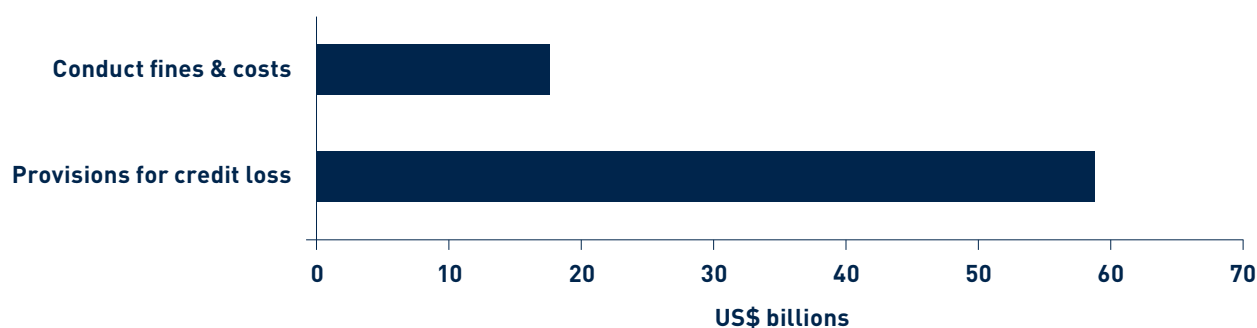
fines, and client litigation and redress, which on average have amounted to about 7.5 percent of the operating cost base of the banks.

Figure 2 shows, over this period, credit loss provisions have decreased by an average of 34 percent year-on-year, and the nonperforming loans held on balance sheets have decreased by about 10 percent per year since 2010. Over the same period (see figure 3), conduct-related costs have been steadily increasing year-on-year; conduct fines and redress averaged 30 percent of the total amount provisioned for credit losses by the banks, but the number has been higher in the last two years. With reference to figure 3, this partially explains

why the ROE of banks does not improve substantially despite decreasing credit provisions.

Not surprisingly, bank valuations have suffered. The price-to-book ratio for the average bank is just below 1, and analysis reveals that uncertainty over conduct costs is one of the major barriers to a fundamental reevaluation of the banking sector.

The severity of the conduct problems and issues has motivated policymakers to focus intently on prudential and conduct standards. National- and state-level prosecuting authorities have also aggressively targeted individual banking leaders in some jurisdictions, while in other jurisdictions significant institutional fines have been levied.

FIGURE 3. “Average bank” conduct and credit costs, 2009–Q4 2014

SOURCES: Company annual reports; regulatory statements; global press; Oliver Wyman analysis.

Banks also face a highly exercised media that is focusing on the social impact, value, and accountability of banking and business, which both reflects and influences the views of the voting public and consumers.

Banks need to fix their culture to fix the doom loop⁴ with policymakers and society, and to reestablish a firm financial footing based on a restored reputation grounded upon trust and sustainable cultures.

Banking is at a low point in terms of customer trust and reputation. Rebalancing the focus from delivering for shareholders to also taking into account broader stakeholder and public accountability will be critical to reestablishing trust, both externally and with employees. The management challenge of embedding values and desired conduct cannot be overestimated, but it needs urgent action, from the banks and their leaderships, as an ongoing task.

The reputation of banking and the broader financial sector has deteriorated since the financial crisis, and is now at a historical low in terms of trust on the part of clients and consumers. In fact, consumer surveys

reveal banks are the least trusted service provider. For example, the Edelman Trust Barometer⁵ asks participants to indicate, on a scale of 1 to 9, “How much do you trust businesses in each of the following industries to do what is right?” According to the Barometer, consumer trust fell dramatically across industries in the wake of the financial crisis. But the banking sector saw the biggest decline in public trust, which plummeted 21 percent from 2006 to 2008 and which lost its second-place position behind the technology sector. As levels of trust began to increase in 2009, financial services lagged all other major industries. And while overall trust levels have regained their precrisis levels, the financial services sector is still about 30 percent below its precrisis level.

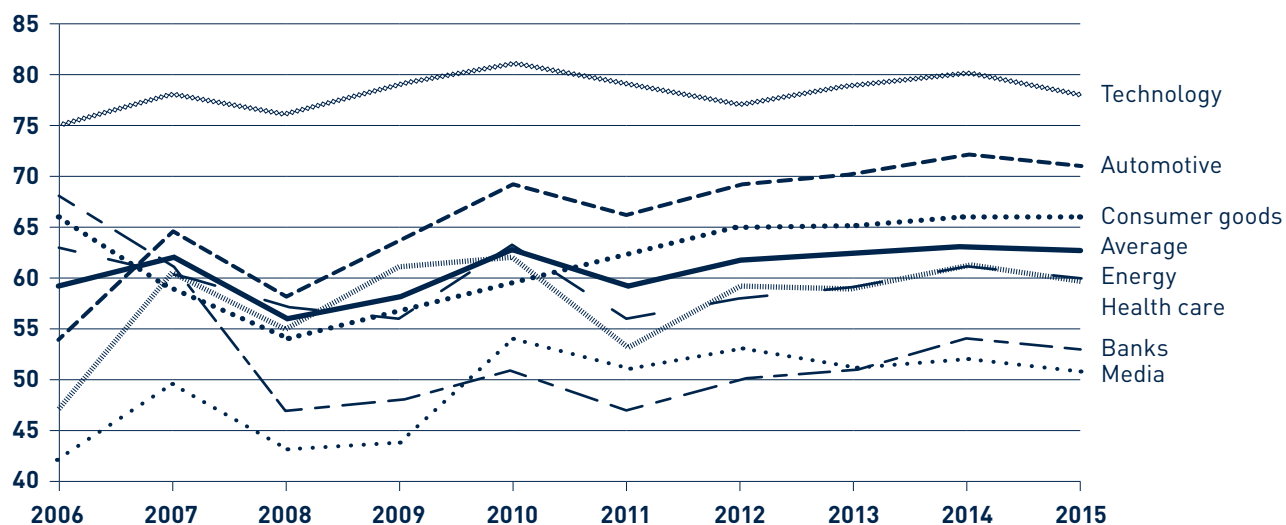
Despite the severity of ongoing conduct issues in banking, the reputation of the sector saw some improvement in 2013, although trust declined again in 2014. Trust in banking remains extremely low, at only marginally above the weak reputations of journalists and the media, which are dead last (figure 4).

4 A doom loop is “A virtuous circle in which banks take ever-greater risks to boost returns (secure in the knowledge the state will underwrite them), and governments are forced to break their promises ‘never again’ to bankroll losses (further encouraging banks to take dangerous risks)” (http://schott.blogs.nytimes.com/2009/11/12/doom-loop/?_r=0).

5 The Edelman Trust Barometer is published annually by Edelman, a global public relations company.

FIGURE 4. Comparative trust of selected sectors

Percentage of interviewees trusting businesses in different industries



SOURCE: Edelman Trust Barometer Archive; www.edelman.com.

Other surveys concur. Lippincott,⁶ for example, in its annual brand study, which covers thousands of UK and US brands over all the major industries, found financial services brands to be consistently among the worst performing, specifically in measures such as “being trustworthy,” “caring about customers,” and “meeting expectations.”

When asked whether consumers considered the brand to “share my values,” in the United States, financial services brands were over 20 percentage points behind the overall average. In the UK, the gap was even greater at 30 percentage points behind the brand overall average, and 20 percentage points behind the next-worst-performing sector, the restaurant sector. In summary, trust in banking and banks is at a low ebb across many major markets and among the public at large.

Previous work by key policymakers and the G30—primarily on risk culture—stresses that the optimal culture is bank-specific, is set by the “tone at the top,” and is best enhanced through principles-based mechanisms and robust internal enforcement of existing codes of conduct. Banks need to ensure they have the values and behaviors in place to support a robust risk culture.

Culture has received more attention from policymakers since the crisis, because they realize a strong and effective (positive) culture is critical for a successful and resilient banking franchise. Much work has concentrated on risk culture and organizational changes, in support of new prudential and capital standards and rules that have been introduced since the 2008–2009 crisis. Work by the Basel Committee on Banking Supervision (BCBS), the Financial Stability Board (FSB), and the G30 (summarized in Appendix 1) also touches on cultural aspects and leads to two conclusions:

1. CULTURE IS UNIQUE TO EACH INSTITUTION.

There is no one “best practice,” and therefore banks should seek to define what their target culture is, and what good and bad culture is uniquely for their institution.

2. CULTURE CANNOT BE REGULATED. Supervisors can encourage processes and analyses to ensure that bank leadership is accountable for having the appropriate culture in place, but ultimately it should not be the regulator’s objective to judge an institution’s culture per se.

These conclusions remain valid. While the risk aspect of culture (as it relates to prudential matters) has seen a marked improvement, it is broader conduct, values, and behavioral matters that need significant improvement.

We propose a comprehensive framework to deliver a more effective set of actions and powerful monitoring

The challenge for management of embedding values, behaviors, and desired conduct throughout banks cannot be overestimated, but it needs urgent action primarily from the banks, addressing both the “what” and the “how.”

THE WHAT?

We have taken a broader view of culture than just the risk culture considered by policymakers. Our framework includes prudential and conduct-of-business standards set by regulators, and broader consideration of the role and profile of banks in society as a critical but missing ingredient in the definition of a bank’s target culture. There are three principal reasons for this broader focus.

First, a bank’s risk culture cannot be isolated from its overall culture; it is a fundamental cultural issue that needs to be addressed.

Second, the overall culture of a bank determines how it views its social responsibility, how clients are treated, and what ethical norms exist in a bank. It is about doing the right thing—even in the absence of rules.

Third, rules will not effectively and sustainably regulate proper behaviors. What is needed and should be encouraged is a sustained focus by industry participants on changing aspects of the culture of how the banking industry operates.

⁶ Lippincott, which is part of the Oliver Wyman Group, publishes an annual brand survey.

It is increasingly thought that banks should be “socially accountable” to the public and community at large. This call for social accountability may re-adjust the balance seen in the last two decades slightly away from shareholder returns, and require banks to include broader public factors in their economic and financial calculus.

It is no longer sufficient for banks merely to comply with regulations. Banks have a broader responsibility to society that goes beyond putting customers first and delivering value to shareholders. Porter and Kramer (2006) call this “Creating Shared Value” which, they maintain, requires firms to create economic value and sustainability.

As William C. Dudley, President and CEO, Federal Reserve Bank of New York, put it:

“Although cultural and ethical problems are not unique to the finance industry, financial firms are different from other firms in important ways....Financial firms exist, in part, to benefit the public, not simply their shareholders, employees and corporate clients. Unless the financial industry can rebuild the public trust, it cannot effectively perform its essential functions. For this reason alone, the industry must do much better.” (Dudley 2014)

Banks’ purposes should include supporting their customers, their customers’ businesses, and the economies of the communities in which they operate.

There is no universal prescription for how these broader obligations should be met. Rather, banks and other financial institutions need to make their own decisions based not just on pressure from stakeholders, but on their vision of what the firm stands for, and how it should shape its interaction with society going forward. The sole focus on short-term shareholder value is not enough.

Corporate social responsibility (CSR) is often part of a firm’s broader corporate objectives. However, these programs tend to be add-ons to a firm’s core activities, often involving significant charitable donations. CSR in this form is rarely explicitly linked to the defining purpose and core strategy of the company

or the expected values, conduct, and behaviors of employees. Relatively few firms demonstrate that social responsibility measures influence the way the core business is conducted.

This pursuit of broader social and public obligations can provide competitive advantage over time, and some niche institutions are building their differentiation around this concept. Management and their Boards will need to make explicit trade-offs consistent with the culture being sought, and with its place within the broader social context.

A bank that does not build and sustain demonstrably broader accountability is likely to be increasingly vulnerable to political and other challenges, and to an erosion of its competitive position and its ability to attract talent, both of which will ultimately work to the detriment of its shareholders.

Building a strong bank culture can be thought of as a form of risk reduction. With a weak culture comes high governance risk, but with a strong culture comes lower governance risk. It is beneficial in both the long and short term for a bank to reduce this risk.

At a time when social accountability is heightened for banks and banking, regulators across key jurisdictions have tightened conduct-of-business rules and standards and pursued past misdeeds, in part in response to market pressures and events. Because there has been no “conduct of business” equivalent of Basel III, a mix of tighter rules-based and principles-based requirements has resulted, as has a divergence in national approaches and degree of enforcement actions. Tighter rules requirements have been promulgated in areas of conduct risk (for example, anti-money laundering, Know Your Client, and the Markets in Financial Instruments Directive), which are narrowly defined and have clear behavioral and compliance requirements. Other principles-based requirements are not easily codified and transposed into compliance and behavioral requirements (for example, fair customer treatment, product suitability, customer affordability, and effective complaints resolution).

Banks have invested significantly in upgrading and improving their ability to monitor compliance with new requirements. However, addressing both types of conduct requirements through a traditional “compliance-driven” approach can lead to

inconsistent outcomes and confusing standards in businesses across jurisdictions (a challenge for global banks). In addition, the compliance-driven approach can lead to an inefficient use of resources, with staff spending time on tracking and reporting against rules, which are not guaranteed to deliver lasting good-conduct outcomes.

Robust cultural underpinnings and their implied embedded behaviors are the only practical solution to this problem. A tendency for regulators to be more

prescriptive is inevitable if better cultural outcomes are not observed in the marketplace and in banks.

Therefore, culture is and will be critical, as banks work on maintaining, defining, and enforcing a set of behaviors that can interlink with the principles-based standards that could be a better basis upon which the industry should operate (box 1).

In our framework, culture is the mechanism that delivers outcomes through values and conduct standards within firms. It is relatively simple to stipulate

BOX 1. Standards vs. Rules

In the debate about standards vs. rules, it is important to start by considering the areas in which standards are more likely to deliver improved outcomes, and subsequently to introduce a plan for their development and implementation. Standards may be market based with significant industry input, can have statutory backing, and can complement statutory requirements.

Most governments recognize there is a place for market-based solutions and standards. In some jurisdictions, this is a reliance on conformity with, or enforcement of, governance codes that are framed as market best practice (but which can be enforced through listing and conduct rules, which have the effect of law).

Standard setting can take place at the international level, such as the Financial Stability Board's principles for sound compensation practices. In this case, the standards or principles route was chosen because international rules were not a viable option, administratively or politically. In others areas, such as resolution regimes, FSB standard setting is also chosen as the main approach used in a sphere where international rules are not possible.

Rules also have a place in regulation and in directing specific behaviors or prohibiting others. Rules are needed in areas where requirements are clear, actions binary, and sanctions easy to apply, and they are required in areas of sales practice, such as the full disclosure of costs and commissions, and in areas of market integrity.

But, equally, rules impose a cost. In areas where there are ambiguities and definitional gaps, such gaps can be exploited and the rules' intention and desired effect circumvented, since individuals may redefine activities or engage in regulatory arbitrage so as to avoid the impact of the rules.

Reliance by public authorities on rules in areas where rules do not easily work can result in failure to deliver desired outcomes. And rules can have undesirable unintended outcomes, since one rule may permit the use of a mechanism (such as special purpose vehicles), designed to allow the circumvention of another set of rules (on capital). In this sense, poorly designed rules can be ineffective or counterproductive.

what a culture should prohibit, such as activities that could lead to reputational risks or improper or illegal activity, financial misreporting, money laundering, fraud, anticompetitive practices, bribery and corruption, and the violation of consumer rights. The much more difficult and significant challenge is to define the values and conduct standards that a firm considers core to its target culture, broader purpose, and business model.

Consistent with the strong conclusions of previous G30 work and this study, each firm's leadership and employees must craft and sustain the desired values and norms of conduct that collectively constitute a firm's culture, and determine its position and role more broadly in society. (Indexes such as the Prosperity Index, the Better Life Index, and the Happy Planet Index list desired behaviors and outcomes for industrial and financial corporations to society beyond the profit motive. These indexes' key outcomes and behaviors, and regulators' desired outcomes and behaviors, are summarized in Appendix 2.)

Entities can of course choose not to pursue any social outcomes and build a culture consistent solely with the profit/shareholder objective that has dominated to date. More commonly, however, banks and their leaders are trying to identify a series of broader intended outcomes and desired behaviors

and to internalize them within the firm and among the employees, and to communicate them to their customers and to the wider public. Most firms have begun this process, some have just started, and others are further along. But it is a long process, and this report seeks to identify mechanisms and practices that can assist banks and banking in achieving the goal of sustaining the desired values, behaviors, and conduct that constitutes the culture that each firm seeks to promote.

THE HOW?

As a bank or financial institution defines its target values, culture, and desired norms of conduct, its leadership must own them, live them, and set the tone from the top and work consistently to ensure an echo from the bottom and their adoption by employees across the firm and its businesses. This ongoing process of cultural evolution in the firm should be systematically tracked to ensure it is continuous and self-reinforcing, as recommended by the BCBS, FSB, and G30 (see Appendix 1).

We propose four pillars for achieving the desired results: senior accountability and governance, performance management and incentives, staff development and promotion, and an effective three lines of defense, the details of which are presented in Chapter 2.

ASSESSMENT OF BANK AND SUPERVISOR PROGRESS

Many banks are failing in implementation and monitoring, and conduct-of-business supervisory agencies have to improve their roles in most jurisdictions.

Broadly speaking, the “what to aspire to” is in place. Most banks have made bold assertions about their expectations in terms of individual cultures and values, and have refreshed or strengthened their codes of conduct.

A statement of values, whether articulated on a company’s website, distributed internally, or found in their code of conduct, should state how the institution intends to conduct itself and what responsibilities it has toward clients, employees, and the broader stakeholders. Most major banks stipulate a set of values as a communication tool directed at employees, potential hires, customers, and shareholders alike. They provide an opportunity to make comparisons across institutions, and while there is considerable variation in their content and audience, they all provide one thing: an insight into an institution’s intended culture.

The use of values as a mechanism to communicate purpose is an established concept, and their prevalence and prominence have dramatically increased in the wake of the financial crisis. We analyzed 46 major banks across various countries and found that a majority (thirty-nine) explicitly stated a set of values, the vast majority of which convey some element of

trust or respect. The institutions that do not explicitly state values do, however, allude to values or principles in their code of conduct. This is indicative, however, that these institutions tend to operate with a more performance-orientated mentality.

Of the values observed, seven key themes were identified as the most prominent: trust and integrity, respect and teamwork, excellence, customer service, financial performance, accountability, and leadership. Over 70 percent of values across institutions aligned with one of these themes, with institutions on average stating four values. The intent was to create a strong and effective culture.

The number of values stated is an important factor in effective implementation; too many values can detract from the effectiveness and clarity of the message, while too few may not have the breadth to address the key responsibilities of a bank. The most common combination of themes in the sample was some variation of trust, respect, excellence, and customer service. The most frequent themes were trust and integrity, presumably to convey value messages of dependability and ethical motivation. Only half the banks included customer-centricity in their value set.

Accountability featured in less than one-fifth of the value sets. Yet without a comprehensive and effective accountability system, there may be a lack of application of the values to day-to-day activities of institutions, and employees cannot be expected to feel responsible for their actions or to understand the role they play in the bank and the need to behave in a responsible and ethical manner. Therefore, accountability is a pivotal feature of the proposed framework.

Values also determine whether an institution is inward or outward facing. Values such as “respecting each other” and “teamwork” are focused internally and act as a guide to employees, whereas statements

such as “deliver for our shareholders” and “ensure excellent service” address an external audience. The majority of the values of banks and financial institutions have some outward-facing implications. When these values are not tied to accountability, however, it indicates the values are being used more to communicate an entity’s purpose and less as guidelines for employee conduct.

Figure 5 presents a word cloud of the words and broad range of themes in the values sets of the thirty-nine banks and financial institutions we studied, with text size proportional to frequency of occurrence.

FIGURE 5. Word cloud of words and themes found in the value sets of the thirty-nine banks examined



SOURCE: Bank websites.

Banks are increasingly keen to demonstrate social accountability. Corporate social responsibility (CSR) is often the main mechanism used to satisfy community and stakeholder demands beyond those of customers, employees, and shareholders. CSR objectives describe the philanthropic, environmental, and social engagement initiatives, but banks almost always position such objectives as add-ons to the core business, and more rarely explicitly link them to their defining purpose and core strategy.

Banks are, to varying degrees, still failing to implement desired ethics, values, and behaviors, and weaknesses in embedding values and codes of conduct for all staff are widespread.

Numerous conduct-related issues have cost the banking sector hundreds of billions of dollars. The range and severity of cultural failures has been astonishing, and these failures have affected all financial services businesses. Cases have centered on market rigging in traded markets, selling of structured and bundled products to unsophisticated wholesale and retail clients, and high-profile anti-money laundering violations. The egregious behaviors that investigations have uncovered, and the size of the fines (sometimes in the tens of billions of dollars), have been shocking.

There has, however, been less visible but persistent supervisory action in cases where there has been demonstrably poor behavior, which has manifested itself through weak adherence to internal codes of conduct or specific conduct-of-business requirements specified by regulators. These cases have included failures to properly test client suitability for a specific product; poor or opaque product documentation; improper sales tactics; and poor post-sales processes centered on fair customer treatment, and breaches of client asset protection. The high-profile cases and other cultural breakdowns demonstrate a failure by banks to consistently promulgate and reinforce desired values and the desired culture within their organizations and staff.

Even firms not directly affected by scandals and that have a history of adhering to codes of conduct and values identify persistent challenges. These include:

- Disappointment with the pace of change, because it takes many years to fully embed a culture within the firm as a whole. Two business sectors—caveat emptor businesses (trading, private banking, asset management) and international subsidiaries—with different cultural underpinnings, are seen as particularly challenging.
- Persistent difficulties on the part of staff in understanding what behaviors are expected of them, and lack of clear guidance, feedback, and leadership from their immediate superiors. This can result in limited staff trust in the employer and a cynical attitude toward values and conduct initiatives.
- The limitations of top-down implementation; hence the need for employees, from bottom to top, to effectively “spread the change” throughout the organization.
- The continued prevalence of “willful blindness,” or a willingness of superiors and peers to ignore bad practices that should have been—or (even worse) were—visible to colleagues. The failure of employees, senior and junior, to raise flags or escalate when they see bad behaviors is symptomatic of not living the values and conduct standards.

The overarching approach to the implementation of culture and values matters. Banks with the mindset that this problem is core to our business model and fixing it is key to the economic sustainability of the institution achieve better progress than those with the mindset of a defensive focus on values and conduct so as to minimize future redress, fines, and additional enforcement actions.

Banks that have stated values and codes of conduct aim to deeply embed and widely implement them. These values and desired conducts are key components of the “tone-from-the-top,” and indicators of what senior members of the bank consider to be the essence of the bank’s behavior and purpose. There are two different approaches pursued in implementation. The first positions the challenge as core to the economic

viability of the institution, rather than a regulatory issue. The second views the challenge as defensive, with the aim of minimizing future client redress, regulatory fines, and costs of compliance. This study finds that no more than a third are in the former category.

We find that there is greater internal impact and relative satisfaction within the banks that have taken the first approach, which generates positive internal affects, including strong first-line engagement and ownership over internal enforcement and personnel decisions, stronger senior management focus and visibility (particularly by the CEO), a general willingness to impose robust internal penalties and sanctions

more swiftly ahead of possible supervisory action, a more broad-based staff engagement (that is, an “echo from the bottom”), and a recognition that different businesses may need subtly different messages and methods of applying the desired values and conduct.

In addition, some banks are building client satisfaction into compensation decisions and internal signaling of desired behaviors and conduct. A number of firms have also concluded that business models with integrated views of the client are more likely to promote the desired conduct than firms that operate using product silos or separation of product lines. Case Study 1 highlights the evidence from one such bank.

CASE STUDY 1

The CEO of the bank in this case study emphasized the need to appreciate that culture, purpose, values, and behaviors are all intertwined. Acknowledging that there is a clear need for a fundamental definition of “culture” in the context of the financial industry, the bank concentrates on tangible actions and evidence that it conducts itself in a responsible way.

The measures used range from turning business away because the client or product does not fit the firm’s culture, to banning traders from participating in chat rooms. In addition, the bank uses a reputation risk framework to highlight potential values and conduct issues, with monitoring of press activity, campus reputation, employee surveys, number of fines, internal conduct breaches, and other specific behavioral indicators.

The bank’s CEO leads by example both in terms of transparent performance appraisal of the management team and in internal sanctioning of senior staff for relatively minor behavioral incidents that involve external and internal stakeholders. This leading by example is intended to make staff aware of broader reputational risks that even minor behavioral incidents can cause, even if they do not strictly break the law or breach the bank’s internal code of conduct, but are considered errors of judgment, particularly by senior officers of the bank.

The second defensive approach appears less effective, perhaps in part because of the narrower interpretation of the centrality of culture to the firm and its sustainability. This defensive approach can potentially be a signal of less buy-in from top management of culture as a core strategic priority that should be fully integrated across the bank. As a result, the

tone from the top may not effectively reach all staff. This can result in uncertainty over practical expectations for values, behaviors, and conduct. Banks that take a defensive approach can potentially face escalating compliance costs and a slower embedding of desired values and conduct, and face possible further failures leading to fines or supervisory action.

Irrespective of the overarching implementation approach, we have identified a number of persistent implementation pitfalls relative to the comprehensive framework set out in this report. These implementation pitfalls can broadly be categorized into four areas: 1. senior accountability and governance, 2. performance management and incentives, 3. staff development and promotion, and 4. an effective three lines of defense.

1. SENIOR ACCOUNTABILITY AND GOVERNANCE

Senior accountability and governance requires a clearly articulated and communicated strategy, vision, and purpose, with an explicit link to target culture and implied standards across risk, social outcomes, and conduct and behaviors. Implementation should be driven by the CEO and Executive team, with the Board providing overall direction, oversight, and challenge, when required. The study has found four implementation failures:

- a. **A lack of sufficient focus and pragmatic engagement from Boards.** Most Boards struggle in addressing culture. Difficulty defining the underlying concepts, a lack of clear metrics, diffuse responsibilities across the Executive team, a lack of sufficient time to consider cultural issues properly, and lack of visibility on key cultural issues are cited as challenges to improving the Board's oversight and engagement on conduct and values. Oversight responsibility for culture can also fall between the Risk and Human Resources committees of the Board, or between the Conduct and Values and Human Resources committees. Boards do recognize, however, that because of past and recent cultural failures, and the relatively immature bank processes that have been set up to address the issue, culture does require an increased sustained focus.
- b. **Relatively small downward adjustments to CEO and Executive team compensation despite persistent conduct and values problems or failures in the firms.** The compensation revisions (10 to 20 percent) some banks have levied on the Executive team despite highly visible cultural failures and damage to the firms' reputations send an unhelpful, mixed message to observers

inside and outside that financial performance is all important and that conduct and values are of secondary importance. This is unfortunate and counterproductive. If investor-driven constraints seek to impose "formulaic" senior management compensation narrowly based on financial performance, further muddying the message on culture, this should be resisted.

- c. **The "blocking middle."** Despite a good tone from the top, the vast majority of middle management often revert to traditional performance criteria (such as revenues, profits, return on equity). This undermines the importance of conduct and values in the eyes of most employees, and reinforces the message that traditional performance is clearly the most important metric. Most banks use a version of a balanced scorecard approach to determine individual performance, and this requires the inclusion of nonfinancial performance criteria. But the effect of a scorecard approach can be diminished if a bank is underperforming relative to financial expectations during the year, if pressure for bottom-line performance is reasserted.
- d. **A lack of uniform progress in improving culture and values across the firm due to entrenched behaviors and a lack of buy-in on conduct and values initiatives.** Business areas where resistance to cultural change can be seen include international subsidiaries, wholesale asset management, and private banking. Generally, it is difficult for large, complex groups to roll out conduct and values initiatives across diverse businesses and countries with different cultural attitudes. Without management support and visibility in a roll-out process, it can be difficult to maintain momentum across a complex group. In addition, the formulation of the desired values through a top-down process, presented in a single language, can be met with significant resistance and lack of buy-in across a large firm, in part because nonnative speakers do not understand the precise meaning of the words. Case Studies 2 and 3 discuss how two banks overcame these challenges.

CASE STUDY 2

The bank CEO stresses that the bank has been able to achieve what they consider to be a lasting change in culture and behaviors, relying heavily on a consistent and relentless tone from the top.

Their success is largely attributed to the degree of ownership of the values achieved by each employee through a rigorous and structured process.

First, the values were defined collaboratively, involving a large number of employees in local workshops. This ensured that the bank naturally identified with the formulated values set as much as possible.

Second, the language of the values was considered key. For a company operating across multiple geographies, the meaning of the values should be as transferable as possible. This process allowed a significant amount of adaptation to local languages to ensure that nuance was not lost in the use of a single language and that employees could interpret the values more fully. Cultural differences matter.

The CEO of another bank identified the need for a careful choice of language around the issues of raising red flags or escalating a concern related to problematic conduct or behaviors. What is an acceptable approach in one culture and geography may not work well in another. In this bank, the firm settled on discussing approaches to “self-disclosure” as the best phraseology.

Behavioral examples were described for each value. This allowed employees to more easily identify with the values and measure themselves, and their own actions and behaviors, against the appropriate conduct seen in the examples. To further drive the learning process home and embed the lessons, the intended values were enshrined in all policy and business processes and communications. Thus, the CEO ensures that every message issued from the top of the organization, including communication on behaviors, executive speeches, conferences and events, and strategic action or direction taken, is not just aligned with, but actively reinforces, the desired tone, values, and intended direction of the bank.

Recognizing the first tier of management as critical in facilitating the inculcation of values into the firm, the bank holds dedicated “cultural off sites” for the senior management teams twice a year to allow time for discussion, with an emphasis on cultural issues.

Finally, the bank does not present the organization’s work on culture as corporate social responsibility, but rather as a broader program closely aligned with its core strategy. The bank includes concrete targets within its behavioral program, ensuring it is taken seriously by investors and referenced in financial communications (quarterly performance reviews, annual reports, and so forth).

CASE STUDY 3

Shareholders of this bank had insisted on a formulaic compensation formula for the Executive team. The formula was primarily driven by performance above a certain rate of return for capital, and some qualitative adjustments based on progress relative to strategic objectives.

The Board challenged this approach, saying that the bank had many ongoing conduct issues, and that the Executive team should be highly incentivized to address these and other prior cultural failures. There was considerable resistance from investors to this approach.

In the end, however, the Board succeeded in agreeing a method that adjusted the compensation of the Executive team 50 percent based on financial performance and 50 percent based on assessments of tangible improvements in the culture of the bank (defined in terms of desired conduct and values).

2. PERFORMANCE MANAGEMENT AND INCENTIVES

Embedding desired values and culture requires a performance management and incentives framework that takes conduct and values into account in a meaningful way. Each employee should have objectives consistent with the broader purpose and set of behaviors, so that assessment of their performance relative to expectations, either positive or negative, can be attributed to outcomes. The study identified four types of implementation failure:

a. **Definitive cultural indexes and performance metrics have proved elusive.**

Banks are searching for metrics to assist in monitoring and understanding cultural progress over time, and while a broad range of metrics has been adopted, most banks are still experimenting and have neither found a definitive set of indicators nor concluded what those metrics should be. However, there are qualities and values like integrity, honesty, trustworthiness, and accountability that should be the very sine qua non of banking—elements that many banks already include in their codes of conduct and should be part of any and all of those cultures, irrespective of whether there is a **definitive** culture index or single metric of cultural measurement.

b. **The extent to which conduct and values are integrated into employee performance appraisals is mixed.**

This signals that even when banks are still experiencing significant conduct failings, senior management will still receive only limited compensation adjustments. But in addition, there are widespread difficulties in gathering data on individual staff members, and on their adherence to conduct and values as part of a firm's "balanced scorecard" appraisal system. And as previously noted, there is a lack of emphasis by middle management on conduct and values (compared to traditional performance measures). Thus, outcomes of year-end appraisals, which should include cultural and values components and that affect pay and bonuses, are inconsistent.

Bankers' pay and remuneration is understandably a focus of public interest and controversy, and firms need to set clear expectations around values and conduct. Otherwise, ad-hoc compensation adjustments (either positive or negative) lose both the required signaling value to staff, and the opportunity to use the annual appraisal process to reinforce conduct and values expectations.

- c. **There is an emphasis on negative rather than positive reinforcement, and a lack of celebration of those who live the firms' values in difficult circumstances.** There is a bias toward applying penalties in response to individual values, ethics, or cultural mistakes. This is understandable given the breadth and severity of cultural failures. However, the risk of this bias is that employees may interpret behaviors and values as having only negative consequences. Fewer incentives are provided for behaviors that are positive and beyond the minimum expected that should be the threshold set by the internal code of conduct. As a result, an opportunity to celebrate and reward positive situations or behaviors may be missed.

In addition, focusing on bad behaviors rather than also highlighting those who live the desired values might make it less likely that difficult issues will be escalated, which is essential to banks embedding desired conduct on a sustained basis, because employees may be afraid of

the consequences. Banks should celebrate individuals who escalate potential issues, and should go out of their way to support colleagues who clearly put the firm before self, who performed outstanding client or community work, and who show internal leadership of diversity and inclusion initiatives.

- d. **There is limited voluntary flagging and escalation of conduct and values issues.** There have been many instances of “willful blindness,” in which employees remained silent when they were observing, participating in tangentially, or overseeing dubious behaviors and practices. The extent of willful blindness that has been observed in certain investigations highlights a lack of conformity with values banks espouse, of which accountability, integrity, and teamwork are the most obvious.

Case Studies 4 and 5 present examples of firms that successfully tackled aspects of performance management and incentives.

CASE STUDY 4

In this bank, there is recognition of the importance of a comprehensive review process to assess staff behavior and culture. Values and behavioral alignment are reviewed concurrently with performance, giving both equal standing in the review process and reflecting the close link between them.

The bank ensures that all management staff are reviewed using a 360-degree assessment that examines the extent to which the employee behaves in line with the expected values, and seeks to understand how the firm can best assist the individual in improving his or her alignment with expected values and behaviors.

This firm believes the assessments should be led by those working closely with an individual. This ensures that the most informed judgment of behaviors is noted and reflected in a “local” review process for the majority of the employee base. At the top of the organization, there is a process to ensure strong Board commitment to the review of the senior management team against values compliance and behavioral considerations. To

achieve that, first-line management members (comprising roughly 45 people) are discussed individually by the Board every two years.

These discussions consider the overall performance of the individual, and ensure emphasis on the how, not just the what, of an individual's performance and achievements. There is input from Human Resources, including information they have collected from broader feedback and cultural metrics. If the Board feels that the individual being assessed is deviating from the values of the bank, they will take action against him or her.

The second line of management (comprising roughly 550 people) is discussed in a similar fashion by panels of first-line management, with at least one member of the Board present. This commitment from the Board plays a critical part in demonstrating to the organization the importance the Board places on cultural and behavioral issues.

Beyond the first and second management lines, behavior is discussed as part of the overall performance assessment on a yearly basis, and feeds into salary adjustments and bonus calculations. Unsatisfactory "behavioral performance" against bank values is discussed with the individual in question.

The penalty for nonalignment varies among values. Nonalignment with excellence and performance criteria affects the bonus awarded, lack of adherence to trust-and-integrity-themed values will cast more serious questions over the individual's future at the bank. The bank commented that not meeting the respect/teamwork/leadership value themes tends to have a more nuanced effect on an individual's career progression, often causing them to leave the firm.

The bank recognizes the importance of ongoing measurement, and continues to work on metrics and management tools as it seeks to develop an "alert mechanism" that can warn when an individual is straying from the values and behaviors defined, and identify the areas in the bank where its values and code of conduct are not effectively implemented.

CASE STUDY 5

At this bank, the entire Executive Committee (and their reports) are reviewed using an in-depth review process that focuses 50 percent on objective measures of performance, and 50 percent on their cultural and behavioral alignment, ethical performance, and visible effort to embed the company's values across their areas of direct responsibility. For example, how has the individual engaged in the company's interests? How well are they doing in leading people?

This review process results in a detailed, individual assessment of performance and behavior, with actionable feedback for the individual under review. The emphasis on an in-depth review process is maintained throughout the rest of the senior management team. For the top approximately 100 executives in the bank, the review process is conducted over the course of a two-day retreat with the entire Executive team and Board members, in which each member of the Executive Committee is given a portfolio of people to review, for behavioral and performance factors (again demonstrating simultaneous review of both areas, resulting in a holistic process). Those conducting the review fall outside of the individual's direct line of management to maintain independence of review.

The reviewees are ranked, with the highest and lowest performers flagged, and given precise guidance on areas of improvement across all aspects of performance (including values and ethics). Typically, under this process, about 5 percent of those reviewed are identified as underperformers. Usually (but not always) the majority of these individuals end up leaving the bank, either voluntarily or through structured exit discussions with their managers.

3. STAFF DEVELOPMENT AND PROMOTION

Staff development and promotion must include adherence to values and conduct. This should address employees' knowledge and understanding of what is expected of them and be consistent with the values, ethics, and behaviors set by the tone from the top. The study identified four broad implementation failures:

- a. **There is an inconsistent application of values and conduct screening as part of staff development and promotion decisions, and often consideration of these factors is not even part of the process.** Some banks treat values and cultural alignment as the first part of the promotion screening process; in others, there is little if any apparent consideration of these factors. Even in banks that consider values and cultural factors as part of the promotion process, rarely does an employee's personal development or promotional opportunities increase because he or she shows significant or "above-average" alignment with the bank's culture. Instead, a pass/fail-based model is used.

In fact, often the criteria are neither identified nor published, so the decision process is

neither uniform nor transparent, but appears, rather, to be ad hoc. This is an implementation failure, since it misses the opportunity to reinforce expectations of good values and conduct in a key discussion with the employee, and it sends a conflicting message of what is considered critical in career advancement. If the tone from the top emphasizes values and conduct, but staff development and promotion does not do so systematically, then the discussions revert to traditional performance and leadership criteria.

- b. **Most banks have some form of values and conduct training, but often, it is provided as an "add-on" training module,** delivered in a one-off fashion rather than being embedded across all training and development activities. In addition, there is no assessment of whether the information in the training has been digested and internalized. This lack of follow-up, reinforcement, and continuing emphasis on values and conduct can signal to staff that they need not take the message seriously. Delivery of such training by external firms or compliance staff can be particularly problematic, since this approach reinforces the primacy of "compliance" expectations over

values and conduct training as being central to the bank's modus operandi. In contrast, banks reported that staff are more likely to internalize the lessons being discussed when they are presented by senior management, along with concrete examples or case studies that present difficult moral dilemmas that then portray the desired personal behaviors, values, and conduct.

- c. **Most banks point to a defined set of values in their recruiting literature, but fewer banks have recruitment processes that demonstrate adherence to values and “cultural fit” as important elements of the interview process.** This results in a missed opportunity for the interviewer to articulate values and conduct expectations, does not allow the interview process to self-select for people who have a closer cultural affinity with the institution, and the process does not provide an opportunity to potentially identify individuals who might fail to meet values and conduct expectations. Instead, most firms rely on the individual judgment of a relatively small pool of interviewers meeting a given candidate to judge their cultural fit with the firm or, as is often the case, with a smaller pool of interviewees with the attitudes and behavioral traits of the interviewers themselves.
- d. **When recruiting individuals from other banks, there is neither attestation that the new recruit behaved consistently with the values of the previous employer, nor any indication that the reason for separation from**

the previous employer was that the individual had failed to conform to such values. This is a serious problem, and has been an element in several recent cultural and behavioral failures in major banks. This has involved the movement of individuals among banks (in particular, of trading personnel), whose earlier record of highly problematic values, behaviors, and unacceptable actions was not known to new employers; these unacceptable behaviors continue as individuals move from firm to firm.

Banks need to find ways to balance the need to mitigate the risk of this kind of “blind” recruitment, which can have severe negative consequences, as recent experience has shown, with the legal and data privacy protections to which applicants and staff are entitled. These protections have made Human Resources functions in banks reluctant or unwilling to reveal to other banks the actual circumstances of a former employee's dismissal, especially when they involved a breach of the firm's culture and values. In principle, in the long term, this issue might be addressed through legislation or regulation, but it is unlikely that this is a viable approach in the short term, especially on a coordinated international basis. The most practicable approach, at least in the short term, would be an industry-driven initiative.

Examples of institutions that have successfully tackled aspects of staff development are presented in Case Studies 6 and 7.

CASE STUDY 6

This bank set out to tackle inconsistent training and development messages, systematically inserting values and conduct into all training and development processes. This is implemented through the application of an “employee lifecycle” model that facilitates tailored training to large groups of individuals during their employment in the bank.

This approach is a highly data-intensive process that is led by Human Resources, and is constantly being adapted based on new market developments, identified past conduct and values failures, and emerging client demands.

A key input to this process is a risk and compliance scorecard produced for each individual, allowing individuals to understand the actions they have taken that could be considered noteworthy or noncompliant.

Another key input to the process is explicit consideration of some of the commercial trade-offs that need to be made in servicing client demands. This was driven by the insight that a high degree of service tailoring to client needs was creating operational risks.

The bank considered it effective to embed specific discussions on client service trade-offs as part of core values and conduct training, including real-life client examples within the training.

CASE STUDY 7

This bank had identified the importance of not just educating staff on desired values and associated behaviors, but also the need to refine required skills across the organization to empower individuals—both management and staff, more broadly—to deal with cultural and values issues.

The firm undertook a high-profile effort to retrain its compliance staff to be better equipped to deal with the nature of breaches in values and behaviors. This involved the use of behavioral psychologists in the process, who have introduced a new way of thinking about problems, creating greater insight on how to initiate discussions, as well as actions that are likely to generate real behavioral change.

Another approach the bank adopted is a program to train business managers to encourage and effectively manage and react to conduct and values concerns raised by the first line. This was achieved with the use of stories and case studies that were tailored to a particular business, allowing role playing to test different responses to specific situations, and including a range of events and personality types of the employees in question.

The bank's training recognizes that the judgments required to identify potential cultural problems do not come naturally to most managers, and the method of dealing with culture and values needs to be tailored to the personality of the employee to achieve the best outcome for the bank and the employee.

4. THREE LINES OF DEFENSE

The framework envisions conduct and values defined by a set of standards that complement conduct-of-business regulations imposed by specific jurisdictions. These should be monitored and enforced through a classic three-lines-of-defense construct,⁷ with clear accountabilities and interdependencies among different units within the bank.

The study found four broad implementation failures:

a. Although theoretical first-line accountability for conduct and values is clear, in many institutions there is a lack of genuine first-line ownership. Often, there is complacency about this accountability, with first-line employees viewing potential cultural or values problems as problems that should be dealt with after the event primarily by compliance, rather than being identified and addressed by the business managers preventively, and based on careful judgment of developing potential problems.

Such an approach has significant costs for banks: (a) a lack of visible engagement and ownership on the part of line managers undermines the importance of good conduct and values in the day-to-day business decisions staff face; (b) a strong reliance on the compliance function places greater emphasis on the breach of rules rather than emphasizing principles that should drive judgment calls taken by staff; (c) potential issues are identified too late, perhaps when they got worse; (d) opportunities are missed for internal sanctioning led by direct line managers that could have a much more powerful signaling value to staff generally; and (e) it typically results in more rigid forms of internal sanctioning and enforcement that limits the bank's freedom.

In addition, weak reliance on the first line is more likely to lead to "willful blindness," namely, the problem of management or colleagues claiming ignorance about instances of employee bad

behavior, when knowledge of the practices was probably widespread. Many of the culture and conduct failures identified in the last few years in the wholesale markets highlight willful blindness as a widespread problem, particularly in some of the market-rigging practices.

Finally, a lack of first-line ownership can imply weak internal penalties. Employment laws are often impediments to internal sanctioning *because of perceived constraints over the need for robust documentation to support internal penalties*. This results in legal departments recommending timid or no action, since this is the lowest-cost action for the bank in the short term.

b. In contrast to the theoretical clarity on first-line accountability for cultural and behavioral issues, there is often a lack of clarity over second-line ownership. This is to some degree understandable due to the variety of inputs required to create a comprehensive judgment on values and conduct alignment of individual staff members and to identify possible breaches in a bank.

Compliance, Risk Management, Human Resources, and Legal departments have insights and data relevant to questions of values and culture, and are all involved in processes that evaluate performance. The problem with diffuse responsibilities for second-line duties is that there is a proliferation of methods and processes, which can create confusion and overlap.

One of the pitfalls of diffuse ownership is the lack of a coherent and consistent framework to address the issues, and a significant risk of errors in staff and situational judgments, as well as duplicated investment in processes and methodologies. Because there is no one function tasked with responsibility for reporting to Management and the Board, the supervisors are unlikely to find one, efficient interface as part of their supervisory engagement.

⁷ The three lines of defense include: A first line, of senior executives, frontline management and risk takers; a second line, charged with compliance monitoring and control; and a third line, normally an auditing function.

Creation of clear second-line accountability is not straightforward. Most frequently, compliance is viewed as first among equals, but there are clear issues with that choice (see below). Human Resources is sometimes cited as being in the lead, but this only works if the function has evolved into a strategic and judgment-based advisor to management. Risk Management is also cited as being in the lead, but this carries with it the possibility of greater emphasis on prudential matters rather than on conduct and behavioral issues. The Legal function is rarely in the lead, and when it is, this may be a compromise choice, when none of the other functions appeared to be in a position to step up to the role.

c. There is a significant challenge for Compliance functions in overseeing the upholding of standards of values and conduct in that standards of values and conduct cannot be codified in clear rules.

This is the case irrespective of whether the function is positioned as the clear second line or providing input into another second-line function. This is understandable given the way that Compliance functions have historically been built, with a view to monitoring the bank's adherence to specific legal requirements. And, as we have stressed, good conduct and values cannot be enshrined in rules, given the grey areas and requirements for sound judgment. This strains the historical skill set, mindset, and processes established by most Compliance functions. This is therefore a problem for banks that have designated Compliance as their second line of defense; the effectiveness of compliance is often hampered by the unsuitability of the traditional compliance skill set to behavioral issues, and the lack of appropriate and authoritative internal standing of the function when it comes to behavioral or broader values.

d. Multinational banks are struggling to find the right balance between satisfying local requirements and achieving broadly consistent global standards. Compliance and control adequacy

is fast becoming a priority area for supervisors in most jurisdictions, frequently under the leadership of separate institutions. As discussed in Chapter 1, there is no uniformity of approach, no equivalent of Basel III or Solvency II on the prudential side. Supervisors pursue good conduct and controls by deploying a mix of increased principles-based requirements, and tighter rules with a high degree of local requirements and enforcement. Being reactive to the political priorities in various jurisdictions can lead to inconsistent outcomes and confusing standards in the businesses across jurisdictions. This is a significant challenge for multinational banks.

Notwithstanding this challenge, banks require clear and unambiguous values and conduct standards that are robust and rigorous enough to cascade through the organization, across businesses and countries, and which can be measured and championed. While banks must be mindful of local conduct requirements that apply to local subsidiaries or branches, they should be vigilant against locations that may set a lower bar than their own global standards, or risk creating potential mixed signals for local staff, and sustained conduct and values risks for the bank overall.

Many of the conduct problems identified with global banks involved local subsidiaries in which either oversight and compliance were weak, or oversight and compliance were adequate, but local rules were inadequate relative to global standards set by the institution.

While grappling with this, banks must also seek to avoid duplication; where local standards and rules are in line with global standards, a firm's global processes should not then duplicate local processes.

Banks are at best running inefficient global and local compliance and monitoring processes, and at worst running the risk of local requirements not being adequate relative to global standards, and possibly both.

Case Studies 8–11 present examples of institutions that successfully tackled aspects of the three lines of defense construct.

CASE STUDY 8

This bank made a significant investment in a big data capability that aimed to link current anomalous staff behaviors with past instances of bad conduct and values. The dataset had been built over a ten-year history of specific events and had been used to inform the algorithm.

The methodology looks at staff behaviors across all businesses and jurisdictions, and raises flags when the behavioral patterns match past conduct and values issues.

The methodology was successful in identifying potential conduct and values issues, but also flagged areas in which policies could be changed to mitigate risks. For example, it was found that a number of traders who had been caught in market-rigging investigations never took holidays, so it modified its vacation policy accordingly.

In another example, it found that unusually high accessing of client accounts in the retail branches was often correlated with fraudulent activity, so it modified its client access protocols accordingly.

The bank felt the methodology created value both to business management through being able to identify potential issues preemptively, and to traditional second-line monitoring for a complex group with many different businesses in a large number of jurisdictions.

CASE STUDY 9

This bank decided it needed to change the skill set required for effective compliance capabilities to deal with behavior and conduct issues.

Recognizing the need to monitor, understand, and influence behaviors, this bank is employing behavioral psychologists in the Compliance functions, and retraining existing compliance individuals to equip them with the soft skills they believe are required to empower compliance to best monitor cultural and behavioral compliance.

This activity is reframing the expectations of the Compliance function and retooling them to become more effective in the broader mandate. This was not without its challenges, since bringing an academic discipline into a traditional compliance mindset was not straightforward, because of the differences in approach, vernacular, and mindset between long-term compliance specialists and behavioral psychologists.

CASE STUDY 10

This bank decided it needed a different approach to internal penalties. It was struggling with the inability to take action against individuals who were in breach of standards, but not in breach of specific compliance rules. The internal legal department was cautioning management not to take action, since the choice of any type of internal sanctioning was likely to be successfully challenged in the courts by the employee, and hence end up being relatively expensive for the bank.

The bank's leadership decided to change course. They adopted a more aggressive stance against employees who had breached standards (including co-workers who should have raised concerns).

This course of action was pursued in high-profile cases involving some degree of fraudulent activity in branches and trader behavior. The cases were successfully challenged by the employees in the courts, but the bank observed that the signaling value to all employees was strong and conveyed a "zero tolerance" on conduct and values standards. The sanctioning was led by line management rather than compliance or legal teams.

CASE STUDY 11

Many banks have struggled with the "divide" between control functions, primarily Compliance and Risk Management, and the business lines. This led to persistent problems in the implementation and operation of the three lines of defense. There was an inability of the second line to add value in their advisory capacity; poor accountability from the first line because of strong reliance on the second line; and poor skill sets and a general inability to make difficult trade-offs in specific customer, product, and pricing decisions inherent in many of the day-to-day conduct and values standards.

The solution applied by some banks has been cross-staffing across business lines and control functions. This has the obvious advantage of ensuring that the first and second lines share common skills and understand their respective challenges. While the business functions may have different hierarchical structures, compensation models, and career tracks, these are solvable. The banks that succeeded in implementing this type of rotation observe much more effective and efficient communication and collaboration between the first and second lines.

In summary, banks face enormous challenges as they seek to make real improvements in desired conduct, values, and behaviors. Implementation failures are widespread. However, as the case studies illustrate, some banks, spread across the globe in diverse markets and businesses, are overcoming the challenges, and were a valuable reference for the recommendations presented in the next chapter.

Conduct-of-business supervisors are having difficulty supporting the required transformational change.

The study found that supervisors fall into three broad categories with respect to culture:

- 1. SUPERVISORS WHO HAVE NO SYSTEMATIC APPROACH TO CULTURE.** This group—the vast majority—instead rely on what can be regulated and enforced, and hence a “default” approach through conduct-of-business rules and standards (A review of policy-making literature published by supervisory agencies supports the conclusion that the majority of supervisors have not hitherto focused systematically on culture.⁸)
- 2. SUPERVISORS WHO USE TARGETED ENGAGEMENT AT THE BOARD OR SENIOR EXECUTIVE LEVEL.** This group has no specific methodology directed at culture but believe their lead supervisors have enough experience and interaction with banks to be able to make useful observations about the institutions’ culture. For these supervisors, these observations may come from a root cause analysis of specific supervisory findings. Formal intervention on cultural issues may be rare, and focused on clear cases where the supervisor believes the matter at hand is serious.
- 3. SUPERVISORS WHO HAVE FORMALLY INTEGRATED CULTURAL CONSIDERATIONS INTO THEIR SUPERVISORY APPROACH.** In these agencies, which constitute only a small number of

jurisdictions, this firm-level cultural assessment is part of the mainstream supervisory process. In one case, supervisory teams have been bolstered by behavioral experts, and the emphasis is on testing whether the governance and oversight mechanisms work in the cultural context of the bank being assessed. Some banks may have benefited from this approach, which has resulted in constructive debates between supervisors and bank management and boards, which have yielded material and preventive outcomes.

Aside from a small number of relatively successful examples, our interviews highlighted shortcomings that are common to most jurisdictions. Two broad failings stand out:

1. There has been significant emphasis on prescriptive conduct rules in a number of jurisdictions. This has led to an enforcement-led approach to supervised firms, and can in some jurisdictions amount to a deficit of supervision. This is understandable given the huge pressure agencies are under to deliver better conduct, and the cultural- and conduct-related scandals we have witnessed. These severe breaches must be punished accordingly. In general, however, sole reliance on this approach will not deliver better outcomes. Enforcement alone after a failure does not facilitate trust, open dialogue, and information sharing to prevent or mitigate issues before they magnify. Indeed, banks may become reluctant to engage with supervisors early (due to fear of enforcement actions resulting from information sharing), and problems can therefore magnify prior to identification due to the lengthy procedures implied by enforcement. Lack of a clear distinction between supervision and enforcement teams clearly exacerbates this problem.
2. There is a shortage of experienced and suitably skilled supervisors. The ability to interface with senior bank executives on culture, conduct, and

8 The study analyzed approximately 500 post-crisis policy documents, which were classified into one of five categories: prudential risk/capital/liquidity, conduct of business, governance and remuneration, culture, and addressing multiple areas. Only three documents were classified as dealing with culture as a central concept. Only eleven documents made reference to culture in passing. The largest category was “conduct,” on which nearly half of the documents surveyed focused. Governance and remuneration were the key themes for just under a third (29 percent) of the documents, and prudential (risk/capital/liquidity) a key theme of about a quarter (24 percent).

values requires highly credible supervisors with experience and expertise, valued by the supervised firms. This is generally the case in supervision, but it is particularly acute in this domain, given the need to express judgments on highly sensitive and delicate issues. When such discussions involve junior supervisors interacting with senior executives or Board members, this may result in inadequate outcomes because the junior supervisors

may not fully understand the senior executives' and firm's approach, and the senior executives or Board members may feel they are not working with equals who have the required depth of knowledge. Some jurisdictions have invested in new skill sets to attempt to bridge the knowledge and seniority gap. But there is no substitute for senior supervisory engagement on these issues, bringing to bear experience and perhaps perspectives from other industries.

RECOMMENDATIONS FOR BANKS, REGULATORS, AND SUPERVISORS

This chapter presents recommendations for banks and supervisors. We do not see an important role for *further regulatory prescription* with respect to conduct and values. But we see a very important role for *supervisory monitoring and guidance* in ensuring that bank governance and internal checks and balances as set out in our recommendations are implemented.

Many banks will require a radical change in approach, while most require a far more comprehensive and decisive set of initiatives. The recommendations are designed to produce comprehensive changes and improvements in the culture of banks that is now an imperative for the banking sector. There are no “quick fixes,” and some of the recommendations may not appear innovative. But persistence and dogged focus in following these recommendations is what is required to deliver tangible, permanent results.

Success, in the short term, will be evidenced by banks implementing the permanent management and governance processes presented in this report. In the medium term, success will be evidenced by significant reductions in the incidence and severity of contraventions of accepted codes of conduct and firm values, improvement in economic returns, a recovery in banking’s standing with consumers, and an ability to attract and retain good staff.

Banks should challenge the *what* and the *how* of their cultural foundation. Achieving the desired cultural transformation will be a long process and will

require persistence and consistency to overcome years of entrenched behaviors and attitudes and to ensure that changes are lasting rather than in response to short-term pressures. The how should ensure ongoing reinforcement, monitoring, and corrective action.

1. MOST BANKS SHOULD AIM FOR A FUNDAMENTAL SHIFT IN THE OVERALL MINDSET ON CULTURE.

If not there already, banks should shift the implementation approach to “this problem is core to our business model and fixing it is key to the economic sustainability of the institution.” This includes raising the bar for CEO and Executive team leadership, visibility, and appetite to consistently take difficult internal sanctioning decisions (ensuring material consequences both in terms of termination of implicated management and employees, and significant compensation adjustments). Sanctioning must affect those with oversight responsibility, including the CEO, for any new issues that arise, and include those who exercise willful blindness.

Even firms that have been proactive have room to improve their oversight and implementation of the management practices necessary for sustained success throughout their banks. This should be managed by banks, and overseen by boards, as a **permanent** priority so they contribute to their clients, their clients’ businesses, and the economies and communities in which they reside. Case Study 1, in the previous chapter, provides a good illustration of this.

a. **Banks should look at culture, and at achieving consistent behavior and conduct aligned with firm values, as key to strategic success, rather than as a separate work stream or add-on process** to respond to short-term public, regulatory, or enforcement priorities. Culture is an outcome of focused, persistent efforts to ensure that the values and desired conduct banks espouse are actually followed in practice, and that behaviors reliably exhibit “the way the firm wants to do things.” All banks have values, ethics, mission, strategy, and conduct statements. The challenge is making them consistent, and consistently following them.

b. **Banks should reinforce the messages in their actions and internal communication.** While there may be subtle differences in what the effort means in practice across businesses, core values should be the same.

c. **Banks’ behaviors and conduct should be open to constructive internal challenge.** Banks need to have processes that welcome and can deal with self-identification or escalation of issues. This requires that people feel they can operate in that fashion. Management should have adequate capability and training to receive that kind of input and know how to deal with it constructively and effectively. There are well-documented methods for assessing the extent to which these capabilities exist in various parts of banks.

2. SENIOR ACCOUNTABILITY AND GOVERNANCE.

Boards should ensure that oversight of embedding values, conduct, and behaviors receives continuous attention in their agenda setting, with explicit delegation to the CEO and Executive team the primary responsibility for ensuring that the “tone from the top” has a clear and consistent “echo from the bottom.”

a. **The high sensitivity of Boards to reputational risks should be harnessed** to ensure that oversight of embedding values, conduct, and behaviors receives regular attention in their

agenda setting. The CEO and the Executive team will shoulder the primary responsibility to ensure that the tone at the top is matched in the middle, and has a clear and consistent echo from the bottom. Boards should create sufficient time and focus to be a sparring partner for the executive. Board oversight should be designed to ensure that the board sets appropriate values for the firm, that the board itself demonstrates the desired behaviors, and that the board performs effective oversight of the implementation of the necessary processes.

b. **Published charters of the Board should include responsibility for oversight of values and conduct.** Unless the board itself can commit sufficient and continuous time and attention to these matters, the task should be undertaken by a dedicated committee of the Board, accountable to the Board. Boards should report on their oversight of conduct and values, and institutional investors should do more to take this into account in their assessment of likely long-term success. Moreover:

i. Boards should ensure that their oversight processes specify how the board responsibility for oversight is exercised. How to organize board oversight of values, behaviors, and conduct is not straightforward. It touches processes that are part of frontline businesses, compliance functions, risk management, human resources, and remuneration. So there is no one way to organize board oversight. Having a separate board committee can add focus and clear priority. What is key is that decisions on how to organize board oversight of the firm’s culture and mission be taken explicitly, and that this be reflected in mandates and work of the board and its committees.

ii. Boards should be satisfied with the bank’s statement of values, code of ethics, code of conduct, and whistleblower policy. These should include clear statements of expectations, duties to escalate, and the conduct

expected of managers and team members. Boards should also be satisfied with the broad approach to communication of these policies throughout the institution. Boards should look for opportunities to explain, champion, and demonstrate the culture of the firm and to communicate the cultural norms to employees that help make clear what is expected of them.

- iii. Diversity on boards contributes to broad-based perspectives and more constructive debate within the Board. In executing highly judgment-based responsibilities such as assessing values and conduct, this diversity is particularly important. Boards should therefore consider how the mix of their composition, including different mindsets and viewpoints, as well as nonfinancial industry experience, add value to management through a diversity of advice and perspectives.
- c. **Build a reputation, values, and conduct risk tolerance dashboard.** Boards (and/or the relevant committees) should regularly receive monitoring information on culture and values and build a reputation, values, and conduct dashboard to monitor progress and facilitate debate and challenge between the board and the executive. In monitoring, boards should recognize that certain business models and strategies are easier to imbue with a common culture, conduct, and values. That may affect how and in what markets and geographic locations the bank conducts its business. In businesses or locations that are potentially challenging from a cultural perspective, the board and senior management need to be even more proactive in following the practices outlined in this report.

In addition, board members should look for opportunities to gain insights into the actual behaviors of the firm, including through spending time with individual businesses and with midlevel management. The board should regularly review with the CEO the individual results of the CEO assessment of adherence to firm values by his or her direct reports. Boards should be satisfied

with how the CEO assesses the direct report's awareness and oversight of desired conduct and behaviors in their businesses or function, and should receive summaries of those assessments.

- d. **If the Chair and CEO positions are not split, ensure that the lead independent director spends adequate time in the effective challenge role to the CEO.** If the Chair and CEO positions are not split, (and splitting is now the norm in the industry), the lead independent director needs to ensure that he or she spends adequate time in the effective challenge role to the CEO. An effective lead independent director should spend adequate time leading the board oversight of values and conduct issues.
- e. **Boards should ensure that the CEO and Executive team are highly visible in championing the desired values and conduct.** As part of this effort, the CEO and senior management team should seek to identify areas of likely resistance or areas where achieving the desired adherence to values and conduct norms is likely to be more challenging. This requires a good understanding of the cultural norms in the institution, business strategies that may be more prone to producing questionable behavior, and areas and subcultures where individuals may be more interested in their own rewards than the good of the firm. This assessment needs to recognize, for example, that the culture and long-accepted norms for dealing with "counterparties" are different from the norms of dealing with customers or clients.

Acquired entities may have very different cultures. These areas of the bank may require more focus and persistence in achieving the culture the banks wants, and may require an alteration in the business model. The CEO and Executive team should be highly visible by exercising ongoing scrutiny of, and participating in, significant remediation plans. When deciding on CEO remuneration, his or her performance and commitment to this effort should be a significant part of the annual assessment for the foreseeable future.

Success in embedding the firm's values and desired conduct consistently and reliably in firm-wide processes and behaviors requires the personal focus of the CEO, and persistent high-quality management effort on multiple fronts for lasting success, as set out in this report. Boards should be satisfied that the CEO has engaged the senior management team and that they have a well-thought-out strategy to involve others. The Board should also ensure that management faces material consequences in the event of persistent or high-profile failures. Case Study 2 in Chapter 2 is a good illustration of this. Moreover:

- i. Boards should ensure that there is adequate flexibility in the CEO and Executive team remuneration arrangements for them to exercise the necessary judgments they are making, and adjust rewards as necessary. In making those judgments, boards should take into account that consistent modeling of the desired behaviors is a key success factor. Even small deviations can send major messages to the organization. Financial consequences for deficiencies of action or oversight should be material, and be perceived so internally. Case Study 3 in Chapter 2 is a good illustration of this.
- ii. When assessing successors to the CEO and other senior management positions, the Board should ensure that significant consideration is given to the extent to which candidates have demonstrated the commitment to promote the firm's desired values and conduct. Those appointed to these positions should exhibit a willingness to play a focused leadership role in sustaining the effort.
- iii. Regular dialogue between Boards and supervisors should be maintained. Senior executives and board members can in particular benefit from supervisory advice on and insights into developing good (or bad) cultural practices in the sector as a whole.

Boards, in particular, would benefit from a regular, structured, and open discussion on the institutions' standing relative to peers in the eyes of the supervisors. In line with *A New Paradigm: Financial Institution Boards and Supervisors*, we recommend a regular dialogue between Boards and supervisors, with a specific focus on distinguishing the respective roles of Chairman and Chief Executive in the transformational change.

- f. **The CEO should ensure that there is a thorough process that reviews the bank's brand and reputational standing with the full scope of internal and external stakeholders**, and to recommend any corrective or strengthening initiatives to the Executive team. External stakeholder and investor perspectives are valuable, since they provide an outside view on the cultural shift that banks are undertaking, and may assist in identifying problem areas and potential solutions. Other industries have successfully implemented robust processes overseen by a senior "Brand Management" officer who is tasked with understanding and monitoring the perception of the institution among key stakeholders (internally and externally), and providing guidance to the businesses and control functions on specific actions that can improve brand and reputational perception. We recommend that banks implement similar processes.
- g. **Asset owners and third-party fund managers should tell boards directly that they consider effective governance and accountability to be a priority cultural matter**, rather than doing so primarily through proxy voting. Some investors insist on "formulaic" management compensation models, which is counterproductive because it limits the ability of Boards to make qualitative judgments on management pay. We recommend that investors significantly upgrade their engagement on these matters, to ensure that governance arrangements are robust and Boards and Executive teams adequately emphasize conduct and values.

3. PERFORMANCE MANAGEMENT AND INCENTIVES. Banks should ensure that their performance management does not reward individuals who do not meet a threshold of acceptable behavior in alignment with firm values and conduct expectations. This implies material and consistent compensation adjustments (for example, bonus reduction or elimination, claw backs) in the event of identified breaches. This requires use of a balanced scorecard approach based on objective criteria.

The general public continues to be very sensitive about compensation issues in the banking industry. For trust to be reestablished with the public, Boards and senior managers must demonstrate that those who engage in misconduct and violation of firm culture will face penalties. Banks should ensure that their performance management system only rewards individuals who meet a threshold level of acceptable behavior in alignment with firm values and expectations. This requires use of a balanced scorecard approach.

a. Improve compensation and promotion processes to ensure they take account of desired behaviors, including consequences for weak management oversight or willful blindness. The processes should ensure that those who engage in misconduct and violation of firm culture will pay a price for such behavior (for example, reduced compensation, termination, career limitation). Management and staff should be made aware that appropriate disciplinary action will follow unacceptable behavior and transgressions. Banks should have zero tolerance for behaviors that are not in alignment with firm values, ethics, and desired conduct. That does not mean issues will never arise. However, the desired attitude means proactively looking out for inappropriate behaviors, dealing consistently and firmly with breaches, ensuring they are not present elsewhere in the bank, and communicating that message internally and externally. In addition, banks should have a policy of celebrating those who go above and beyond the norm to deal with difficult conduct issues or to demonstrate the firm's

values in challenging circumstances. The goal is a demonstrable commitment to the bank and its clients rather than the self.

To ensure that staff assessments are thorough and consistent, approximately half the rating of balanced scorecards should be based on *how* business results are achieved and behaviors and conduct exhibited, as opposed to the achievement of the business results themselves (that is to say, the balanced scorecard should be split 50/50 between performance, and conduct and culture metrics). The system should be careful not to incentivize behaviors that could lead to conduct problems (such as an overreliance on sales-driven compensation). Staff teams that do not escalate issues observed, that fail in their oversight of conduct issues, or that fail to satisfy the expected conduct and values standards, should suffer material consequences. These should include compensation adjustments (such as bonus reduction or elimination), limits on the ability of the individual to progress in their career at the bank, and employment termination.

A substantial shift in remuneration models would be needed to one based on a systematic evaluation of performance relative to values and conduct standards:

- i. While this requires the exercise of more judgment, it is essential for embedding desired values and conduct in actual behaviors. Firms should ensure that frontline management and leadership are properly trained in how to conduct the judgment-based elements of performance related to adherence to firm values (see below).
- ii. In addition, how banks deal with code-of-conduct violations needs to be more transparent, as does the celebration of how values are lived in challenging situations. Values statements need to be clear and clearly communicated so that employees are more likely to remember them. These are very powerful motivators and signals to staff of what is expected. Some banks have demonstrated

that it is possible, with clear expectations set out in codes of conduct and proper documentation, to achieve the goals set out in this recommendation (see below). Even if not fully successful, bank policy and practice of disclosure of material conduct breaches would send the right message about the seriousness of these issues.

b. Develop a comprehensive set of indicators to monitor and assess individual and team adherence to firm values and desired conduct.

This is a key input to first-line awareness of what is actually occurring, early warning actions by management and second line of defense, and effective staff appraisal. Case studies suggest that indicators should include external measures such as press mentions, client surveys, client complaint data, ombudsman decisions, and regulatory reviews. They should also include internal indicators such as staff surveys, 360-degree assessments of individuals, compliance and risk management breaches, internal audit results, staff behavior, and client activity tracking. There is no universal prescription here, since banks should find what suite of indicators best suits each firm, its businesses across the globe, and business model. But certainly the approach should include as many indicators as possible until some degree of satisfaction and certainty is achieved that the right indicators are being reported and tracked.

- c. Implement individual review and assessment of the top 200 to 400 most senior executives (in G-SIFIs or D-SIFIs) by the senior leadership and CEO.** For smaller banks, the number would be reduced, but would be many more than just the executive committee who report to the CEO. Senior management in banks need to devote significant attention to performance assessments, not only of their direct reports, but also of at least one level below. This ensures that standards are applied consistently across businesses and geographic locations, and promotes unbiased assessments. It also allows

experience of an individual's behavior in their dealings across the bank to be brought together in making assessments.

Some banks have assigned individuals outside the reviewees' organizational unit to conduct reviews, with input from others, as a way of reducing the tendency for managers to favor their own staff. This approach should be considered more widely. Board compensation committees should be provided with summary information of the results of the assessment process for the top several hundred individuals, and be satisfied that the process is adequately taking account of values and conduct.

- 4. STAFF DEVELOPMENT.** Banks should continue to build and implement robust processes to explain and regularly reinforce to staff what is expected of them. Promotion should be awarded only to those who have consistently exhibited commitment to firm values and desired behaviors. Case Studies 7 and 8 in Chapter 2 provide a good illustration of this.

- a. Strengthen first-line skills and ensure that frontline management and leadership is properly trained in how to conduct a judgment-based staff evaluation on desired values and conduct and dealing with identified breaches.** It is essential to make real to employees at all levels what firm values and conduct statements mean in practice in real situations that are relevant to them, particularly since some of these will be in "grey areas." The examples need to be meaningful to employees and the businesses they are in, so examples from the bank's own experience (both positive and negative) would be particularly powerful.

In addition, while pay and bonus decisions are significant motivators, staffing and promotion decisions also send powerful messages across the organization about what values and conduct are valued by the firm. These processes and judgments should be led by line managers. However, successful execution by line managers can require training in how to deal with complex trade-offs and personnel issues. In some cases,

management may lack these capabilities, and when this is so, banks may need to invest in training with role-playing and case studies that can give line management tangible experience and valuable perspectives.

b. Develop programs for staff across all areas of the bank, tailored to the firm's circumstances, which regularly reinforce what the desired values and conduct mean in practice.

Forming a new behavior and ensuring it becomes a habit occurs through a shift, typically gradual, in cognitive control from intentional to automatic processes. Key to understanding the challenge is recognizing that behaviors are mostly automatic, not “thought through.” Changing behaviors should therefore be thought of as a developmental program that cannot always be achieved through “standard” training. Indeed, changing behaviors is a complex undertaking, and may not lend itself to standard training or teaching methods.

“Culture champions” (individuals who are seen to notably embrace and demonstrate the values of the bank) deployed throughout the bank, acting as role models for those around them, should be considered. These individuals can help create transparency on internal best practices, and knowledge sharing on the bank's progress on implementing target culture. This mechanism can also be effective in identifying structural or individual problem areas that need to be addressed, but a good balance between positive reinforcement and calling out of bad practices should be sought, in order to neutralize a potentially negative interpretation of these roles as the “culture police.”

In addition, development programs need to be extensive, repetitive, and fundamentally different from classic training or compliance programs. The programs should be delivered by management or champions (not by externals), and might include elements such as extensive, business-unit-specific examples of behavior that is acceptable or not in a variety of circumstances, including grey areas. Such programs should be designed to be *frequent* and *self-reinforcing* based on two key questions:

i. How long does it take to change behaviors?

Generally accepted research shows that it can take from 18 to over 250 days, depending on the type of behavior (and several other factors). In a complex business system such as a bank, it is more likely that longer periods in that range will be required.

ii. How frequently do individuals need to be nudged?

Behavioral research shows how quickly adults forget what they have learned if they do not practice or repeat it, and what level of repetition is required to remember things. According to the research, within four weeks, adults forget about 90 percent of the new things they have learned and remember only 10 percent. If what they learned is repeated in the first week, adults retain 30 percent. If what they learn is repeated again in the following week, they remember 60 percent, and so on.

This is focused on remembering, not learning, a new behavior, but is the foundational research behind how employees need to be supported during the process of first remembering a specific behavior and doing it as a task or activity. Continued nudges or repetition and modelling the behavior at the same rate helps individuals make self-corrective adjustments based on feedback, so the task or activity becomes a behavior or habit.

c. Implement a system-wide values and conduct screen for internal promotions and external hires.

This implies significant input into succession planning and recruitment processes from a wider variety of executives and functions in the firm, who will have evidence of adherence to desired values and conduct. It also implies Human Resources (HR) functions having more stature, expertise, and being expected to develop and contribute meaningfully to these processes. Senior HR executives should have access to the CEO and business unit leaders and be viewed as partners with the rest of management in this effort.

- d. **Sustained emphasis on diversity in development programs and hiring should be a key contributor to improved values and conduct,** and a further catalyst to sustained behavioral and mindset change. There is a widely accepted body of research that demonstrates that diversity in the broadest sense—cognitive, gender, background, ethnicity, religion—is valuable to a talent-based business.

5. AN EFFECTIVE THREE LINES OF DEFENSE.

Adherence to values, conduct, and expected behaviors should be the business of all employees and all levels of management in the firm. Business line management (the first line of defense) should shoulder primary responsibility for delivering the desired values and conduct, with the second line setting standards, monitoring, and providing advice to the first line. The third line should be robust and mandated to test adherence to the stated standards.

- a. **Staff and management in the business (the first line of defense) should shoulder the largest responsibility.** All employees and all levels of management in the bank should adhere to values, codes of conduct, and expected behaviors. Frontline staff (the first line of defense) shoulder the largest responsibility for judging what behavior is or is not in line with the bank's values and desired conduct, within a framework established by the second line (and signed off by the executive and board). This is an individual responsibility, a management responsibility, and a collective responsibility of teams. It is also an essential of accountability that frontline staff who are unsure how to apply bank values or the code of conduct in grey areas escalate issues for resolution.

In the case of banks with activities in multiple jurisdictions, first-line accountability is of primary importance. Without first-line accountability, it is difficult to get the second line to fully police behaviors. Moreover, the head office will always be hostage to “jurisdiction XX is different from others, we need to be treated differently....” unless the first line shows true leadership. Therefore, for many global banks,

the primary emphasis should be ensuring that governance arrangements are suitably robust, and are well supported by the global standards that will be established by the second line.

- b. **Allocate clear second-line ownership.** Banks should allocate clear second-line ownership to Compliance or Risk Management functions, and ensure that the designated function is on the Executive team. The designated function should seek input from all other relevant functions as necessary (for example, Human Resources). Moreover, the designated second line should develop skill sets and priorities to be better equipped to deal with tricky judgments on values and behaviors and act as a more effective advisor to the first line.

Regardless of how a bank assigns second-line responsibility, it is important that there is a clearly defined process for bringing the views of the various functions together (across HR, Compliance, Risk Management, and Legal) to identify issues that need remediation and positive leadership that should be celebrated. Whatever function(s) are accountable as the second line of defense, they should have the stature and experience, and soft skills, to be able to make difficult judgments. Compensation levels for these functions need to be adequate to attract high-caliber staff with credibility with the businesses. Staff performing these important functions should have ongoing access to senior leaders, including business line heads and the CEO.

- i. Irrespective of the chosen line, HR functions should be proactive and develop more internal credibility to support management. This implies a profile for the HR functions that may be quite different from its current profile within the firm. HR needs to have the mandate and stature within banks to contribute its insights to the CEO and senior business leaders on areas needing improvement. HR should consider investing in staff with expertise in behavioral dynamics as part of their developing skillset.

- ii. Most Compliance functions are accountable for adherence to rules and regulations as a second line of defense. As a result, it is typically difficult for Compliance functions to set and monitor broader standards and principles. The overarching finding of this report is that culture (through values and conduct) should be defined by a set of standards that complement conduct-of-business regulations imposed by specific jurisdictions. Therefore—irrespective of the chosen line—compliance functions may need to consider investing in new skill sets to improve their ability to add value in conduct and values judgments. Case Study 9 in Chapter 2 provides an instructive example.
- c. **Boards and management should implement systems that provide assurances to all employees that if and when they report wrongdoing that they witness in the workplace, their complaints will be taken seriously and confidentially and they need not fear reprisals.** Banks need clear policies on escalation procedures and on protection for internal flag-raising or whistleblowing, and have in place an internal arbitration and investigation body (potentially the ethics officer). Employees should feel that they do not have to go the formal whistleblowing route to escalate every issue that needs consideration. As part of their oversight activities, Boards and management should periodically review the overall results of the whistleblowing process and be satisfied that it is working in a satisfactory manner.
- d. **Banks should challenge the conventional wisdom on legal impediments with respect to penalties for cultural failures by employees.** Some banks have challenged the conventional wisdom on legal impediments across businesses and countries of operation with respect to internal penalties. Too often, the legal stance leads to “no action” being recommended by the internal Legal function. Penalties should include staff or management termination and compensation adjustments. For some banks, the signaling value of taking public action against staff involved in serious breaches of agreed behavioral and cultural norms of conduct, even in “grey areas” in which employment law creates constraints, far outweighs the short-term cost of a legal challenge from the individual employee to their termination. Case Study 10 is a good illustration of a bank that radically changed its approach to internal sanctioning. In addition:
 - i. A difficult issue concerns the fact that persons who are let go by a bank for violations of the bank’s code of conduct or other policies are often hired by other firms. Depending on the jurisdiction, some combination of employment law or privacy law can deter banks from disclosing reasons for termination. Some commentators have called for banks or the authorities to create a registry to deal with this issue. There are many factors that need to be considered in doing this, not the least of which is the need to provide legitimate protections and redress mechanisms to staff who believe they have been wrongly treated, and the need for a critical mass of countries to be involved.

As noted, some banks have accepted the higher legal or financial risks that accompany disclosing this information, and this report encourages more of that attitude. Employers should ensure that full due diligence is completed on past employment history of potential new hires, exploring all sources of relevant information, including previous employers. Policymakers and legislators should also explore the possibility of providing more legal safe harbors in employment and/or privacy law in order to potentially facilitate greater transparency. Authorities might consider launching a registry, conditional on local legal impediments.
 - ii. Banks should consider investing in advanced monitoring capabilities, such as the one illustrated in Case Study 8 in Chapter 2. Some banks have evidently found significant value in monitoring the kind of activities

and communications that in the past have revealed conduct or values issues, as an early warning tool that can inform both the first and second line of defense.

e. Staff rotation between control and business functions.

Many of the implementation failures described in Chapter 2 relate to lack of relevant experience and “siloed” thinking within control functions or businesses. To break down some of these barriers, some banks point to substantial improvement of the three-line construct through a policy of staff rotation between control units (Compliance, Risk Management) and businesses. This can facilitate both good knowledge sharing and a more pervasive embedding of the firm’s culture across the company, which can be reflected in the day-to-day conduct of staff with first- and second-line duties. Case Study 11 is a good illustration of this.

f. 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. This responsibility is usually discharged by internal Audit functions that have freedom to examine any businesses or units within the bank, and test their adherence to the standards established by the second line of defense. The third line should have full autonomy to report to the Board and executive management as it deems necessary.

We recognize that these recommendations represent a significant undertaking and will need to compete with other management initiatives. However, the economic and public trust imperative of concerted action by the banks is clear: quick fixes and slapdash “cultural reviews” will simply not deliver the vast behavioral change required in the banking sector.

In addition to the recommendations mentioned above that are needed to help banks embed the desired cultural changes, regulators, supervisors, and enforcement authorities also have a role to play.

6. REGULATORS, SUPERVISORS, AND ENFORCEMENT AUTHORITIES. Addressing cultural issues must of necessity be the responsibility of the Board and management of banks. Supervisors and regulators cannot determine culture, but supervisors should have an important monitoring function.

Supervision has a strong complementary role in achieving the shared objective of an improved banking culture. Supervision is not regulation. Regulation, or rule making, has a limited role in the area of values, conduct, and culture.⁹ Supervision does not have a role in judging good culture, but has an important role in testing whether elements of “the how” described above (senior accountability and governance, performance management and incentives, staff development, three lines of defense) are in place at the board and senior-executive level to oversee, understand, measure, and manage the problem.

This does not imply grading institutions on their culture. It is not necessary for supervisors to develop a formal add-on to their methodology in order to deal with cultural issues. To do so would be to set higher expectations than they can achieve. Supervision requires qualitative monitoring and assessing of the capability and behavior at the board and senior-executive level. It requires considerable judgment on the part of the supervisor, and deep knowledge about the bank. Supervisors of necessity need to rely on governance and control processes of the bank, while testing to confirm whether reliance is well placed. A properly resourced supervisory function can add value by sharing its insights with firm management and the board. While culture, values and conduct are not fully measurable, they are observable and describable by various indicators that are both “hard” and “soft,” such as compliance

⁹ Market conduct regulation does have an important role in setting rules for particular markets, products, or processes (for example, complaint handling or anti-money laundering), but that is distinct from regulation of values, conduct, or culture generally. In some financial markets, banks have developed industry codes that may or may not be recognized by the authorities, as an alternative to regulation.

failures, customer complaints, internal or external surveys, and internal audit and supervisory observations. It is possible for supervisors to credibly identify serious weaknesses that the bank is not dealing with.

Prudential supervisors are making progress on risk culture, with more to come. The recommendations presented in the G30 *New Paradigm* report (2013) about enhanced constructive interaction between supervisors and boards, progress in assessing governance, and having appropriate supervisory skills and resources, continue to be relevant. There was a range of approaches by conduct-of-business supervisors in the balance between ex-ante supervision (using informal and formal tools) as opposed to ex-post enforcement. We believe that conduct-related prevention, backed up by robust enforcement, is a better outcome for society than the current default approach by some conduct-of-business supervisors of almost sole reliance on deterrence and enforcement. A preventive approach may require more judgment, but it can better protect consumers in the long run.

- a. **Regulators should carefully consider the limited effectiveness of promulgating rules on values and conduct.** The principles already set by the FSB and BCBS and summarized in Appendix 1 are a good framework. Culture is about behaviors. Behaviors in general are not amenable to legislation or regulation. Getting behaviors aligned with established values and codes of conduct is properly the preserve of firms. More rules could prove counterproductive. Instead, sustainable cultures need to arise from, and be embedded in, banks' DNA. Proper embedding led by the banks themselves is a more effective way to restore trust in the industry.
- b. **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.** This can be achieved through benchmarking and identification of best practices, including setting reasonable

expectations about what board members can be held accountable for and the adequacy of governance, performance management, and compensation mechanisms and control systems. Sharing of supervisory observations with firms should more often occur without leading inevitably to enforcement actions. This should allow for early intervention by the supervisor to have the institution rectify serious deficiencies through a variety of informal and formal tools.

- c. **Authorities should ensure that conduct-of-business supervision has sufficient focus on early intervention to prevent issues before they materialize or magnify in severity.** Of course, robust enforcement should be a component of the supervisory structure, but enforcement should not become the default tool for conduct authorities. Mandates and strategies of these banks should be reviewed and adjusted as necessary to make sure a better balance can be achieved. This may require strengthening the skill sets and experience of supervisory teams and refining internal governance arrangements and rules of engagement between supervision and enforcement teams. In addition:
 - i. Supervision strategy should be visible, proactive, and aimed at problem prevention. This should include a clear policy for safe harbor for banks that are judged to be proactive in raising cultural concerns with supervisors when they first arise.
 - ii. Conduct supervisors should be properly resourced and staffed by experienced individuals who understand and can execute judgment-based, forward-looking supervision about conduct matters. Such skills and seniority are essential when they are evaluating boards and senior management effectiveness. This supervisory role can be further supported by the addition of small expert teams (governance, behavioral) to the core supervisory teams, to aid in assessments related to culture that should take place as

part of the normal supervisory processes. This expertise might also allow supervisors to form a view of what “good” looks like to provide benchmarking and guidance to supervised firms.

- iii. To achieve desired incentives, enforcement authorities should review the balance between enforcement actions against individuals, as opposed to against entities, to ensure that they are not predominantly pursuing the latter. Both are required.

d. Industry-led standard-setting initiatives should be encouraged. Supervisors may also consider using their ability to convene industry to identify forward-looking issues and issue soft guidance. They can and should consider using public communication and moral suasion as a contribution to identifying emerging practices that pose conduct challenges and that deserve attention by firms. Such efforts should be in addition to their rule-making authority, which should be used only if firms do not adequately respond. But industry-led standard-setting initiatives should seek broad industry support, and industry bodies tasked with strengthening codes of conduct and creating transparency on implementation progress should be welcomed. These initiatives can receive broad-based industry support, and provide a useful repository for standards and some degree of transparency on industry progress.

These bodies could be a powerful complement to conduct-of-business supervision activities

by ensuring a suitable focus on standards and principles of conduct and values. With most conduct-of-business agencies focused on specific conduct-of-business rules, we view these initiatives as a complementary mechanism to supporting the banks’ implementation efforts. Finally, the convening power of supervisors could be extended to institutional investors, to encourage owners’ sustained pressure on disclosure, board and management accountability, and sustained implementation of the processes recommended above.

We have constructed roadmaps (see Appendixes 3 and 4) for banks and supervisors to bring together the key recommendations into a set of key challenges against which both constituencies should test themselves.

REVIEWING PROGRESS TOWARD COMMON GOALS

Banks, themselves, need to continue to take the lead in championing, implementing, and embedding their core values, ethics, and behaviors in a manner that ensures a sustainable organizational culture. There is understandably skepticism about their doing so and staying the course to make improvements sustainable. There should be a review in approximately twenty-four months of the progress made by major banks in implementing these recommendations, and the results should be published. This review, of course, should also take account of any other reviews done by national bodies.

LIST OF PREVIOUS BCBS, FSB, AND G30 REPORTS

REPORT	KEY INSIGHTS RELATED TO CULTURE
BCBS: “Consultative Document: Corporate Governance Principles for Banks,” October 2014	This document is a revision of the original 2010 principles on corporate governance, and identifies the use of culture as an informal governance mechanism: “A fundamental component of good governance is a corporate culture of reinforcing appropriate norms for responsible and ethical behavior. These norms are especially critical in terms of a bank’s risk awareness, risk-taking and risk management.” The document does not give detailed explicit guidance on how culture can be used for this purpose, but does make the recommendation that in order to promote a sound (risk) culture, the board should take the lead in establishing “the tone at the top.” The document also suggests that supervisors need to strengthen their ability to assess the effectiveness of a bank’s risk governance and its risk culture and should engage more frequently with the board and its risk and audit committees. Risk culture is defined here as “a bank’s norms, attitudes and behaviors related to risk awareness, risk taking and risk management and controls that shape decisions on risks. Risk culture influences the decisions of management and employees during the day-to-day activities and has an impact on the risks they assume.”
FSB: “Guidance on Supervisory Interaction with Financial Institutions on Risk Culture: A Framework for Assessing Risk Culture,” April 2014	The document says this about risk culture: “Sound risk culture consistently supports appropriate risk awareness, behaviors and judgments about risk-taking within a strong risk governance framework. A sound risk culture bolsters effective risk management, promotes sound risk-taking, and ensures that emerging risks or risk-taking activities beyond the institution’s risk appetite are recognized, assessed, escalated and addressed in a timely manner.” The document does not define a perfect risk culture, but highlights that it should be expected to include legal and ethical conduct and integrity. The document identifies some of the “foundational elements” that contribute to good risk culture and provides advice to regulators and supervisors for assessing risk culture (risk governance, risk appetite, compensation). Recommendations include that supervisors conduct periodic reviews of the culture across multiple organizations, synthesize findings, look for themes, and apply high-level judgments on whether culture is the underlying cause of the problems observed.

REPORT

KEY INSIGHTS RELATED TO CULTURE

However, supervisors should be mindful of the assessment of culture being viewed as a compliance-driven exercise. A set of “indicators” are proposed (tone from the top, accountability, effective communication and challenge, incentives) that may be used, but it is explicitly stated that these should not be considered an exhaustive checklist for regulators. It is suggested that these indicators be assessed via discussion with the board and senior management, to assess the process by which purpose and values are communicated, and the institutions’ willingness to define and articulate its risk culture. Indicators identified are:

- Tone from the top (leading by example, assessing espoused values, ensuring common understanding and awareness of risk, learning from past experiences)
- Accountability (ownership of risk, escalation process, clear consequences)
- Effective communication and challenge (open to alternate views, stature of control functions [positions] vs. the business)
- Incentives (remuneration and performance, succession planning [for key management positions], talent development).

FSB:
“Principles for an Effective Risk Appetite Framework,”
November 2013

The report specifies elements required for a strong and effective risk management framework, recognizes culture as critical to sound risk management, and alludes to the power of culture as an informal compliance mechanism:

- “Establishing an effective RAF [Risk Appetite Framework] helps to reinforce a strong risk culture at financial institutions, which in turn is critical to sound risk management. A sound risk culture will provide an environment that is conducive to ensuring that emerging risks that will have material impact on an institution, and any risk-taking activities beyond the institution’s risk appetite, are recognized, escalated, and addressed in a timely manner.”

FSB:
“Principles for Sound Compensation Practices,”
September 2009

This report does not explicitly discuss culture, but rather how compensation practices should be changed. The report outlines a series of principles “to ensure effective governance of compensation, alignment of compensation with prudent risk taking and effective supervisory oversight and stakeholder engagement in compensation.” The work notes that for the principles to be effective, they “need to become ingrained over time into the culture of the entire organization,” that is, there needs to be a change in the organization’s compensation culture. The principles are intended to be implemented by firms, and reflected as a change in an organization’s risk culture, but will be “reinforced by supervisory examinations and interventions.” It is noted that changing compensation practice will be challenging, time-consuming, and will involve material costs. By implication, the same can be inferred for changing culture.

REPORT

KEY INSIGHTS RELATED TO CULTURE

G30:

***A New Paradigm:
Financial Institution
Boards and
Supervisors,
October 2013***

This report states that it is time to create “a new paradigm for interaction between supervisors and boards of major financial institutions across the globe.” The new paradigm relies on trust and understanding among Banks, Boards, and Regulators, and hence implicitly a trust in each other’s culture.

A series of recommendations are presented as to what the new paradigm of board-investor relations should look like and what each party should contribute to a successful relationship that would fulfil the new paradigm going forward:

What the new paradigm of board-investor relations should look like:

- Both parties should adopt the principle of no avoidable surprises.
- Boards and supervisors need to devote time and effort to their interactions, even when there are no particular stresses, and meet regularly.
- Except during periods of significant stress, the subjects for communication should not be dominated by the most recent supervisory findings, or the most recent stress test exercise, or what challenge occurred at the most recent board or committee meeting.
- Boards and supervisors need to understand and respect each other’s duties, powers, responsibilities, and authority.

The report considers risk culture, noting that “Boards should identify and deal seriously with risky culture, ensure their compensation system supports the desired culture, discuss culture at the board level and with supervisors, and periodically use a variety of formal and informal techniques to monitor risk culture.”

Finally, it is acknowledged that culture is unique to each institution and there “is no one culture that is appropriate for a major bank,” but the need is identified for a taxonomy of culture, providing examples of both good and bad cultural traits to be used by both boards and supervisors.

INTENDED OUTCOMES AND SUPPORTING BEHAVIORS FOR INDUSTRIAL AND FINANCIAL CORPORATIONS, RECOMMENDED BY INDEXES AND REGULATORS

Indexes such as the Prosperity Index, the Better Life Index, and the Happy Planet Index include key indicators of behaviors and outcomes of the contribution of industrial and financial corporations to society beyond the profit motive. The table is not intended to be a checklist.

INTENDED OUTCOMES	SUPPORTING BEHAVIORS
1. Good and fair customer outcomes through transparent servicing of client needs 2. Promote financial and economic resilience/stability for both employer and broader economic system 3. Contribute to education and develop talents in the community 4. Support and contribute toward development of a sustainable environment 5. Safeguard savings and ensure the integrity of financial contracts 6. Provide broad access to financial services and products with appropriate confidentiality/transparency 7. Facilitate the efficient allocation of capital to support economic growth 8. Enable smoothing of cash flows and consumption over time 9. Provide financial protection, risk transfer, and diversification 10. Provide and facilitate charitable investment in the community	1. Acts with integrity 2. Acts fairly, ethically, and within the law at all times 3. Risk aware and mindful of risk management 4. Approachable, engages in open dialogue and open to challenge, willing to escalate to address improprieties 5. Customer-focused in all business considerations 6. Long-term perspective and economically rational 7. Creates and promotes an inclusive and collaborative environment 8. Compliant with laws, policies, and management demands

BANK ROADMAP FOR ACHIEVING DESIRED VALUES AND CULTURE

OVERARCHING APPROACH

- **Attitude and commitment.** Bank boards and management should be focused on understanding the culture(s) that exists, and should see achieving desired conduct and values as essential to the sustainability and long-term viability of the bank, as opposed to a more defensive/compliance-based approach. The bank should make a long-term commitment to sustaining and overseeing the desired culture of the firm. It should own the responsibility for identifying and dealing with problems, rather than waiting until authorities find serious breaches after they have germinated and grown into fully fledged scandals. The bank should be transparent internally and externally about employees who have deviated in material ways from desired values and conduct, and not always take the approach of confidentiality. The bank should seek constructive engagement with supervisors.
- **Sound policies anchored in firm strategy.** The board should be satisfied that the published values

and conduct statements reflect the behaviors the board wants the bank to stand for. The statement of the bank's values and desired conduct should reflect the contribution the bank makes to customers, their lives and businesses, and to the economies in which the bank operates. These statements should be consistent with overall firm strategy. The bank's strategy, business model, target return, incentives, performance assessment, desired values, conduct, and risk appetite should fit together coherently to support the behaviors and outcomes the bank wants. Management and the board need to be aware of strategies and business models being adopted by the bank that may be higher risk for culture or conduct problems, and the board should be satisfied that management has a workable approach to mitigation. If it does not, the strategy or business model should be changed. Vigilance in looking out for undesirable subcultures (including in acquired entities) is important.

GOVERNANCE AND ACCOUNTABILITY

- **Board focus.** The board itself and through its committees should have a clear charter with respect to conduct and values, devote sufficient time to issues, and receive comprehensive information on various internal and external indicators of where the bank

stands. In its interactions with management, the board should look for indications of misalignment or that the desired values and conduct are being consistently lived. The board should look for regular opportunities to reinforce the desired

culture in its communication and actions, collectively and as individuals, and question whether it has sufficient diversity to judge values and conduct.

- **Board and management accountability.** Beyond the board, relevant management bodies and committees should have charters that explicitly refer to responsibility for oversight of culture, values, and conduct issues relevant to the work of the board and its committees. There should be fulsome annual public reporting by the bank and its board on the approach being adopted, how oversight is exercised, and achievements during the year. The CEO's objectives must include conduct, values, and culture matters. There should be a senior

management position responsible for monitoring the reputation of the bank. Key investors should ensure that appropriate accountability mechanisms are in place for both the Board and Executive team.

- **Management championing.** Management should demonstrate a strong commitment to frequent, persistent championing and communication throughout the bank of the desired conduct and values, including through the use of examples relevant to the bank that are refreshed regularly. The Executive team and midlevel managers should be assessed and compensated based in part on how well they promote and assess values and conduct issues in their teams.

PERFORMANCE MANAGEMENT AND INCENTIVES

- **CEO and executive performance.** In determining annual CEO performance and compensation, and in deciding on CEO succession, the board should take account of the CEO relentlessly demonstrating the desired values and culture, effectively overseeing remediation programs, and the CEO effectively engaging his or her direct reports in the process. The board should be satisfied that the incentive regime in practice has material financial consequences for managers (including the CEO) who do not fully champion the firm's values or whose oversight of values or conduct issues is weak.
- **Balanced incentives.** The bank should have a practice of celebrating those who live the firm's values and desired conduct in difficult circumstances, and a practice of material consequences for those who do not, at all levels of the bank hierarchy, including the CEO.
- **Balanced scorecard.** Bank management can usefully apply a balanced scorecard for promotion, and compensation decisions that includes an approximately 50 percent weight for *how* results are achieved, not just for what is achieved. The board should be satisfied that it is generally working in practice. Senior management should implement individual review and assessment of the top 200 to 400 most senior executives (in G-SIFIs or D-SIFIs) by the senior leadership and CEO. For smaller banks the number would be reduced, but would be many more than just the executive committee who report to the CEO. That review should include their alignment with firm values and desired conduct as an important contributor to success. The board should receive and discuss the results of the performance and cultural assessments for the Executive team. Including input into the incentive system from customers and employees (as well as from control, compliance, and risk functions) is essential, and there should be wide and consistent use of 360-degree assessments.

STAFF DEVELOPMENT

- **First-line skills.** Frontline management and leadership should be trained in how to conduct the judgment-based elements of performance related to adherence to firm values and existing codes of conduct, and dealing with identified breaches.
- **Development programs.** Recognizing that “standard” training is ineffective with respect to conduct and values, development programs should be suitably anchored in behavioral testing and case management, and should be self-reinforcing and led by management, not outside consultants.
- **Promotions and hires.** A systematic values and conduct screen should be in place for internal promotions and external hires.
- **Diversity.** Consideration should be given to whether suitable mechanisms are in place to promote broad diversity across the bank (for example, cognitive, background, racial, gender).

THREE LINES OF DEFENSE

- **Robust lines of defense.** Banks should ensure first-line accountability regarding the behaviors, values, and conduct that the bank requires. There needs to be clear accountability for second-line-of-defense activities related to values and conduct, with input from Compliance, Human Resources, and risk functions. The mandate and practice of internal audit as a third line of defense should include assessing adherence to desired values and conduct, with necessary upgrading of their skill set and suitable organizational independence. The various lines of defense (and external audit) should provide senior management and the Board with regular comprehensive and useful reporting to assist in their understanding of the firm’s values and conduct and to assist in governance responsibilities to oversee values and conduct policies and practices.
- **Internal sanctioning.** Banks need an approach to identifying and dealing with areas where achieving desirable culture and conduct may be more difficult (including embedding culture, values, and behaviors among middle managers). There should be evidence of taking action in the event of breaches of principles and standards, not only in the event of legal breaches.
- **Welcoming escalation.** Banks should have in place internal processes and penalties for willful blindness by team members or those with management responsibilities for areas where problems arise. A board should be satisfied that escalation or self-identification of issues is welcomed, and that the revelations of whistleblowers are treated seriously. Staff who raise internal flags that lead to material risks being mitigated should be protected and celebrated.

SUPERVISOR ROADMAP FOR ASSESSING CONDUCT AND CULTURE

- **OVERALL APPROACH.** Since culture, conduct, and values are about behaviors, the authorities should be committed to an approach of using supervision rather than rules and regulation to deal with conduct and values issues. Supervisors should look on cultural questions as root cause analysis and intervene when they see demonstrably serious problems as opposed to making culture a generalized additional supervisory add-on. It is possible for supervisors to have enough information to credibly identify serious problems. In addition to normal supervisory tools, supervisors should be prepared to discuss concerns at an early stage with bank management and board, and use their convening power and moral suasion to deal proactively with practices they see emerging in the market.
- **SUPERVISION VS. ENFORCEMENT.** A supervisor's mandate should be balanced between supervision (prevention) and enforcement (pursuit of wrongdoing). Sufficient "distance" between supervision and enforcement units should be maintained, allowing supervision units to engage with banks on preventive, corrective action.
- **SUPERVISION.** It is essential that there be enough supervision resources, and with the right skill sets/seniority and expert support if needed, to engage constructively with banks on these issues. The main objective should be early problem identification and bank-led corrective action. Conduct and values should be part of mainstream supervisory processes as opposed to a separate add-on.
- **WHAT "GOOD" LOOKS LIKE.** Supervisors should have clear ideas about what it considers good or acceptable with respect to conduct and values, recognizing that firm cultures do differ, and the primary emphasis should be on the effectiveness of the banks' internal governance processes. Banks should be able to demonstrate to supervisors how they meet and monitor their own values and cultures.
- When supervisors' root cause analysis indicates that the culture needs to be assessed, or when supervisors are considering a firm's adherence to its values and conduct, they might consider organizing their work and synthesis around some or all of the following questions (depending on the circumstances), which mirror the roadmap for banks set out above:

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- Are the bank board and senior management adequately focused on understanding the culture that exists and seeing adherence to firm values and conduct as a strategic imperative for the bank?
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- Is this evidenced in practices such as transparency for material transgressions, and owning the responsibility for identifying and dealing with problems?
-

- Are the bank's values and conduct statements taken seriously, and is there consistency among strategy, business model, target returns, risk appetite, incentives, performance assessment, desired conduct, and values to support the behaviors and outcomes the bank wants?
-

- Does the board focus adequately on the embedding of values and conduct by devoting adequate time to these issues, receiving regular comprehensive reporting on these issues from a variety of sources, acting on those as necessary, and itself participating in the internal communication of the desired behaviors?
-

- Do the board and committee charters include oversight of values and conduct?
-

- And how are these matters reflected in the work of the board and its committees?
-

- Do the relevant management bodies and committees have charters that explicitly refer to responsibility for oversight of values, conduct, and culture issues; and is sufficient regular management time, energy, and focus devoted to the matters presented in this report?

Do the CEO and Executive team demonstrate persistent championing throughout the bank of the desired conduct and values?

Are the Executive team and midlevel managers engaged, and are they assessed and compensated on how well they promote and assess conduct and values issues in their teams?

- Do the CEO and Executive team objectives include conduct, values, and cultural matters?

Is an important part of the board's annual evaluation of the CEO and his or her direct reports championing the desired culture and effectively overseeing embedding of the desired conduct and values and any remediation program?

Does the Executive team demonstrate sound understanding of how a chosen remediation program will achieve results, and does it have ways of measuring progress?

Does the CEO and Executive team incentive regime have material financial consequences for managers whose oversight (and living) of desired values and conduct is weak?

- Does the firm celebrate those who live the firm values and desired conduct in difficult circumstances?
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- Is there evidence that the firm is using a balanced scorecard with input from Compliance, Risk Management, and Human Resources, and with significant weight on *how* results are achieved?

Are there robust and comprehensive data to identify alignment with conduct and values by the business and functional units and individuals?

Is the Executive team reviewing in detail the top leadership group, and is there use of tools such as 360-degree assessments?

Are annual appraisals and penalties applied to breaches of cultural norms, values, and principles, and not just to breaking specific rules of legal requirements?

When deficiencies are identified, does the bank look at whether similar issues exist in related areas of the bank?

Is there evidence of robust internal sanctioning, with material consequences for staff in the event of poor alignment with conduct and values?

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- Do the bank's promotion and hiring processes (including for senior management and the CEO) place material weight on compatibility with the desired values and conduct and consistent demonstration of the desired behaviors?

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- Is frontline accountability clear?

Do the frontline management and staff demonstrate understanding of, and the ability to identify, values and conduct issues and act accordingly?

Do frontline management demonstrate the ability to deal with breaches and to assess staff performance?

Are training and development programs anchored in cases relevant to the bank, delivered by management, and regularly refreshed?

-
- Is there a clear second line of defense for values and conduct issues with demonstrated input from Human Resources, Compliance, and Risk Management?

Are second line and third line (that is, internal Audit) providing senior management reporting to assist in understanding where the bank is at on conduct and values issues and how any remediation program is working, and to support governance and oversight responsibilities?

Do Compliance and Human Resources functions have stature and a proactive preventive mindset in dealing with these issues?

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- Is there a culture of welcoming escalation or self-identification of issues, including the expectation of such conduct, and are there sanctions for willful blindness?

Have managers been trained in how to constructively deal with escalation?

Is the board satisfied that whistleblowing is treated seriously, and that staff who raise internal flags are suitably protected and celebrated?

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