SPEECH

Opening Remarks at Reforming Culture and Behavior in the Financial Services Industry: Expanding the Dialogue

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Welcome to the Federal Reserve Bank of New York, and to our third conference focused on culture within the financial services industry. It is encouraging to see all of you in attendance today—in particular, the many non-executive directors, representatives from the investor community, and foreign supervisors who have joined us to help broaden and deepen the dialogue. Thank you for your participation. As always, what I have to say today reflects my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.[1]

The evidence is pervasive that deep-seated cultural and ethical problems have plagued the financial services industry in recent years. Bad conduct has occurred in both investment banking and securities market activities as well as in retail banking.[2] This has eroded the industry's trustworthiness.

This erosion impedes the ability of the financial services industry to do its job. That job is financial intermediation—to facilitate the efficient transfer of resources from savers to borrowers, and to help customers manage the financial risks they face. Verification—whether through regulation or internal controls—is an expensive substitute for trustworthiness. Fines for bad behavior drain resources that could be better used to expand access and improve services, but billions of dollars in avoidable penalties are just the start. The time spent handling a legal crisis is time not spent on more productive pursuits. Moreover, I worry that, in the long term, an industry that develops a reputation for dubious ethics will not attract the best talent.[3]

In contrast, a trustworthy financial services sector will be more productive and better able to support the economy. Reliable financial intermediaries can help increase the flow of credit, promote economic growth and make the financial system more stable. This is why restoring trustworthiness must be the ultimate goal of reforming culture.

The industry's shared norms—its culture—will not change by mere exhortation to the good, whether from me or from the industry's CEOs. In my experience, people respond far more to incentives and clear accountability than to statements of virtues and values. The latter are worthy and necessary, but remain aspirational or even illusory unless they are tied to real consequences.[4] What does it mean for a firm to profess to putting the customer first, if employees are compensated and promoted regardless of what's good for customers? Or, worse, if they are not held to account for activities that can harm customers? If we focus on nothing else in today's conference, let's explore how best to structure incentives and reinforce accountability to align with core purposes and first principles.

To put it very simply, incentives drive behavior, and behavior establishes the social norms that drive culture. If the incentives are wrong and accountability is weak, we will get bad behavior and cultures. This implies a role for both firms and supervisors. Firms need to continually assess their

incentive regimes so that they are consistent with good conduct and culture. When they are not consistent, the incentives need to be changed.

Supervisors should also play a role in assessing firms' incentive structures. For example, they should evaluate:

- How is compensation determined? In particular, is questionable conduct—such as compliance violations—consistently reflected in decisions about compensation and promotion?
- Do risk managers have the appropriate authority to challenge frontline revenue producers and prevent activity that is questionable? When that occurs, are there appropriate negative consequences for the frontline revenue producers?
- When people speak up to point out potential conduct issues, how are they treated? Are they held up as examples to emulate, or are they discouraged or even penalized?

The answers to these questions should indicate whether incentives must be changed in order to foster the appropriate behaviors and culture.

The primary responsibility for reforming culture—and changing incentives—belongs to the industry. However, the industry does not act alone. The public sector can play an important role as well. I'll discuss that issue this morning with my colleagues Norman Chan, chief executive of the Hong Kong Monetary Authority, and Minouche Shafik, deputy governor of the Bank of England. Later this morning another panel will discuss the ways in which supervision can further contribute to improving bank culture.

Let's also consider ways in which new laws or regulations might help—especially to overcome perennial collective action and first-mover problems that are common across the industry. Two years ago I proposed solutions to two such obstacles to reforming culture. First, there should be a database of banker misconduct to combat the problem of "rolling bad apples."[5] Second, a baseline assessment of culture is needed in order to measure progress. I proposed an industry-wide survey, but there may be other good alternatives. Once again, I invite the industry to take the initiative on these issues, and to look to the public sector for support.

I also hope that we will attend to issues that we may have overlooked in our earlier discussions. Gillian Tett of the *Financial Times* argues in her new book, *The Silo Effect*, that the key to understanding any culture is identifying and explaining "social silences"—the issues that are not being discussed.[6]

Where do we encounter those issues in reforming the culture of financial services? One place might be the role of investors in firms. Are their expectations of returns reasonable and consistent with a trustworthy financial services industry? Another place might be the boardroom. Boards should establish and promote a culture based on ethics and respect for law. Have boards risen to this challenge? If not, what's needed? And, going forward, are we thinking hard about how technological change will influence incentives, behavior and culture? We'll hear these issues discussed in several panels today.

These issues require thoughtful reflection by the industry. The need for reflection, though, is not limited to boards, or even to banks. Regulators and bankers alike can benefit from such a habit. In that vein, I want to share with you an everyday checklist proposed by Ignazio Angeloni of the European Central Bank.[7] He has posed six questions that seek to make responsibility for culture both individual and routine:

- Are you doing what you promised to do?

- Are you using your best knowledge and intention in doing it?
- Are you doing what public authorities, superiors, colleagues and business partners expect you to do, and if not why?
- Are you conforming to the mission and the values of your company, as they are publicly stated?
- Will your actions enhance public confidence in your company and in the financial sector?
- Finally, and crucially, would you behave similarly if your actions were publicly observed?

I suspect that while seemingly simple, the discipline of asking ourselves these questions on a regular basis and answering them thoughtfully and honestly may be more challenging, thought provoking and effective than one might initially think.

I thank the staff at the New York Fed who put together today's program, and their colleagues who are in the audience and watching today. The diverse professional training and experience of our staff are among the New York Fed's strengths. Bank supervisors, risk managers, economists, traders and lawyers contribute insights from their respective professions that lead to better outcomes.

In the spirit of learning from other disciplines, I am delighted to introduce today's keynote speaker. Some of you may recall that, two years ago, Sir David Walker opened our first culture conference with the words, "I am grateful to the philosopher Onora O'Neill for reference to very relevant advice."[8] Today we have gone to the source.

Baroness O'Neill is professor emeritus of philosophy at the University of Cambridge, former president of the British Academy, and former chair of the United Kingdom's Equality and Human Rights Commission. She was appointed a life peer and member of the House of Lords in 1999, and, in 2007, was elected an Honorary Fellow of the Royal Society.

Today, Baroness O'Neill serves as a member of the Banking Standards Board. Her 2002 lectures on trustworthiness—reprinted in the book *A Question of Trust*—have been tremendously influential among New York Fed staff working on culture. Baroness O'Neill, the floor is yours.

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[1] Stephanie Chaly, James Hennessy, Jacqueline McCormack, Thomas Noone and Joseph Tracy assisted in preparing these remarks.

[2] William C. Dudley, Ending Too Big to Fail, Remarks at the Global Economic Policy Forum, November 7, 2013.

[3] Thomas C. Baxter, Jr., The Rewards of an Ethical Culture, Remarks at the Bank of England, January 20, 2015.

[4] Daniel Awrey and David Kershaw, "Toward a More Ethical Culture in Finance: Regulatory and Governance Strategies," in Nicholas Morris and David Vines, eds., *Capital Failure: Rebuilding Trust in Financial Services*, 284 (2014) ("While codes of conduct, ethics, and best practice can be drafted and held up as identifying desirable behaviors, the norms these codes purport to reflect may be overpowered by other countervailing influences.").

[5] Mark Egan, Gregor Matvos, and Amit Seru, "The Market for Financial Advisor Misconduct," Working Paper 22050, National Bureau of Economic Research, February 2016.

[6] Gillian Tett, *The Silo Effect*, 45 (2016).

[7] Ignazio Angeloni, Ethics in finance: a banking supervisory perspective, Remarks at the Conference on "The New Financial Regulatory System: Challenges and Consequences for the Financial Sector," September 26, 2014.

[8] David Walker, Trust and Trustworthiness in Banks and Bankers, Remarks at the Federal Reserve Bank of New York, October 20, 2014.