

# SCIENCE-BASED REGULATION IN FINANCIAL SERVICES: FROM DETERRENCE TO CULTURE

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## Summary

Recent regulatory responses to major adverse events have produced a range of responses, encompassing either retrospective reactions or attempts to control future behaviour. This paper juxtaposes the extremes of such responses in two models of how to regulate, which are almost diametrically opposed in their theoretical justifications. The two approaches are the legal model, based on the theory of deterrence, and the cultural model, based on behavioural science. We summarise some major examples of these models from different sectors, notably the Australian response to misconduct by banks (wholly based on deterrence) and the cultural approach to civil aviation safety (involving an open, ‘no blame’ culture that leads to necessary consequences in a ‘just’ culture). Traditional legal and economics-based theories of regulation (especially the theory of deterrence) have been re-thought in some industries and can now be based on the scientific findings from behavioural psychology and how humans behave in groups or organisations. With a focus primarily on financial services, we then discuss developments that are influenced by one or other model, illustrated by increased regulation of financial services managers, increased enforcement, changes to corporate governance, a focus on the purpose of organisations, and attempts by regulators and firms to change the cultures of the latter. We conclude that many recent initiatives conflict because they are unclear whether their underlying model is to blame, sanction, and deter or to support doing the right thing in an open and just culture. This is clear from confusion about the meaning, objectives and effects of terminology around responsibility and accountability. The evidence indicates that the legal model will have limited success in avoiding major disasters, but that the cultural model may be more effective as long as it is pursued under the right conditions. This includes understanding the meaning of accountability and responsibility in new ways. There is a need for detailed analysis of the causes of recurrent problems and of the responses that science indicates would reduce future risk.

## A. INTRODUCTION

This paper aims to examine policy and practice in regulation in relation to attempts to affect behaviour and reduce non-compliance. The issues raised are of general application, but they are illustrated here by particular reference to the financial services sector. We begin by summarising two models of how states try to control the behaviour of companies through regulation. The models are described in Part II and their juxtaposition focuses attention on evidence whether either will succeed in delivering the outcomes and impacts<sup>2</sup> intended. The first model is the traditional one based on enforcing rules based on the theory of affecting future behaviour through deterrence. The second model is the more recent idea of affecting the behaviour of individuals who work in organisations systemically by building on individuals’ inherent ethical values to create an ethical culture. After short statements of each model, they are illustrated by recent examples, namely the Australian response to banking misconduct and the use of ‘open and just culture’ in aviation safety globally.

Part III describes major reforms and initiatives in the past decade based on one or other of the two models. These cover (under the legal model) regulation of senior managers, and use of expressly deterrent sanctions, and (under the culture model) attribution of failures to culture, including culture in

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<sup>2</sup> These terms are examined in G Russell and C Hodges, *Regulatory Delivery* (Hart, 2019).

corporate governance, a preoccupation with organisational purpose, moves toward regulating the culture of financial institutions, organisations' own moves to control their cultures and to rebuild trust from all stakeholders. We then note that any initiative to change culture rests with firms rather than external authorities, and confused signals coming from the Australian Royal Commission on Banking. Part IV calls for rebasing policy and practice on evidence, and analyses the nature of responsibility and accountability before moves to respond to 'culture risk' and emerging analysis of the root causes of specific problems. Part V draws conclusions, including that the evidence indicates that the legal model is unimpressive in controlling behaviour so as to prevent repeated and major lack of protective and compliance behaviour, whereas the culture model may be more effective provided firms and regulators pursue it consistently and do not undermine it by perpetuating conflict with the legal model.

## B. CONTRASTING TWO REGULATORY MODELS

### I. The Legal Model of Regulation Based on Deterrence

The Legal Deterrence Model is familiar to all lawyers<sup>3</sup> and economists,<sup>4</sup> as well as politicians and the media. It postulates that behaviour is controlled through fear of adverse consequences being imposed in response to wrongdoing. The model is based on a linear sequence of events: the existence of legal rules, the identification of breach of a rule (characterised as blameworthy, wrongdoing and misconduct), and the imposition of a sanction for such breach. The *theory* is that imposing a sanction affects future behaviour through a mechanism known as deterrence. The essence of deterrence is based on triggering either the emotion of fear<sup>5</sup> or a utilitarian calculation that the costs would exceed the benefits of committing wrongdoing.

Hence, the imposition of criminal or civil sanctions *after* committing a breach of law are supposed to affect *future* behaviour. Specific deterrence supposedly affects the behaviour of the wrongdoer who is being sanctioned, and knowledge of imposition of the sanction supposedly affects the behaviour of everyone else. It is unclear whether such effects cause complete or only partial deterrence—i.e. complete or partial future compliance. In economic theory, fines and damages have the same effect, forcing internalisation of the cost of the external harm caused by the breach, on the assumption that an individual or corporation makes decisions solely on the basis of rational action.

Frustrations at the limitations of sanctions imposed on corporations have led to requirements or incentives for companies to have internal compliance mechanisms.<sup>6</sup> The theory is that internal training, monitoring, surveillance and disciplining of staff by the company will prevent or reduce them from causing the corporation to commit breaches of law.<sup>7</sup> However, business' systems have been termed

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<sup>3</sup> eg J Bentham, *An Introduction to the Principles of Morals and Legislation* (JH Burns and HLA Hart, eds) (London: Methuen, 1789/1982) 158, referring to 'reformation'.

<sup>4</sup> G Becker, 'Crime and Punishment: An Economic Approach' (1968) 76 *Journal of Political Economy* 169-217; GJ Stigler, 'The Theory of Economic Regulation' (1971) 2 *Bell Journal of Economics and Management Science* 3-21; M Faure, A Ogus and N Philipsen, 'Curbing consumer financial losses: the economics of regulatory enforcement' (2009) 31 *Law & Policy* 161-191.

<sup>5</sup> 'A common theme in these discussions [of the UK finance industry sponsored by the FCA] was fear. Fear of the short-term focus on profit and expectations of shareholders, elevated in importance by financial KPIs and short time horizons for reporting. Fear of regulators, and the potential for inadvertently breaching an obscure rule, making regulation a distraction. And fear of being the first mover to do the right thing and getting left behind a pack not yet willing to make a collective bold and purposeful move.': *Transforming culture in financial services. Driving purposeful cultures. Discussion paper* (Financial Conduct Authority, March 2020), DP20/1.

<sup>6</sup> A leading example is *Evaluation of Corporate Compliance Programs. Guidance Document* (U.S. Department of Justice, updated April 2019).

<sup>7</sup> See eg A Stephan, 'See no evil: cartels and the limits of antitrust compliance programmes' [2010] 31.8 *The Company Lawyer* 3; J Etienne, 'Compliance Theory: A Goal Framing Approach' (2011) 33(3) *Law & Policy* Vol. 305; GC Gray and SS Silbey, 'The other side of the compliance relationship' in C Parker and V Lehmann Nielsen

avoidance rather than compliance departments.<sup>8</sup> Research led by John Armour into compliance systems shows that they result in reduction of fines where they have been in place for a couple of years.<sup>9</sup> No evidence seems to be forthcoming that compliance systems achieve compliance.

### *Brief Criticism of the Model*

There are now multiple arguments against the effectiveness of deterrence as a means of affecting behaviour. Empirical evidence of effects of deterrence across a range of situations is unimpressive.<sup>10</sup> Unless it is used widely and well, deterrence may have negative consequences as well as positive ones.<sup>11</sup> Those running organisations may be unable to control the activities of large numbers of staff, and may merely treat fines and damages as a ‘cost of business’. Sanctions policies may impact more on risk management and compliance activity than preventing occurrence or applying remedial strategies after the event.<sup>12</sup> It is unacceptable in a democracy for governments to rule citizens by fear. We now know many other means of affecting the behaviour of people than through deterrence.

An extensive empirical study found that in post-1970 common law countries corporate regulation is reactive in nature, and has little role to play in moderating future corporate behaviour.<sup>13</sup> In the United States, the practice of holding boards to account, illustrated by decisions of Delaware fiduciary law and federal securities doctrine, has driven courts to place strong reliance on internal reports by legal and compliance personnel.<sup>14</sup> Such personnel were at risk for failure to bring facts to the attention of the board, and boards were at risk for failure to react.

The idea of affecting change through deterrence fails to clarify the mechanism by which change or compliance occurs. Given evidence discussed below on the multiple ways actions can occur, this is profoundly unsatisfactory. The term deterrence also raises a lack of clarity over whether imposition of a sanction is claimed to result in the complete avoidance of future wrongdoing or only some diminution in its incidence or severity. A recent study showed that the type, magnitude and frequency of sanctions imposed by statutory bodies and the courts for insider trading vary significantly between countries, even those with similar laws.<sup>15</sup> This is alongside any evidence that some countries are more effective than others in the outcomes of their sanctions. Given the empirical evidence, continuing use of the term ‘deterrence’ as a goal or justification for practice starts to look like an excuse for an assumed effect,

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(eds), *Explaining Compliance. Business Responses to Regulation* (Edward Elgar, 2012); S Killingsworth, ‘Modeling the message: Communicating Compliance through Organizational Values and Culture’ (2012) 25 *Georgetown Journal of Legal Ethics* 961; K Voss, ‘Preventing the Cure: Corporate Compliance Programmes in EU Competition Law Enforcement’ (2013) 16(1) *EuroparättsligTidskrift* 28; R Steinholtz, ‘Ethics Ambassadors: Getting under the skin of the business’ (2014) *Business Compliance* 03-04, 16; GP Miller, *The Law of Governance, Risk Management and Compliance* (Wolters Kluwer, 2014).

<sup>8</sup> C Mayer, *Firm Commitment: Why the corporation is failing us and how to restore trust in it* (Oxford, Oxford University Press, 2013), 60.

<sup>9</sup> J Armour, J Gordon & G Min, ‘Taking Compliance Seriously’ (2020) 37 *Yale J. on Reg.* at: <https://digitalcommons.law.yale.edu/yjreg/vol37/iss1/1>.

<sup>10</sup> TC Pratt, FT Cullen, KR Blevins, LE Daigle and TD Madensen, ‘The Empirical Status of Deterrence Theory: a Meta-analysis’, in FT Cullen, JP Wright and KR Blevins (eds), *Taking Stock: The Status of Criminological Theory* (New Brunswick, NJ: Transaction Publishers, 2006).

<sup>11</sup> N Gunningham, ‘Enforcement and Compliance Strategies’ in M Cave, R Baldwin, M Lodge (eds), *The Oxford Handbook of Regulation* (Oxford University Press, 2010).

<sup>12</sup> R Baldwin, ‘The New Punitive Regulation’ (2004) 67 *Modern Law Review* 351-383, 373.

<sup>13</sup> L Hail, A Tahoun and C Wang, ‘Corporate Scandals and Regulation’ (ECGI Working Paper 2017) at [http://ecgi.global/sites/default/files/working\\_papers/documents/hail-tahoun-wangunpixelated\\_0.pdf](http://ecgi.global/sites/default/files/working_papers/documents/hail-tahoun-wangunpixelated_0.pdf).

<sup>14</sup> S Gadinis and A Miazad, ‘The Hidden Power of Compliance’, at <https://ssrn.com/abstract=3123987>

<sup>15</sup> L Bromberg, G Gilligan and I Ramsey, ‘[The Extent and Intensity of Insider Trading Enforcement - An International Comparison](#)’ (2017) 17(1) *Journal of Corporate Law Studies* 73-110. This studied 1400 sanctions imposed for the contravention of insider trading provisions during the seven year period from 1 January 2009 to 31 December 2015 in Australia, Canada (Ontario), Hong Kong, Singapore, the United Kingdom, and the United States.

and hence as an assumed justification for the use of punitive sanctions. Continuing to cite ‘deterrence’ as justification and policy avoids confronting the deeper question of how future behaviour is in fact influenced or controlled.

*Example: Reliance on Deterrence in Regulating Australian Financial Services*

In 2018 a Royal Commission on Banking in Australia reported on its inquiry into determining ‘whether any conduct of financial services entities might have amounted to misconduct and whether and conduct, practices, behaviour or business activities by those entities fell below community standards and expectations’.<sup>16</sup> The Royal Commission answered both questions in the affirmative. There had been egregious misconduct by banks and regulators<sup>17</sup> had been ineffective in controlling this.

The Royal Commission was asked supplementary questions by the Treasury after its work had commenced, but the Royal Commission decided to publish its Report soon after completing its work on the ‘misconduct’ issue, without calling for further evidence on issues such as causation or culture, or extending its time for further reflection.

The Royal Commission proclaimed a very clear prescription on how things should be dealt with in future. There should be public denunciation of wrongdoing and public punishment, firmly based on the idea that that would deter future wrongdoing. It stated what it described as six norms of conduct, starting with ‘the law must be applied and its application enforced’.<sup>18</sup> It said that the rule of law requires public denunciation through litigation, rather than ‘negotiated outcomes’<sup>19</sup> on the basis that ‘adequate deterrence of misconduct depends upon visible public denunciation and punishment.’<sup>20</sup> The Royal Commission did not cite empirical evidence that imposing public punishment acts as a deterrent to future wrongdoing, or that deterrence is in fact effective. The focus was firmly on punishment: ‘Rewarding misconduct is wrong. Yet incentive, bonus and commission schemes throughout the financial services industry have measured sales and profit, but not compliance with the law and proper standards.’<sup>21</sup>

The thinking of the Royal Commission was based on its view that the causes of all the misconduct were to do with money and greed:<sup>22</sup>

‘...in almost every case, the conduct in issue was driven not only by the relevant entity’s pursuit of profit but also by individuals’ pursuit of gain, whether in the form of remuneration for the individual or profit for the individual’s business. Providing a service to customers was relegated to second place. Sales became all important.’

The Royal Commission did not, in fact, make a finding on *actual* causation in relation to a range of individual examples of behaviour, but instead treated them all as misconduct. It attributed retrospective *responsibility* for the misconduct on corporate entities and their senior management:<sup>23</sup>

‘There can be no doubt that the primary responsibility for misconduct in the financial services industry lies with the entities concerned and those who managed and controlled those entities: their boards and senior

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<sup>16</sup> *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. Final Report, Volume 1* (Government of Australia, 2019).

<sup>17</sup> The two central regulators were and remain the Australian Prudential Regulatory Authority (APRA) and the Australian Securities and Investments Authority (ASIC).

<sup>18</sup> *Ibid*, section 1.5.2.

<sup>19</sup> *Ibid*, section 3.3. ‘Infringement notices give the regulator a course of action (reportable as an ‘enforcement action’) that is unlikely to have any real deterrent (or punitive) effect’: section 3.5.

<sup>20</sup> *Ibid*, section 3.4.

<sup>21</sup> *Ibid*, section 1.

<sup>22</sup> Royal Commission, section 1.

<sup>23</sup> *Ibid*, section 1.2.

management. .... Everything that is said in this Report is to be understood in the light of that one undeniable fact: it is those who engaged in misconduct who are responsible for what they did and for the consequences that followed.’

## II. The Model of Regulating Organisations through Culture

The Cultural Regulation Model seeks to affect the behaviour of everyone working in an organisation through basing expectations and actions on the shared understanding of ethical values. The purpose of the combined enterprise is seen to be ethical and to have social value.<sup>24</sup> Behaviours demonstrate a shared culture of ethical values, based on innate ability to differentiate between what is morally right and wrong.<sup>25</sup> Relationships between staff internally, and externally between the organisation and its stakeholders (investors, suppliers, customers, communities, regulators, society and physical environment), are all based on evidence that the individuals and the organisation can be trusted. Such evidence is sufficient, transparent and generated over time, including from the responses that occur whether things go well or poorly. An organisation that aims to behave fairly on a holistic basis can be said to have adopted Ethical Business Practice (EBP).<sup>26</sup>

A business that adopts EBP should have the advantage that it deserves the trust of its staff, suppliers, customers, investors, regulators, communities, society. It is likely to perform and innovate well.<sup>27</sup> It will tend to identify and resolve problems quickly. It will have a culture of psychological safety<sup>28</sup> (without blame or fear) where people can admit and examine mistakes and put things right and therefore be accountable. Other aspects of EBP relate to quality of leadership, the existence of shared values and a belief that ethics is everyone’s responsibility.

This approach may seem at first sight impossibly idealistic but is based on extensive scientific evidence of how humans behave.<sup>29</sup> It responds to evidence that the overwhelming majority of people who come to work, and of businesses, do not intend to cause harm to others or break the law.<sup>30</sup> Further, good people may break rules for many reasons. For example, we may make decisions too quickly,<sup>31</sup> persuade

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<sup>24</sup> See J Welby, *Reimagining Britain. Foundations for Hope* (Bloomsbury, 2018); Paul Collier, *The Future of Capitalism* (Allen Lane, 2018).

<sup>25</sup> J Haidt, *The Righteous Mind. Why Good People are Divided by Politics and Religion* (Penguin Books, 2012); EO Wilson, *The Social Conquest of Earth* (New York, Liveright Publishing, 2012).

<sup>26</sup> C Hodges and R Steinholtz, *Ethical Business Practice and Regulation: A Behavioural and Values-Based Approach to Compliance and Enforcement* (Hart, 2017).

<sup>27</sup> See multiple references cited by P Nichols and P Dowden, *Improving Ethical Culture by Measuring Stakeholder Trust* April 10, 2017 by SCCE, at <http://complianceandethics.org>.

<sup>28</sup> AC Edmondson, *The Fearless Organization* (John Wiley & Sons, Inc., 2019).

<sup>29</sup> Accessible texts in extensive literature include: D Ariely, *Predictably Irrational: The Hidden Forces That Shape Our Decisions* (HarperCollins 2008); MH Banaji and AG Greenwald, *Blindspot: Hidden Biases of Good People* (Bantam Books 2016); R Barrett, *The Values-Driven Organization: Cultural Health and Employee Well-Being as a Pathway to Sustainable Performance* (2<sup>nd</sup> ed, Routledge, 2017); MH Bazerman and AE Tenbrunsel, *Blind Spots: Why We Fail to Do What’s Right and What to Do about It* (Princeton University Press 2011); J Haidt, *The Righteous Mind. Why Good People are Divided by Politics and Religion* (Penguin Books 2012); M Heffernan, *Wilful Blindness. Why we ignore the obvious at our peril* (Simon & Schuster 2011); D Kahneman, *Thinking, Fast and Slow* (Allen Lane 2011); AE Tenbrunsel and D Chugh, ‘Behavioral Ethics: A Story of Increased Breadth and Depth’ (2015), 6 *Current Opinion in Psychology* 205.

<sup>30</sup> *Drivers of compliance and non-compliance with consumer protection law: a report by Ipsos MORI commissioned by the OFT* (Office of Fair Trading, 2010); *Business Regulation. Understanding business’ perceptions and behaviour* (Dept for Business, Energy & Industrial Strategy, October 2019) BEIS Research Paper Number 2019/024.

<sup>31</sup> Footnotes 30-36 cite accessible books on these subjects rather than the multiple underlying scientific studies. D Kahneman, *Thinking, Fast and Slow* (Allen Lane, 2011); MH Banaji and AG Greenwald, *Blindspot: Hidden Biases of Good People* (Bantam Books, 2016).

ourselves that we comply when we obviously do not (cognitive dissonance),<sup>32</sup> discard evidence or reasoning that does not support the decision taken,<sup>33</sup> and see what we are focusing on whilst missing other things, however important, and think that all we see is all there is.<sup>34</sup> Hence, it is important to have time to reflect, to ask ourselves and others if our fact-base, analysis and judgment is correct, to check, and be open to challenge.<sup>35</sup> We will make poor decisions when we are under stress, focus just on certain targets, or feel threatened.<sup>36</sup> We are particularly open to following the behaviour of the group in which we function.<sup>37</sup>

Governments have made considerable strides in applying this scientific base to ‘nudging’ citizens, and financial regulators have used the findings in understanding decisions of consumers.<sup>38</sup> But the ‘behavioural insights’ science is not yet embedded in the regulatory context. The FCA described its approach to consumers thus:<sup>39</sup>

We regulate for the real world and wherever possible our approach will be based on what we know about how consumers really behave rather than theory. Behavioural research shows us that consumers are not the economically rational “super consumers” research models might assume. We will continue to base our interventions on how individuals in markets behave in practice, rather than just according to theory.

The ideas are built up from the following propositions. People achieve more when they work collaboratively together (rather than when they are adversarial). Effective relationships are based on trust. Trust is based on evidence that a person (and both sides) can be trusted, i.e. evidence of their behaviour over time. Such evidence is evaluated against humans’ inherent internal ethical framework (unless the person is a psychopath or sociopath). The evidence can include demonstrating what people do, and their intentions in acting, and the outcomes that they produce, not only when things go well but also when things go wrong or mistakes are made (such as do they hide bad things or seek to put them right?). A lot of this evidence comes from existing compliance and regulatory systems (like complying with rules and operating quality systems) but it is increasingly recognised that evidence of the culture of an organisation is profoundly relevant to how they act, and that too much focus on compliance can harm trust. Organisational culture is important because human behaviour is always co-determined by the prevailing social norms.<sup>40</sup>

‘Research on national cultures and nations’ success reached a similar conclusion regarding the potential value of cooperative cultures. ... implying that cooperative national cultures are as important for a country’s performance as corporate cultures are for a firm’s performance.’<sup>41</sup>

A relationship of trust between businesses and regulators is Ethical Business Regulation (EBR). Both sides need to show that they deserve trust. On this basis, relationships between businesses and regulators can be built that are open and problem-solving, based on a conception of regulation involving principles, risk- and outcome-based models, and appropriate intervention when necessary.<sup>42</sup> A business that can

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<sup>32</sup> R Fairman and C Yapp, *Making an impact on SME compliance behaviour: An evaluation of the effect of interventions upon compliance with health and safety legislation in small and medium sized enterprises* (Health and Safety Executive, 2005); M Syed, *Black Box Thinking. Marginal Gains and the Secrets of High Performance* (John Murray, 2015), 80.

<sup>33</sup> J Haidt, *The Righteous Mind. Why Good People are Divided by Politics and Religion* (Penguin Books, 2012).

<sup>34</sup> C Chabris and D Simons, *The Invisible Gorilla* (Crown Books, 2010) (‘they can’t find what they’re not looking for but they won’t find what they’re not looking for, no matter how dangerous it is.’).

<sup>35</sup> A Gawande, *The Checklist Manifesto. How to Get Things Right* (Profile Books, 2010).

<sup>36</sup> D Gentilin, *The Origins of Ethical Failures. Lessons for Leaders* (Routledge, 2016).

<sup>37</sup> MH Banaji and AG Greenwald, *Blindspot: Hidden Biases of Good People* (Bantam Books, 2016), 130.

<sup>38</sup> *Applying behavioural economics at the Financial Conduct Authority* (Financial Conduct Authority, 2013).

<sup>39</sup> *FCA Mission: Our Future Approach to Consumers* (Financial Conduct Authority, 2017).

<sup>40</sup> E Fehr, *Behavioral Foundations of Corporate Culture* (UBS International Center of Economics in Society, November 2018), UNS Center Public Paper 7.

<sup>41</sup> Y Algan & P Cahuc, ‘Inherited Trust and Growth’ (2010) 100 *American Economic Review* 2060; Y Algan & P Cahuc, ‘Trust and Growth’ (2013) 5 *Annual Review of Economics* 521.

<sup>42</sup> G Russell and C Hodges, *Regulatory Delivery* (Hart, 2019).

be trusted will have high compliance and low regulatory risk. It will openly engage with regulators to raise and solve problems. Regulators who understand the scientific basis differentiate in the selection of their responses to organisations and individuals after problems occur depending primarily on segmentation of the motivations and evidence of trust of ‘infringers’ (a development of responsive regulation).<sup>43</sup>

The model is not about regulating culture but regulating *through* culture. In other words, governments, stakeholders and regulators should incentivise and support those involved in enterprises to self-regulate their cultures so as to deliver ethical behaviours, outcomes and impacts through controlling culture risk.

### *Brief Criticism of the Model*

A criticism of ‘regulating through culture’ is that it is merely self-regulation, based on a system of signs within an organisation, or attitudes shared by organisational members that cognitively drive and shape action as matters of individual responsibility, and will inevitably fail.<sup>44</sup> It is argued that the mechanism that produces the systemic meanings is missing and involves great complexity. Scholars point out that information can be actively buried,<sup>45</sup> discredited,<sup>46</sup> or segmented in organisations,<sup>47</sup> hidden through fear,<sup>48</sup> or subject to different understandings of risk and error.<sup>49</sup> They conclude that ‘embracing compliance or safety as part of an organisation’s culture demands an unusually public, active, and continuing commitment.’ A response to the criticism is that the EBP model specifically provides the holistic frameworks that are needed.

A New Zealand scholar has identified examples of self-regulating corporations.<sup>50</sup> But EBR is more than self-regulation. The UK Government suggested in 2018 that the future of regulation involved ‘regulated self-regulation’ and ‘earned recognition’.<sup>51</sup> A review of evidence on designing self- and co-regulatory systems<sup>52</sup> indicated that the involvement of business had a significant effect on effectiveness and compliance.

A recent criticism of classical economic theory by Sir Paul Collier<sup>53</sup> describes ‘economic man’ as presumed to be lazy and self-regarding, in contrast to ‘social man’ who is still rational (i.e. he maximises utility) but gets utility not just from his own consumption but from esteem, and mutual benefit from

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<sup>43</sup> I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, 1992).

<sup>44</sup> R Huising and SS Silbey, ‘From Nudge to Culture and Back Again: Coalface Governance in the Regulated organization’ (2018) 14(91) *Annual Review of Law and Social Science* 114; SS Silbey, ‘Taming Prometheus: talk about safety and culture’ (2009) 35 *Annual Review of Sociology* 341.

<sup>45</sup> SD Sagan, *The Limits of Safety: Organizations, Accidents and Nuclear Weapons* (Princeton, NJ: Princeton Univ. Press, 1993).

<sup>46</sup> D Vaughan, *The Challenger Launch Decision: Risky Technology, Culture, and Deviance at NASA* (Chicago: University of Chicago Press, 1996); D Vaughan, 2003. Chapter 8: history as cause: Columbia and Challenger. *Report of the Columbia Accident Investigation Board* 1:195–204

<sup>47</sup> P Galison, ‘Removing knowledge’ (2004) 31 *Crit. Inq.* 229–43.

<sup>48</sup> D Glassner, *The Culture of Fear: Why Americans Are Afraid of the Wrong Things* (New York: Basic Books, 2010).

<sup>49</sup> GC Gray and SS Silbey, ‘Governing inside the organization: interpreting regulation and compliance’ (2014) 120(1) *American Journal of Sociology* 96–145.

<sup>50</sup> T O’Callaghan, *Reputation Risk and Globalisation. Exploring the Idea of a Self-Regulating Corporation* (Edward Elgar, 2016).

<sup>51</sup> *Regulatory Futures Review* (HM Government, 2017).

<sup>52</sup> K McEntaggart, J Etienne, J Uddin, *Designing Self- and Co-regulation Initiatives: Evidence on Best Practices. A literature review* (Department for Business, Energy & Industrial Strategy, 2019), BEIS Research Paper Number 2019/025.

<sup>53</sup> P Collier, *The Future of Capitalism* (Allen Lane, 2018).

exchange.<sup>54</sup> Collier noted psychologist Jonathan Haidt's findings that humans globally cherish six fundamental values: loyalty, fairness, liberty, hierarchy, care and sanctity.<sup>55</sup> Fairness and loyalty support *reciprocity*, which is what links our fundamental drive for esteem to the shame and guilt we feel when we breach an obligation. Collier argued for 'an ethical capitalism that meets standards that are built on our values, honed by practical reasoning, and reproduced by the society itself', emphasising reciprocal obligations. If the trust-based model works, there will be a 'regulatory dividend':<sup>56</sup>

'Where firms' cultures clearly demonstrate appropriate behaviours and acceptance of responsibility, regulatory authorities can place increased reliance on these firms, enabling a more efficient and effective prioritisation of regulatory resources.'

#### *Example: Open and Just Culture in Aviation Safety*

In the 1980s regulators and airlines realised that if they failed to adopt a radically different approach to achieving safety the incidence of crashes would increase and put an end to public confidence in aviation and hence the industry. They adopted a shared responsibility for what is called an 'open and just culture', which is now enshrined in legislation.<sup>57</sup> The culture-based approach has proved to be overwhelmingly successful in delivering safe outcomes and is regarded as essential throughout the industry.<sup>58</sup> It is built on the recognition that the improving performance of organisations is critical, that this is achieved where all relevant individuals and organisations work together, that people will not share vital information if they fear blame (hence, an open culture),<sup>59</sup> but they will do so in a culture of mutual trust where lessons are learned and necessary actions are taken (a just culture). Just culture involves accountability without blame provided there is ethical intention:<sup>60</sup> 'A wilful violation is not acceptable. An honest mistake is'.<sup>61</sup> This does not mean that firm consequences are never appropriate. The response to intentional wrongdoing (such as an operator lying to a regulator) should be firm, such as losing a licence to operate. Failure to deal with regulators in an open and co-operative manner is a serious issue.<sup>62</sup>

A number of relationships between businesses and regulators are based on EBR or are very close to it. The review of water prices in Scotland is expressly based on EBR and has been a considerable success.<sup>63</sup> The Primary Authority scheme between Local Authorities and businesses in the UK now covers 100,000 businesses and is based on dialogue that raises issues and solves them, significantly reducing adversarialism, concealment, prosecutions and judicial reviews, whilst solving more problems and

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<sup>54</sup> J Norman, *Adam Smith: What He Thought and Why it Matters* (London, Allen Lane, 2018)

<sup>55</sup> J Haidt, *The Righteous Mind. Why Good People are Divided by Politics and Religion* (Penguin Books, 2012).

<sup>56</sup> *Behaviour and Culture of the Irish Retail Banks* (Central Bank of Ireland, 2018).

<sup>57</sup> Commission Regulation (EU) No 691/2010.

<sup>58</sup> The failure of safety and subsequent responses by Boeing are attributable to poor culture in the organisation and an inadequate relationship between corporation and its primary regulator.

<sup>59</sup> S Dekker, *Just Culture. Balancing Safety and Accountability* (Ashgate Publishing 2007), 103; RL Helmreich, 'Building safety on the three cultures of aviation' in *Proceedings of the IATA Human Factors Seminar* (Bankkok, 1999), 39-43; D McCune, C Lewis and D Arendt, 'Safety Culture in Your Safety Management System' in AJ Stolzer, CD Halford and JJ Goglia (eds), *Implementing Safety Management Systems in Aviation* (Ashgate 2011).

<sup>60</sup> 'a culture in which front line operators or others are not punished for actions, omissions or decisions taken by them that are commensurate with their experience and training, but where gross negligence, wilful violations and destructive acts are not tolerated.': Commission Regulation (EU) No 691/2010, art 2(k).

<sup>61</sup> Dekker S. *Just Culture*. Ashgate Publishing, 2007, 15.

<sup>62</sup> An example is the imposition of financial penalties by the Prudential Regulatory Authority in 2017 of £17.85m against The Bank of Tokyo-Mitsubishi UFJ Limited (BTMU) and a fine of £8.925m against MUFG Securities EMEA plc for failing to be open and co-operative with the PRA in relation to enforcement action by the New York Department of Financial Services over pressuring a consultant to water down a supposedly objective report on BTMU's dealings with sanctioned countries. See *Annual Report and Accounts. 1 March 2016-1 March 2017* (Prudential Regulation Authority, 2017).

<sup>63</sup> *Prospects for Prices. Strategic Review of Charges 2012-27. Final Decision Paper* (Water Industry Commission for Scotland, 2020).



improving performance and compliance.<sup>64</sup> A recent study of regulatory approaches by different Trading Standards bodies indicated that ‘support before compliance’ was more effective when compared with more traditional ‘compliance before support’ interventions in relation to both protection and prosperity outcomes.<sup>65</sup>

### III. REFORMS AND INCONSISTENCIES

Having set out the opposing models, we now turn to examining more facts on what has happened in the past decade on policy and practice, focussing on the financial services sector, to see to what extent either or both of the models have been utilised in practice. We find that some developments are influenced by the Legal Model and some by the Culture Model, so we will group major developments under those two headings. There is increasing individual accountability, especially of senior managers, aimed to control and frighten them into compliance with the rules (deterrence in action). There are also attempts to address the institutional conditions for improving organisational culture, such as through defining corporate purpose and governance, and diverse internal but untransparent changes. Overall, a picture emerges of change but the developments that are inspired by one or other model end up being undermined because of the underlying inconsistency caused by the continuation of both models.

#### A. Developments Influenced by the Legal Model

##### *Personal Responsibility: Regulating Managers*

The UK’s Parliamentary Commission on Banking Standards considered that a key problem lay with a lack of individual responsibility of bankers, and that the answer lay in punitive accountability:<sup>66</sup>

##### *The problem*

Too many bankers, especially at the most senior levels, have operated in an environment with insufficient personal responsibility. Top bankers dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision-making. They then faced little realistic prospect of financial penalties or more serious sanctions commensurate with the severity of the failures with which they were associated. Individual incentives have not been consistent with high collective standards, often the opposite.

A package of reforms followed. First, three new criminal offences were introduced in 2013: making false or misleading statements; creating false or misleading impressions; and making false or misleading statements or creating a false or misleading impression in relation to specified benchmarks.<sup>67</sup> Second, a new criminal offence for Senior Managers of reckless misconduct in the management of a bank.<sup>68</sup>

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<sup>64</sup> See *Primary Authority Overview* (Office for Product Standards and Safety, 2019) and [www.gov.uk/guidance/local-regulation-primary-authority](http://www.gov.uk/guidance/local-regulation-primary-authority)

<sup>65</sup> Staffordshire University, ‘Measuring the Impact of Regulation’, study for Stoke-on-Trent and Staffordshire Enterprise Partnership (forthcoming).

<sup>66</sup> *Changing Banking for Good: Report of the Parliamentary Commission on Banking Standards: Volume I: Summary, and Conclusions and Recommendations HC Paper No.27-I, II* Parliamentary Commission on Banking Standards June 2013; *Government Response to Parliamentary Commission on Banking Standards* (HM Treasury and Department for Business Innovation & Skills, 2013), Cm 8661; *Banking reform: a new structure for stability and growth* (HM Treasury and Department for Business, Innovation and Skills, February 2013); *Bank of England response to the Final Report of the Parliamentary Commission on Banking Standards* (Bank of England, 7 October 2013); *The FCA’s response to the Parliamentary Commission on Banking Standards* (FCA, October 2013).

<sup>67</sup> Financial Services Act 2012, ss 89-95; see *Financial Services Act 2012: Summary of consultation responses on draft secondary legislation and Government response* (HM Treasury, January 2013).

<sup>68</sup> Introduced in the Financial Services (Banking Reform) Act 2013, s 36 as taking, or agreeing to the taking of, a decision as the way in which the business is to be carried on, or failing to take steps that could prevent such a decision, while being aware of a risk that the implementation of the decision may cause the failure of the group

Third, a Senior Managers Regime ensures that a named individual is accountable for each key risk in their businesses. The most important responsibilities are assigned to specific, senior individuals.<sup>69</sup> This helps regulators hold these individuals to account in the event of failure. Fourth, a Certification Regime requires relevant firms to assess the fitness and propriety of all employees whose roles mean they could potentially cause significant harm to the firm or consumers. People performing these roles do not need FCA approval before they start their job. However, firms need to check and confirm that these people are fit and proper to perform their role at least once a year, taking into account factors including their level of competence, qualifications and training.

Together, the Senior Manager and Certification Regime (SM&CR), the most senior people, performing Senior Management Functions (SMF, as defined) need approval from the Financial Conduct Authority (FCA) before they can act in that role. Firms must also allocate specific prescribed responsibilities to individual senior managers. Each SMF has a specific set of responsibilities. Every SMF holder must have a statement of responsibility, which clearly sets out their roles and responsibilities. Some firms must have a responsibilities map, which sets out the firm's management and governance arrangements. The responsibilities map must include details on who has overall responsibility for the firm's activities, business areas and management functions and how responsibilities have been allocated.

Fifth, a new set of 'Conduct Rules', with far wider application than previously, set the minimum standards of good personal conduct against which the FCA can hold people accountable. The Senior Manager Conduct Rules only apply to SMF holders, and include:

- You must take reasonable steps to ensure that the business of the firm for which you are responsible is controlled effectively.
- You must take reasonable steps to ensure that the business of the firm for which you are responsible complies with the relevant requirements and standards of the regulatory system
- You must take reasonable steps to ensure that any delegation of your responsibilities is to an appropriate person and that you oversee the discharge of the delegated responsibility effectively.
- You must disclose appropriately any information of which the FCA or PRA would reasonably expect notice.

The Individual Conduct Rules apply to all staff including SMF holders (but excluding staff solely performing support roles, such as cleaning, catering and reception staff), and are that they must:<sup>70</sup>

- act with integrity
- act with due care, skill and diligence
- be open and cooperative with the FCA, the PRA and other regulators
- pay due regard to the interests of customers and treat them fairly
- observe proper standards of market conduct.

Sixth, a new Remuneration Code aimed to more closely align risk and reward in banking. Under this, a greater proportion of senior employees' remuneration is to be deferred. The regulator has power to cancel all outstanding deferred remuneration for senior staff in the event of their banks needing taxpayer support.

The government also introduced general powers in relation to any directors of public companies, citing that 'some senior management individuals' behaviour in looking after the long-term interests of their

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institution, such conduct falling far below what could reasonably be expected of a person in that position, and implementation of the decision causes the failure of the institution.

<sup>69</sup> This replaced the former Approved Persons Regime. The origin of this approach was bewilderment by regulators from 2008 onwards in investigating firms at the extensive lack of clarity within banks over who was responsible for what roles. FSMA ss 59 (functions for which approval is required), 59ZA (senior management functions), 60 (statements of responsibilities) and 60A (vetting of relevant authorised persons), introduced by the Financial Services (Banking Reform) Act 2013. New 'threshold conditions' for persons: The Financial Services and Markets Act (Threshold Conditions) Order 2013/555. See *Regulatory reform: the PRA and FCA regimes for Approved Persons* (FSA, October 2012), CP12/2.

<sup>70</sup> COCON 1.1.2R sets out who COCON applies to. *FCA Handbook Conduct of Business Sourcebook (COBS)* Release 48, March 2020, available at <https://www.handbook.fca.org.uk/handbook/COCON.pdf>.

company has been seriously deficient'.<sup>71</sup> Firstly, sectoral regulators, such as the Pensions Regulator, FCA and PRA, were given additional powers to disqualify directors, either by taking court action or by accepting an undertaking from directors. Secondly, in order to assist in providing compensation to creditors, 'culpable directors' could be pursued where they were responsible for allowing companies to trade wrongfully or fraudulently by allowing a liquidator to sell or assign a civil action to a third party, and could be subject to compensatory awards made by the court at the time a disqualification order was made.

UK firms are subject to Principles for Business, which outline the minimum requirements for conduct that an authorised firm must meet. The Principles are:<sup>72</sup>

1 – Integrity	A firm must conduct its business with integrity.
2 – Skill, care and diligence	A firm must conduct its business with due care and skill, care and diligence.
3 – Management and control	A firm must take reasonable care to organise and control its affairs responsibly and effectively, with adequate risk management systems.
4 – Financial prudence	A firm must maintain adequate financial resources.
5 – Market conduct	A firm must observe proper standards of market conduct.
6 – Customers' interests	A firm must pay due regard to the interests of its customers and treat them fairly.
7 – Communications with clients	A firm must pay due regard to the information needs of its clients, and communicate information to them in a way which is clear, fair and not misleading.
8 – Conflicts of interest	A firm must manage conflicts of interest fairly, both between itself and its customers and between a customer and another client.
9 – Customers: relationships of trust	A firm must take reasonable care to ensure the suitability of its advice and discretionary decisions for any customer who is entitled to rely upon its judgment.
10 – Clients' assets	A firm must arrange adequate protection for clients' assets when it is responsible for them.
11 – Relations with regulators	A firm must deal with its regulators in an open and cooperative way, and must disclose to the FCA appropriately anything relating to the firm of which that regulator would reasonably expect notice.

The FCA has described the basis of the SM&CR thus:<sup>73</sup>

'The basic principle of the SM&CR is about accountability and responsibility. A senior manager has to take responsibility for the activities under their control. Likewise, they should be accountable for that responsibility.

...

Lack of integrity

*There is no universally agreed definition of integrity, but the courts have given useful guidance about what a lack of integrity might include. While it can involve deliberate or dishonest misconduct, it can also occur if someone acts recklessly or their 'ethical compass' points them in the wrong direction to a significant extent. If we find dishonesty or lack of integrity this is usually sufficient for us to prohibit an individual.*

Lack of competence and capability

*Here, the position is more nuanced; competent people make mistakes. In many situations, it would be disproportionate or inappropriate for us to prohibit an individual for a mistake, unless the mistake was particularly serious, or was made repeatedly and/or over a long period of time and never corrected. Where we find no evidence of lack of honesty or integrity, we generally focus on conduct that demonstrates sufficiently serious, repeated, prolonged and/or obvious failures, and measure that conduct against the standards expected of the person at the time and in the circumstances.'*

<sup>71</sup> *Transparency & trust: Enhancing the transparency of UK company ownership and increasing trust in UK business. Discussion paper* (Department for Business Innovation & Skills, July 2013), para 9.3.

<sup>72</sup> FCA Handbook Principles for Business.

<sup>73</sup> *Statement on the Financial Conduct Authority's further investigative steps in relation to RBS GRG* (Financial Conduct Authority, 2018).

An interesting insight into the SM&CR has been debate about whether and how it *would* have worked if it had existed earlier. This arose out of mistreatment of small and medium-sized (SME) customers within RBS's Global Restructuring Group (GRG) from 2008. After an independent review, the FCA concluded<sup>74</sup> that the GRG had not treated customers fairly or reasonably, but found no evidence that RBS artificially distressed and transferred otherwise viable SME businesses to GRG to profit from their restructuring or insolvency. 'It did, however, identify that many aspects of GRG's culture, governance and practices were deficient and that in some areas the inappropriate treatment of customers was widespread and systematic.' The GRG failed to 'recognise the emotional stress suffered by SME customers in difficult personal circumstances, who were not only losing their business and income but, in some cases where it was held as security by RBS, their family home as well.' The FCA 'found no evidence of dishonesty or lack of integrity, specifically that senior management sought to treat customers unfairly' but did find that 'There was a significant tension between GRG's twin commercial and turnaround objectives'.

After extensive concern was expressed at political level<sup>75</sup> and fresh arrangements were made for compensation arrangements,<sup>76</sup> a further statement by the FCA<sup>77</sup> stated that 'the evidence does not suggest that management sought to treat customers unfairly' and that it 'found no evidence that any member of senior management was dishonest or lacking in integrity. In particular, we have not found a credible basis to conclude that senior management sought to treat customers unfairly or behaved in any other way that could call their honesty or integrity into question.'

The FCA noted that the SM&CR now defined the responsibilities and accountability of senior managers in authorised firms in a way which applies to all activities they conduct whether they are regulated activities or not. The most illuminating comments on root causes of the unacceptable conduct were that the GRG had both commercial and turnaround objectives, which conflicted with each other, but staff did not know how to balance them or how to best communicate with customers in financial difficulty.<sup>78</sup>

### *The Persistence of Deterrence*

Examples continue to exist of continuing to base the practice of enforcement and the design of regulation on the theory of deterrence in financial services. The Financial Stability Board (FSB) continues to highlight deterrence as the response to misconduct, as shown in these extracts from 2017 and 2018 reports:

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<sup>74</sup> *Statement on the Financial Conduct Authority's further investigative steps in relation to RBS GRG* (Financial Conduct Authority, 2018).

<sup>75</sup> K Hollinrake MP, *Fair Business Banking for All. How to improve access to justice for businesses in financial services disputes* (Centre for Policy Studies, 2018);

<sup>76</sup> *Increasing the award limit for the Financial Ombudsman Service* (Financial Conduct Authority, March 2019), PS19/8; S Walker, *Review into the complaints and alternative dispute resolution (ADR) landscape for the UK's SME market* (2018), at <http://www.ukfinance.org.uk/review-into-the-complaints-and-alternative-dispute-resolution-adr-landscape-for-the-uks-sme-market/>.

<sup>77</sup> *Report on the Financial Conduct Authority's further investigative steps in relation to RBS GRG* (Financial Conduct Authority, 2019).

<sup>78</sup> *Ibid.* the conflicts were:

- turning customers around and returning them to satisfactory (turnaround objective), and
- generating a return for RBS (commercial objective)

We found that there was a significant tension between GRG's twin commercial and turnaround objectives. ... we do not think that GRG's culture or practice was aligned with its stated objectives and mission statements when it came to SMEs. Senior management set the objectives and mission statements of GRG, but did not have sufficiently effective means of overseeing how staff complied with them in practice for SME customers.'

‘The use of fines and sanctions acts as a deterrent to misconduct, but other preventative approaches are also needed to help mitigate the risk of misconduct through improved governance at individual firms. Addressing the misconduct risk issue calls for a multifaceted approach.’<sup>79</sup>

‘... as noted by Mark Carney, Chair of the FSB, in his July 2017 letter to G20 Leaders, “Fines are essential to punish wrong doing and have an important deterrent effect, but it is insufficient and inefficient to rely solely on ex post penalties of institutions and their shareholders. The resources paid in fines, had they been retained as capital, could have supported up to \$5 trillion in lending to households and businesses.” Fines and sanctions act as deterrents to misconduct.’<sup>80</sup>

The official enforcement policy of the UK’s FCA places deterrence firmly as the basic objective.<sup>81</sup>

‘The overriding principle in our approach to enforcement is a commitment to achieve fair and just outcomes in response to misconduct. Wrongdoers must be held to account and our rules and requirements must be obeyed. Increasingly, severe penalties and sanctions alone are not enough to reduce and prevent serious misconduct. We must increase the likelihood of detection in tandem with efficient investigations.

...  
We aim to make sure the sanction is sufficient to deter the firm or individual from re-offending and deter others from offending. ...

If a firm or individual fails to take steps to address harm or refuses to cooperate fully with us, this will be taken into account and may justify heavier sanctions.’

The FCA certainly levies large fines, as illustrated below.<sup>82</sup> In 2018/19, the FCA issued 265 final notices (243 against firms and 22 against individuals), secured 288 outcomes using enforcement powers (276 regulatory/civil and 12 criminal) and imposed 16 financial penalties totalling £227.3 million. Although the number of fines and prohibitions has fallen in recent years, and the total amount imposed in fines peaked in 2014/15, that total doubled in 2018/19 from the previous year and the average fine imposed rose, indicating continued misconduct viewed as involving some severity. The number of individuals banned remains significant.

Financial year	Fines (£ million)	Number of fines	Prohibitions
2011/12	76.4	59	47
2012/13	423.2	51	45
2013/14	425	46	25
2014/15	1,409	43	26
2015/16	884.6	34	24
2016/17	181	15	23
2017/18	66.9	16	19
2018/19	227.3	16	20

<sup>79</sup> *Stocktake of efforts to strengthen governance frameworks to mitigate misconduct risks* (Financial Stability Board, 2017).

<sup>80</sup> *Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors* (Financial Stability Board, 2018).

<sup>81</sup> *FCA Mission: Our Approach to Enforcement* (Financial Conduct Authority, 2018).

<sup>82</sup> See the FCA’s annual *Enforcement reports*, *annual performance account*. *Annual report 2016/17* (Financial Conduct Authority, 2017). That year included 180 final notices (155 against firms and 25 against individuals), secured 209 outcomes using enforcement powers (198 regulatory/civil and 11 criminal) and imposed 15 financial penalties totalling £181m.

Statements highlighting deterrence sometimes co-exist with different approaches, constituting a source of inconsistency. It is interesting that, in contrast to the policy on *enforcement* just referred to, the FCA's policy statements on its approach to authorisation<sup>83</sup> and supervision<sup>84</sup> do not mention deterrence and instead adopt a more outcomes- and risk-focused approach, with hints of working *with* financial institutions, rather than trying to make them afraid. The policy statement on *authorisation* refers to taking decisions based on a framework with four stages:

‘identify harm or potential harm; diagnose the cause, extent and potential development of harm; assess all our remedy tools and decide which can resolve or mitigate the harm cost-effectively; and evaluate the effectiveness of the remedy.’

It also states that the SM&CR in the banking sector and the Senior Insurance Manager Regime (SIMR) in the insurance sector are designed to:

- encourage a culture in which staff at all levels take personal responsibility for their actions, and
- ensure firms and staff clearly understand and can demonstrate where responsibility lies ...’

The authorisation and approval regime is used ‘primarily as a forward-looking tool in order to prevent harm from occurring; we achieve this by ensuring that all regulated firms and individuals meet common sets of minimum standards at the outset’. It looks at factors including those that ‘have an impact on governance and culture, which are central to improving individual accountability and conduct standards.’ The FCA will refuse to approve an individual if it is not satisfied that ‘they are honest and have integrity, for example, if they have knowingly sold inappropriate services or defrauded customers.’ In assessing a firm, the FCA will ‘look at the drivers of culture of the firm, including its governance, and the priority and importance its business model gives to customers, as this directly links to the firm’s suitability to conduct business.’

In relation to *supervision* of firms, the FCA aims to supervise firms ‘against a framework of principles and rules that represent minimum standards of conduct’ and ‘hold them to account when they fail to meet them.’<sup>85</sup> The FCA states that it aims ‘to assess and address the drivers of culture including firms’ leadership, purpose, governance and approach to managing and rewarding its employees.’ It states its supervisory principles as forward looking, focusing on strategy and business, focusing on culture and governance, focusing on individual as well as firm accountability, proportionate and risk-based, involving two-way communication and being co-ordinated, and putting right systematic harm that has occurred and stopping it happening again.

In continuing to highlight deterrence in enforcement, the financial services sector is out of step with the majority of regulatory regimes for other sectors, at least in the UK. A 2015 study of the enforcement policies of many British regulatory authorities<sup>86</sup> found that the majority no longer rely on deterrence, either at all or primarily, but aim to support businesses to achieve compliance unless the firm has clear criminal intent. One recent example of the alternative approach can be seen in a revised Enforcement Policy issued in December 2019 by the Environment Agency<sup>87</sup> that set out four outcomes it wants to achieve:

- stop illegal activity from occurring or continuing
- put right environmental harm or damage, also known as restoration or remediation
- bring illegal activity under regulatory control, and so in compliance with the law
- punish an offender and deter future offending by the offender and others

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<sup>83</sup> *FCA Mission: Our Approach to Authorisation* (Financial Conduct Authority, 2017).

<sup>84</sup> *FCA Mission: Our Approach to Supervision* (Financial Conduct Authority, 2018).

<sup>85</sup> *FCA Mission: Our Approach to Supervision* (Financial Conduct Authority, 2018).

<sup>86</sup> C Hodges, *Law and Corporate Behaviour: Integrating Theories of Regulation, Enforcement, Culture and Ethics* (Hart Publishing, 2015).

<sup>87</sup> *Environment Agency enforcement and sanctions policy* (Environment Agency, updated 20 December 2019).

In relation to use of fixed monetary penalties and compliance notices the Agency said explicitly that its objective is ‘to achieve a change in the offender’s behaviour’. Although deterrence was included in the text, it was not a major or overarching objective. This is consistent with the radically reformed general Penalties Policy proposed by Richard Macrory in 2005, which relegated deterrence to last position in six objectives:<sup>88</sup>

1. Aim to change the behaviour of the offender;
2. Aim to eliminate any financial gain or benefit from non-compliance;
3. Be responsive and consider what is appropriate for the particular offender and regulatory issue, which can include punishment and the public stigma that should be associated with a criminal conviction;
4. Be proportionate to the nature of the offence and the harm caused;
5. Aim to restore the harm caused by regulatory non-compliance, where appropriate; and
6. Aim to deter future non-compliance.

A contemporary restatement might omit deterrence altogether, given the specification of aiming to change behaviour, but possibly add the protection of society and markets. Some agreements between businesses and enforcers now include specific undertakings to change behaviour, and this can significantly reduce penalties. An example is where Ofwat resolved an enforcement action against Southern Water for major breaches. On the basis that the company committed to ‘ethical business practice’ and repaid £137 million to customers, the regulator reduced the financial penalty from £37.7 million to £3 million.<sup>89</sup>

That approach can be contrasted with six DPAs reached by the SFO with companies since 2015, which have not included any reference to or commitment on *how and what* might change in future systems, internal behaviour and culture. For example, in January 2017, the SFO’s DPA with Rolls-Royce was approved by the court in relation to ‘extensive and systemic bribery and corruption’ payments 1989 to 2013 in India, Indonesia, Thailand, Russia, Nigeria, China, Malaysia.<sup>90</sup> The judge approved a penalty of £497,252,645 (discounted by 50% from £478,165,290 for owning up at the ‘first reasonable opportunity’, with 16.7% for ‘extraordinary cooperation’,<sup>91</sup> plus disgorgement of £258,170,000 gross profit obtained as a result of the criminal misconduct). The judge said that ‘the effect of the DPA is to require the company concerned to become a flagship of good practice and an example to others demonstrating what can be done to ensure ethical good practice in the business world.’<sup>92</sup> However, exactly what was going to be done to achieve any changes in practice or culture was unspecified. Meanwhile, the American head of the Serious Fraud Office complained that the doctrine of ‘identification’ between individuals and a corporation meant that she could ‘go after’ officers of small companies but not large ones.<sup>93</sup>

Overall, these examples reveal inconsistent thinking and practice as between, on the one hand, imposing penalties on the assumption that changes in behaviour and culture will be automatic (produced magically by deterrence) and, on the other hand, positive engagement by some regulators and businesses in exactly what is going to change. The existence of these diametrically opposed approaches can only be inconsistent and confusing for businesses.

### *Deterrence in Australia*

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<sup>88</sup> R Macrory, *Regulatory Justice: making sanctions effective* (HM Treasury, 2006); reprinted in R Macrory, *Regulation, Enforcement and Governance in Environmental Law* (Hart Publishing, 2010).

<sup>89</sup> *Notice of Ofwat’s proposal to impose a penalty on Southern Water Services Limited* (Ofwat, 25 June 2019).

<sup>90</sup> *Serious Fraud Office v Rolls-Royce PLC and Rolls-Royce Energy Systems Inc.* Judgment of Sir Brian Leveson P., 17 January 2017, <https://www.judiciary.gov.uk/wp-content/uploads/2017/01/sfo-v-rolls-royce.pdf>

<sup>91</sup> including investigation, top level commitment to ethics and compliance, compulsory training, improved due diligence, audit, review and suspension of intermediaries, disciplinary proceedings against 38 employees.

<sup>92</sup> Judgment, para 60.

<sup>93</sup> Charles Bott QC and Jonathan Lennon, ‘Corporate Responsibility in Criminal Cases’ <http://blog.carmelitechambers.co.uk/corporate-responsibility-in-criminal-cases/>



It is noted above that the Australian Royal Commission on Banking prescribed a regime based firmly on deterrence and litigation,<sup>94</sup> holding individuals and banks who do wrong to account. Ironically, the Royal Commission made a number of statements about the importance of remuneration, culture and governance (dealing with them in that order). However, it failed to understand their context or to realise the fundamental inconsistency between the deterrence approach and the culture approach. It claimed that the link between the driver of gain and the three issues (remuneration, culture and governance) was ‘Because it is the entities, their boards and senior executives who bear primary responsibility for what has happened, close attention must be given to their culture, their governance and their remuneration practices.’<sup>95</sup> Somewhat more convincing was the following statement:

‘every financial services entity, named in the Commission’s reports or not, must look to its culture. Every financial services entity must look again at the way in which it governs itself and manages not only its employees but also the entities and individuals who act as its intermediaries or are seen by consumers as representing or associated in some other way with the entity. In looking at culture and governance, every entity must consider how it manages regulatory, compliance and conduct risks. And it must give close attention to the connections between compensation, incentive and remuneration practices and regulatory, compliance and conduct risks.’<sup>96</sup>

The Royal Commission accepted that the culture of each entity is unique, that ‘there is no single ‘best practice’ for creating or maintaining a desirable culture’ and that ‘culture cannot be prescribed or legislated’.<sup>97</sup> Culture needs ‘to arise from, and be embedded in, [entities’] DNA.’ The Royal Commission recommended:

**Recommendation 5.6 – Changing culture and governance**

All financial services entities should, as often as reasonably possible, take proper steps to:

- assess the entity’s culture and its governance;
- identify any problems with that culture and governance;
- deal with those problems; and
- determine whether the changes it has made have been effective.

These statements raise fundamental questions about how the culture of an organisation can—and cannot—be affected, to which we turn below.

## B. Developments Influenced by the Culture Model

### *Attribution of Failures to Culture*<sup>98</sup>

In the decade since the 2008 GFC, there have been many statements within the financial services sector that the culture of organisations was a – or indeed *the* – primary cause of the disasters, is the fundamental component in behavioural risk, and remains critical to compliance.<sup>99</sup> Amongst extensive reviews of

<sup>94</sup> In the earlier 5 year period from 1 July 2011 to 30 June 2016, ASIC adopted a pattern of different approaches between four main regulatory areas in the use of enforcement methods (criminal, civil, administrative remedies, enforceable undertakings/negotiated outcomes and public warning notices), influenced by particular enforcement approaches that ASIC took towards certain kinds of misconduct. For example, in the area of market integrity, which includes insider trading, there was a strong emphasis on criminal outcomes. However, in the area of financial services, there was a strong emphasis on administrative outcomes. I Ramsay and M Webster, ‘[ASIC Enforcement Outcomes: Trends and Analysis](#)’ (2017) 35(5) *Company and Securities Law Journal* 289.

<sup>95</sup> *Royal Commission*, above, section 1.2.

<sup>96</sup> *Ibid*, section 6.

<sup>97</sup> *Ibid*, section 6.2.

<sup>98</sup> This section draws on C Hodges, *Law and Corporate Behaviour* (Hart, 2015).

<sup>99</sup> A recent comment by the CEO of Hermes Investment Management was ‘the central cause of the financial crisis was poor culture. A culture in which people were incentivised to increase risk, not manage it. A culture where



individual institutions, Anthony Salz's review of Barclays' business practices found that the bank's culture had predominantly shaped extensive unacceptable business practices, and had favoured 'transactions over relationships, the short term over sustainability, and financial over other business purposes'.<sup>100</sup>

The G30 has issued a sequence of reports on this theme, which show how general thinking has evolved over the past decade. In 2012 the G30 said that behaviour 'appears to be key' and that to achieve the right behaviours a shift is required from the 'hardware' of governance (structures and processes) to the 'software' (people, leadership skills, and values).<sup>101</sup>

'Values and culture may be the keystone of FI governance because they drive behaviors of people throughout the organization and the ultimate effectiveness of its governance arrangements.'

In 2013, the G30 set out 'a new paradigm' of trust-based interaction between public supervisors and boards of major financial institutions across the globe based on clear mutual expectations, with a focus on examining business model vulnerabilities, governance effectiveness, and culture.<sup>102</sup> It noted that much attention had been given to new regulations in areas such as risk-based capital, liquidity, resolution, and risk management. But 'not enough attention had been placed on "softer" issues that rules alone cannot address, such as enhancing supervisor-board relations to improve supervisor and board effectiveness, or on the culture of firms'. It said that the approach should be based on mutual respect and trust, and involve a particular culture.

As at 2013, the G30 made the following recommendations:

1. Supervisors and boards should use a short list of simple descriptors of culture, both "good" and "bad." Using this kind of taxonomy helps boards identify their own FI's unique culture, better understand its benefits and risks, and assess whether mitigants are in place. Boards (and supervisors) should not take it for granted that they know what the culture of the institution is or that desired behaviours are well understood by staff. ...
2. Boards and supervisors should understand that assessing culture is about assessing people, individually and collectively, using so-called "soft" skills (that is, effective leadership and values). Independent board members can be uniquely placed to judge culture because of their senior-level experience in other businesses and other walks of life that they bring to the organization. Supervisors can also assess risk culture if they have the right skills, communication ability, and approach.
3. Boards should determine whether compensation structures and key personnel decisions support the desired culture. Supervisors and boards should discuss how the link between compensation and desired behaviour is working.'

This approach rested on a somewhat simplistic categorisation of an organisation having a (unified) 'good' or 'bad' culture,<sup>103</sup> with primary responsibility for controlling culture resting with boards. Since then many financial supervisors and regulators have increased their efforts to intervene in the culture of financial institutions, and it has been recognised that an organisation may comprise many different cultures.

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client outcomes were secondary to personal outcomes. A culture where effective oversight was a chore, not an imperative. A culture where employees could not bring their whole selves to work, creating discontent and impacting effectiveness. A culture that paid lip service to diversity, but did not embrace it, leading to group think.': Saker Nusseibeh, 'Culture is king' BSB blog <http://bankingstandardsboard.org.uk/culture-is-king-by-saker-nusseibeh-ceo-hermes-investment-management/>

<sup>100</sup> *The Salz Review of Barclays' Business Practices. Report to the Board of Barclays PLC.* (April 2013), para 2.13.

<sup>101</sup> *Toward Effective Governance of Financial Institutions* (Group of 30, 2012).

<sup>102</sup> *A New Paradigm. Financial Institution Boards and Supervisors* (Group of 30, October 2013).

<sup>103</sup> This simple classification was criticised by the UK's Banking Standards Board: 'There is little that is straightforward about culture, and no single 'good' or 'bad' culture that provides a template against which others can be ranked.' *Annual Review 2015/2016* (Banking Standards Board, 2016).

By late 2019, the G30 faced the reality that although ‘much work had been done’ on culture, and banks had ‘shown a clear, rapid, and positive shift in their view of the importance of conduct and culture’, it remained the case that ‘throughout the last decade, the industry has continued to be dogged by failures of corporate culture, conduct, and governance’. The G30 affirmed a ‘key conclusion is that bank conduct and culture are at the centre of a slow, uphill battle for trust.’ There was some recognition that culture existed and was affected *throughout* an organisation. Hence there was a need for culture ‘to become a permanent, fundamental, and integral part of how business is invariably’ rather than a series of ad hoc initiatives; a need for ‘psychological safety’<sup>104</sup> in which employees can speak up, challenge groupthink, and escalate concerns; a need to shift from ‘tone from the top’ to ‘tone from above’ so as to encapsulate imbedding ethical culture throughout an organisation (and capture the role of middle management permafrost);<sup>105</sup> and a need to celebrate role models in behaviour. G30 recorded that there had been significant changes in ‘senior accountability and governance’ yet there remained widespread lack of clarity on how a board should monitor culture issues, and G30 recognised that regulation ‘has a limited role to play given that culture cannot be mandated or defined by rules’. Similarly, many banks had incorporated cultural and behavioural metrics into performance scorecards used in revised remuneration incentive schemes.

G30 displayed a confusion between culture and compliance. Its recommendation that a climate of psychological safety should be created is inconsistent with the recommendation that banks should take disciplinary enforcement action against conduct breaches,<sup>106</sup> given that it also recognised that problems could arise not just from purposeful misbehaviour but also as ‘unintended consequences from decisions and/or lack of skills and knowledge’.

Overall, G30 recognised that a great deal remains to be clarified. The report ended by accepting that ‘A value- and outcomes-based culture may require fundamental shifts in the operating, business, and revenue models of many banks in order to embed these tenets in a sustainable and ongoing manner.’ In other words, organisations need to undergo major shifts in order to take culture seriously. The final word was:

‘Fundamentally, the issue is simple. It is about doing the right things in the right ways – always.’

The conclusion here is that thoughtful policy-makers recognise that organisational culture is critical, but there is a lack of clarity about how to create, sustain, measure, judge, control or regulate culture.

### *Including Culture in Corporate Governance*

Academic thinking about corporations has produced four fundamental and linked shifts. There needs to be, first, a shift from short-term to long-term focus, linked with, second, ideas of sustainability and stewardship, third, a refocusing of corporate governance and, fourth, a redefinition of the purpose of a corporation.

John Kay's report into the effect of UK equity markets on the competitiveness of UK business concluded that short-termism was a problem in UK equity markets, due to the decline of trust and the misalignment of incentives throughout the equity investment chain.<sup>107</sup> The shift from short-termism to long-term

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<sup>104</sup> See AC Edmondson, *The Fearless Organization* (John Wiley & Sons, Inc., 2019).

<sup>105</sup> The changed emphasis on the exclusivity of ‘tone from the top’ was recognised by the Central Bank of Ireland, saying ‘Culture, behaviour and conduct should be driven by standards such as integrity, honesty, skill, care and responsibility. While culture within a firm is influenced by the ‘tone from the top’, management and staff at all levels through their individual behaviours and attitudes influence the culture of an organisation. Every single member of an organisation should be clear as to what is expected of them and the consequences of deviating from such standards.’: *Behaviour and Culture of the Irish Retail Banks* (Central Bank of Ireland, 2018).

<sup>106</sup> Recommendations 8 and 9.

<sup>107</sup> *The Kay review of UK equity markets and long-term decision making: final report* (BIS, 23 Jul 2012).

sustainability was recognised by the 2015 UN Global Compact,<sup>108</sup> which identified sustainability, transparency and voluntary action as the new norms. It set out checklists covering human rights, labour, environment, anti-corruption and safety. The rise of stewardship codes has been described as part of a ‘sustained international push for greater involvement in corporate governance’.<sup>109</sup> The 2012 amendment to the UK Stewardship Code aimed ‘to promote the long term success of companies’ and specifies that activities of investors should include ‘monitoring and engaging with companies on matters such as strategy, performance, risk, capital structure, and corporate governance, including culture and remuneration’.<sup>110</sup> Westbrook has argued that finance is *social*, given that many social goods on which people and their relationships rely (education, health care, employment opportunities and retirement) are provided by the financial system, and that the nature of regulation should be viewed not as permissive but as custodial, involving custody of social assets.<sup>111</sup>

Focusing on the long-term requires changes in corporate purpose, corporate governance and operational incentives. Corporate Governance Codes around the world have been amended to specify that directors should focus on the organisation’s purpose, values and culture. The OECD defined the purpose of corporate governance as ‘to help build an environment of trust, transparency and accountability necessary for fostering long-term investment, financial stability and business integrity, thereby supporting stronger growth and more inclusive societies.’<sup>112</sup> In 2018 the UK’s amended Corporate Governance Code of the Financial Reporting Council (FRC) said:<sup>113</sup>

Companies do not exist in isolation. Successful and sustainable businesses underpin our economy and society by providing employment and creating prosperity. To succeed in the long-term, directors and the companies they lead need to build and maintain successful relationships with a wide range of stakeholders. These relationships will be successful and enduring if they are based on respect, trust and mutual benefit. Accordingly, a company’s culture should promote integrity and openness, value diversity and be responsive to the views of shareholders and wider stakeholders.

The UK Code has set out a clear relationship between the concepts of purpose, values and culture. The organisation’s purpose is achieved through its values, strategy and culture, all of which must be confirmed by its board. The UK Code covers five areas: board leadership and company purpose; division of responsibilities; composition, succession and evaluation; audit, risk and internal control; and remuneration. Adoption of long-term perspectives has been promoted jointly by the FRC and the FCA,<sup>114</sup> and mandated by the UK Investment Association, which said:

‘The role of culture in creating long-term value for a company and its shareholders is increasingly being recognised. There is strong evidence that where employees feel that their company has integrity, companies see an increase in productivity and profitability of the company.’<sup>115</sup>

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<sup>108</sup> *Guide to Corporate Sustainability: Shaping a Sustainable Future* (United Nations Global Compact) (United Nations, 2015).

<sup>109</sup> JG Hill, "[Good Activist/Bad Activist: The Rise of International Stewardship Codes](#)" [Seattle University Law Review, 2017, European Corporate Governance Institute \(ECGI\) - Law Working Paper No. 368/2017](#)

<sup>110</sup> *The UK Stewardship Code* (Financial Reporting Council, 2012).

<sup>111</sup> DA Westbrook, ‘The Culture of Financial Institutions: The Institution of Political Economy’ in G Gilligan & J O’Brien (eds), *Regulating Culture: Integrity, Risk and Accountability in Capital Markets* (Hart, 2013); S Miller, *The Moral Foundations of Social Institutions: A Philosophical Study* (New York, Cambridge University Press, 2010).

<sup>112</sup> *G20/OECD Principles of Corporate Governance* (OECD, 2015). See also *Corporate Governance and Business Integrity. A Stocktaking of Corporate Practices* (OECD, 2015).

<sup>113</sup> *The UK Corporate Governance Code* (Financial Reporting Council, 2018).

<sup>114</sup> *Building a regulatory framework for effective stewardship. Discussion Paper* (FRC and FCA, 2019), DP19/1.

<sup>115</sup> L Guiso, P Sapienza and L Zingales, ‘The Value of Corporate Culture’ (2015) 117(1) *Journal of Financial Economics* 60.

Institutional investors are increasingly demanding long-term sustainability.<sup>116</sup> It has been recognised that business promotion of the profit maximisation model during the past 40 years has ‘often been at the expense of the long-term health of individuals, communities and the environment’, and as a corrective Five Principles for a Purpose Driven Business have been promulgated:<sup>117</sup>

- Honest and fair with customers and suppliers
- A good citizen
- A responsible and responsive employer
- A guardian for future generations
- Has a purpose which delivers long-term sustainable performance.

It is not apparent, however, that directors can ‘govern’ or ‘set’ the values and culture of all staff within an organisation. This reveals an old-fashioned ‘command and control’ assumption about how to affect people’s behaviour. Surely all such staff need to be involved, since the corporate culture will reflect their own, possibly diverse range of values?

The shadow of deterrence, however, remains. The FCA made clear in 2020 that it is building its supervision and enforcement capacity and intends to devote increased resources to more intensive supervision of audit firms and ‘to take enforcement action where it finds infringements’.<sup>118</sup>

### *Preoccupation with Organisational Purpose*

Fernand Laloux’s classic book argued that human consciousness has evolved in a series of stages, at each of which we have had to reinvent new forms of organisation.<sup>119</sup> Further, we are just going through another stage change, from one in which bringing about consensus in large groups is inherently difficult (a pluralistic-‘green’ paradigm) to what Maslow called the ‘self-actualised’ authentic level (a ‘teal’ paradigm). Interestingly, Laloux identified green organisations as those based on empowerment, values-driven culture and inspirational purpose, multiple stakeholder perspectives, and family as the guiding metaphor. For the ‘higher’ teal level, he specifies: taming the fears of the ego, soul searching of who we are and what our purpose in life might be, dealing gracefully with adversity, and striving for wholeness. Breakthroughs in organisations were self-management, wholeness and evolutionary purpose, to operate as living systems.

Realisation has grown that an essential driver of ethical outcomes, behaviour and culture of an organisation is its purpose. Colin Mayer’s research<sup>120</sup> has shown that commercial organisations for most of history have had, and should now have, *social* purpose and long-term sustainability, and he has led a campaign to restore that position.<sup>121</sup> One result has been the inclusion in corporate governance codes

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<sup>116</sup> J Kay, *Obliquity* (Profile Books 2010). See ‘Unilever: In search of the good business’ *The Economist*, August 9 2014, 69; L Fink, ‘Sustainability as BlackRock’s New Standard for Investing’ (2020) at [www.blackrock.com/corporate/investor-relations/blackrock-client-letter](http://www.blackrock.com/corporate/investor-relations/blackrock-client-letter)

<sup>117</sup> *How Can Businesses Contribute To People’s Health? A guide for leaders* (A Blueprint for Better Business and The Health Foundation, 2018).

<sup>118</sup> Speech by David Styles, Director of Corporate Governance of the FRC, reported at ‘UK Financial Reporting Council confirms commitment to enforcement’, 28 Feb 2020, reported at [www.ropesgray.com/en/newsroom/alerts/2020/02/UK-Financial-Reporting-Council-confirms-commitment-to-enforcement](http://www.ropesgray.com/en/newsroom/alerts/2020/02/UK-Financial-Reporting-Council-confirms-commitment-to-enforcement)

<sup>119</sup> F Laloux, *Reinventing Organizations: A Guide to Creating Organizations Inspired by the next Stage of Human Consciousness* (Brussels, Nelson Parker, 2014).

<sup>120</sup> C Mayer, *Firm Commitment: Why the corporation is failing us and how to restore trust in it* (Oxford, Oxford University Press, 2013); C Mayer, *Prosperity* (Oxford University Press, 2019).

<sup>121</sup> *Principles for Purposeful Business. How to deliver the framework for the Future of the Corporation* (The British Academy, 2019). This stated: ‘the purpose of business is to solve the problems of people and planet profitably, and not profit from causing problems’ and that purpose goes before profit. ‘This new corporate purpose should be the reason for a corporation’s existence and its starting point. Profit should then be a product of a

of requirements that boards should ‘promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society’ and ‘establish the company’s purpose, values and strategy, and satisfy itself that these and its culture are aligned’.<sup>122</sup> In other words, it is the job of the board to assess and monitor the organisation’s culture. The views of stakeholders (such as investors, customers or regulators) should be understood and taken into account. ‘Where it is not satisfied that policy, practices or behaviour throughout the business are aligned with the company’s purpose, values and strategy, [the board] should seek assurance that management has taken corrective action.’<sup>123</sup>

However, relying solely on purpose is not enough. Public organisations typically have clear and overwhelming social purpose, but their outcomes, behaviours and cultures frequently fall short. Repeated concerns have been expressed about failures in ethical standards by public service providers.<sup>124</sup> We only need to look at the evidence from a series of disasters in the NHS that have consistently been attributed to cultural failings.<sup>125</sup> The Mafia has purpose (and its origins were even social, in the protection of its flock from other gangs) but the defining characteristic is that its purpose and behaviour is unethical. Values are fundamental and must be defining of both purpose and culture. Jonathan Davidson, the Director of Supervision at the FCA, has used a focus on purpose as a means to affect the culture of banks, rather than vice versa.<sup>126</sup>

Misunderstanding that merely proclaiming a social or ethical purpose for an organisation necessarily and adequately affects the front line culture at day-to-day operational level throughout it. The FSB noted this cleavage:<sup>127</sup>

In many instances of misconduct, there is evidence that the norms and expectations that most strongly influence behaviour within financial institutions can be very different from the institutions’ stated values and policies. Practice does not always follow principle. Word and deed can diverge. The culture of an institution can defeat its formal governance.

These discussions on culture in financial services echo similar debates on the importance of culture in other areas of regulation. For example, the UK water regulator has moved to enshrine ‘purpose, strategy, values and culture’ as an explicit requirement for water companies, given that water is a public good.<sup>128</sup> This was followed by a commitment by water companies to ‘enshrine what it means to operate in the public interest within their business purpose, in line with best practice among leading socially-responsible businesses’.<sup>129</sup>

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corporation’s purpose, but not the purpose of the corporation. The ability to deliver on this purpose would be enabled by a renewed commitment to developing **trust** between corporations and the parties involved or impacted, and an embedded **culture** of ethics and values.’

<sup>122</sup> *The UK Corporate Governance Code* (Financial Reporting Council, 2018). For similar provisions in relation to asset owners and asset managers, see *The UK Stewardship Code 2020* (Financial Reporting Council, 2019).

<sup>123</sup> *Ibid.*

<sup>124</sup> *The Continuing Importance of Ethical Standards for Public Service Providers* (Committee on Standards in Public Life, May 2018).

<sup>125</sup> *Learning from Bristol: The Department of Health’s response to the Report of the Public Inquiry into children’s heart surgery at the Bristol Royal Infirmary 1984-1995*, (2002) Cm 5363; *Independent Inquiry into care provided by Mid Staffordshire NHS Foundation Trust January 2005 – March 2009. Volume I. Chaired by Robert Francis QC*, HC375-I (2010); Dr B Kirkup CBE, *The Report of the Morecambe Bay Investigation* (Department of Health, 2015); *Report of the independent inquiry into the issues raised by Paterson*. Chairman: The Right Reverend Graham James (2020), HC 31.

<sup>126</sup> *Transforming culture in financial services. Driving purposeful cultures. Discussion paper* (Financial Conduct Authority, March 2020), DP20/1, see Introduction.

<sup>127</sup> *Stocktake of efforts to strengthen governance frameworks to mitigate misconduct risks* (Financial Stability Board, 2017).

<sup>128</sup> *Board leadership, transparency and governance – principles* (Ofwat, 2019).

<sup>129</sup> *Public Interest Commitment* (Water UK, 25 April 2019).

## *Moves Toward Regulating Culture of Financial Institutions*

Policy amongst supervisory authorities has continued to focus on the conundrum of how to mitigate misconduct risk and support culture. The FSB produced a toolkit for both supervisors and firms in 2018, which started by talking about deterrent fines (as noted above) but continued.<sup>130</sup>

‘A firm’s culture plays an important role in influencing the actions and decisions taken by employees within the firm and in shaping the firm’s attitude toward its stakeholders, including supervisors and regulators. It also may allow or encourage misconduct by individuals, or large numbers of employees, particularly if instances of misconduct are overlooked. Insisting on clarity in individual responsibilities reflects the priority that the firm places on a culture of good conduct and the need for accountability. By contrast, a lack of clarity in individual responsibilities can make it difficult to hold individuals accountable for their actions and decisions, as well as for reasonably managing the actions and behaviours of those in their area of responsibilities. In some cases, individuals who are not held accountable for their misconduct at one firm surface at another firm (or another division of the same firm) and repeat their misbehaviour – the rolling bad apples phenomenon.’

The toolkit listed 19 tools, under three broad headings, which includes both culture and accountability levers:

### **‘Mitigating cultural drivers of misconduct**

Firms

Tool 1: *Senior leadership of the firm articulate desired cultural features that mitigate the risk of misconduct.*

Tool 2: *Identify significant cultural drivers of misconduct by reviewing a broad set of information and using multidisciplinary techniques.*

Tool 3: *Act to shift behavioural norms to mitigate cultural drivers of misconduct.*

National authorities

Tool 4: *Build a supervisory programme focused on culture to mitigate the risk of misconduct.*

Tool 5: *Use a risk-based approach to prioritise for review the firms or groups of firms that display significant cultural drivers of misconduct.*

Tool 6: *Use a broad range of information and techniques to assess the cultural drivers of misconduct at firms.*

Tool 7: *Engage firms’ leadership with respect to observations on culture and misconduct.*

### **Strengthening individual responsibility and accountability**

Firms and/or national authorities

Tool 8: *Identify key responsibilities, including mitigation of the risk of misconduct, and assign them.*

Tool 9: *Hold individuals accountable.*

Tool 10: *Assess the suitability of individuals assigned key responsibilities.*

National authorities

Tool 11: *Develop and monitor a responsibility and accountability framework.*

Tool 12: *Coordinate with other authorities.*

### **Addressing the rolling bad apples phenomenon**

Firms

Tool 13: *Communicate conduct expectations early and consistently in recruitment and hiring processes.*

Tool 14: *Enhance interviewing techniques.*

Tool 15: *Leverage multiple sources of available information before hiring.*

Tool 16: *Reassess employee conduct regularly.*

Tool 17: *Conduct “exit reviews”.*

National authorities

Tool 18: *Supervise firms’ practices for screening prospective employees and monitoring current employees.*

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<sup>130</sup> *Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors* (Financial Stability Board, 2018). See also *Stocktake of efforts to strengthen governance frameworks to mitigate misconduct risks* (Financial Stability Board, 2017).

Tool 19: *Promote compliance with legal or regulatory requirements regarding conduct-related information about applicable employees, where these exist.*

A related development is a statement of *Principles for Responsible Banking* by the United Nations Environment Programme in July 2019, which sets out a framework for banks to demonstrate that they are sustainable in terms of the UN Sustainable Development Goals and Paris Climate Agreement.<sup>131</sup> A key Principle is to ‘align our business strategy to be consistent with and contribute to individuals’ needs and society’s goals as expressed in the SDGs’. The pack includes a *Reporting and Self-Assessment Template* that may have wider application in EBP/EBR reporting. However, the shift in attention of banking supervisors towards the creation of a global set of ethical standards for bankers is only vaguely defined at best.<sup>132</sup>

The FCA has instituted a *5 Conduct Questions (5CQ)* Programme for institutions, initially focused on correcting bad behaviours and problematic internal processes and procedures by implementing new policies and procedures, training and surveillance, but from 2018 focusing firms on encouraging and protecting positive behaviour. As at 2019, the FCA identified that firms’ treatment of their own staff was a serious issue, and needed to be included in addressing ‘conduct risk’.<sup>133</sup> It also found little evidence of firms restructuring remuneration (such as commission-based) to avoid or manage potential for harm. The FCA specifies these 5 Conduct Questions:

1. What proactive steps do you take as a firm to identify the conduct risks inherent within your business?
2. How do you encourage the individuals who work in front, middle, back office, control and support functions to feel and be responsible for managing the conduct of their business?
3. What support (broadly defined) does the firm put in place to enable those who work for it to improve the conduct of their business or function?
4. How does the Board and ExCo (or appropriate senior management) gain oversight of the conduct of business within their organisation and, equally importantly, how does the Board or ExCo consider the conduct implications of the strategic decisions that they make?
5. Has the firm assessed whether there are any other activities that it undertakes that could undermine strategies put in place to improve conduct?

The Central Bank of Ireland has supported the view that ‘effective culture is essential’ and that the onus is on firms, rather than supervisors, to take responsibility for and drive cultural change from within.<sup>134</sup> ‘However, regulators monitor, assess and influence culture within firms in order to guard against conduct risk and drive better outcomes for consumers.’ It said:

‘Conduct risk can arise from inappropriate, unethical or unlawful behaviour on the part of a firm or its employees. It can be deliberate or inadvertent, and can stem from poor culture, behaviours and practices within the firm. This is why culture within firms is so important, because it drives behaviours and, ultimately, outcomes. The culture of an organisation drives how management and staff act on a daily basis, and is therefore a matter for the firm in the first instance.

Culture should be driven by institutional standards such as fairness, respect, integrity and honesty, which are promoted from the top down, echoed from the bottom up and visible throughout the organisation. Every member of an organisation should be clear on what is expected of them, and the consequences of deviating from such standards.’

The CBI undertook Behaviour and Culture Reviews with Irish banks, which found that all were working to embed a consumer-focused organisational culture, but revealed behavioural patterns in leadership, strategic decision-making and mindset that may jeopardise the successful transition to a consumer-focused culture, and needed to be addressed. It identified risks from the following behavioural patterns:

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<sup>131</sup> UNEP *Principles for Responsible Banking* (United Nations Environment Programme, 2019).

<sup>132</sup> D Zaring, ‘The International Campaign to Create Ethical Bankers’ (2017) 3 *Journal of Financial Regulation* 187.

<sup>133</sup> ‘*Progress and challenges*’ 5 *Conduct Questions Industry Feedback for 2018/19, Wholesale Banking Supervision* (Financial Conduct Authority, 2019).

<sup>134</sup> *Behaviour and Culture of the Irish Retail Banks* (Central Bank of Ireland, 2018).



1. Consumer-focused culture not fully embedded and demonstrated in banks.
2. Executives continue to operate in a ‘firefighting’ mode remnant of a crisis-era mindset.
3. Occasional reversal to directive leadership styles.
4. Concerns around over-optimism.
5. Lack of empowerment and decision-making below executive committee level.

APRA ordered National Australia Bank and ANZ Bank to hold A\$500 million in additional capital until they could produce evidence that they had improved governance and cultural deficiencies.

Although deterrence is embedded firmly within United States political culture, some string statements have been made about the importance of culture by leading officials in financial regulation.<sup>135</sup> Jay Clayton, Chair of the Securities and Exchange Commission, said in 2018 that ‘culture is not an option’ but that:<sup>136</sup>

*‘We do not Expect Perfection; We do Expect Commitment and Action*

A final regulatory observation before I conclude: human beings make mistakes and some break from cultural expectations and legal requirements. We all, including those of us at the SEC, recognize this fact.

When this behavior occurs, key questions a firm should ask include whether the conduct represented a clear breach of the firm’s controls *and* culture as well as whether the firm’s remediation efforts, in addition to any controls enhancements, sent an appropriate and lasting cultural message.’

This is a remarkable statement from a traditionally punitive and unforgiving environment, and has been echoed from the New York Federal Reserve in 2019, which introduced a Culture Initiative stemming from the continuing ‘evidence of deep-seated cultural and ethical failures’ within the financial services industry.<sup>137</sup> The Fed noted that ‘upwards of 70 percent of organisational culture change efforts ultimately fail’ and vowed to draw perspectives from behavioural science. It cited research on how organisations succeed in transition, encompassing three stages of ‘Ending, Losing, and Letting Go’, ‘The Neutral Zone’ and The New Beginning’.<sup>138</sup>

De Nederlandsche Bank (DNB) has had considerable influence on thinking and practice.<sup>139</sup> The approach has been summarised by Wijnand Nuits thus:<sup>140</sup>

‘DNB’s supervision model on behaviour and culture takes group behaviour (instead of individual organisational behaviour) as its departure point. The focus is placed on the following specific behaviours, depending on the applicable context and framework:

- In the context of board effectiveness, it focuses on behaviours with respect to leadership, decision-making and communication.
- In the context of change effectiveness and culture change, it focuses on whether certain group behaviours contribute to or impede organisational transformations, eg relating to the firm’s business model, performance or culture.
- In the context of risk culture, it focuses on how particular groups handle the trade-offs in decision making with respect to risk and reward.’

<sup>135</sup> See Governance & Culture Reform: Archive, Federal Reserve Bank of New York, <https://www.newyorkfed.org/governance-and-culture-reform/archive.html>. See also John C Williams, President and CEO of the Federal Reserve Bank of New York, speech (Getting to the Core of Culture’, Jan 2020 at <https://www.newyorkfed.org/newsevents/speeches/2020/wil200114> : ‘Culture is created—intentionally or otherwise—by the structures, incentives, and behavioral norms that shape our working lives’.

<sup>136</sup> Jay Clayton, Chair of the SEC [www.sec.gov/news/speech/speech-clayton-061818](http://www.sec.gov/news/speech/speech-clayton-061818).

<sup>137</sup> See James Hennessy, ‘We’re Only Human: Culture and Change Management’ of New York Federal Reserve, speech [www.newyorkfed.org/newsevents/speeches/2019/hen190905](http://www.newyorkfed.org/newsevents/speeches/2019/hen190905).

<sup>138</sup> W Bridges, *Managing Transitions: Making the most of change* (Da Capo Lifelong Books, 2017).

<sup>139</sup> A particularly thoughtful and behavioural approach is *Supervision of Behaviour and Culture: Foundations, practice & future developments* (DeNederlandscheBank, 2015).

<sup>140</sup> *Transforming Culture in Financial Services* (Financial Conduct Authority, 2018), DP18/2.



One of DNB's techniques that has been adopted by regulators in other countries, but has caused controversy, is to require a psychologist to be present in Board meetings to identify attendees who are considered to be unacceptable and cultures that are considered to be unethical. This requirement is not seen as a move that treats directors as adults, and has provoked resentment, even if it has raised the profile of the issue of whether an institution has trustworthy people. It may be productive for psychologists to assess applicants for posts before appointments are made. But a complex organisation cannot be run by external monitors or experts in non-core fields. The approach might be seen as an attempt to 'regulate' the culture of banks. But the learning of the science, and of EBP and EBR, is that banks need to create and sustain their own cultures.

### *Financial Institutions' Moves Toward Controlling Culture*

The City of London's City Values Forum issued a set of papers in 2016 that talked of 'positive culture'.<sup>141</sup> In the set, the Chartered Institute of Personnel and Development said 'Even understanding what the culture or sub-cultures really are is challenging, and it is often said that leaders think they know what the culture is, but rarely fully understand it.'<sup>142</sup> The Chartered Institute of Internal Auditors said:<sup>143</sup>

'Organisations are taking an interest in culture like never before; not because they are being forced to, but because they know a healthy culture is integral to their bottom lines, even their survival. Furthermore public and regulatory scrutiny of ethics and behaviour has become even more intense. ... An effective reporting culture depends on, among other things, how the organisation handles blame and punishment. A 'no-blame' culture is neither feasible nor desirable. Most people desire some level of accountability when a mishap occurs, but they also want to ensure people are not scapegoated for things that were not their fault. In a just culture environment the culpability line is more clearly drawn. A 'just culture' is, therefore, not the same as a 'no-blame' culture.'<sup>144</sup>

Annual surveys of UK bankers by the Banking Standards Board reveal ongoing concern over levels of culture and trust, and raise a sequence of important questions, without providing consensus on reliable techniques for improvement. The 2016 report raised the following 'key themes':<sup>145</sup>

#### *a. the alignment of a firm's purpose, values and culture*

Firms varied in terms of their statements of purpose and how they set these out. ... We were particularly interested in whether a firm's purpose and the values it espoused were clearly articulated, understood and perceived by staff to be aligned with the firm's business model and practices – whether the firm's culture and values were intrinsic to its purpose and strategy, or whether they were 'add-ons' and, as such, vulnerable to being forgotten or subsumed if the firm's business strategy or bottom line came under pressure.

Underpinning this was an assumption – and one that we will test – that an organisation that is clear about its purpose and that has a culture and values that reflect and are consistent with its purpose, will be one in which staff are able to feel confident that there is no conflict in principle between what they are expected to do and how they are expected to do it. There would be no mismatch between the pressure to perform and the pressure to behave ...

... It was not always clear from our exercise how cultural variation within firms – whether across geographies or business units or functions – was understood and, as appropriate, managed, reduced or fostered.

#### *b. the difference between a focus on culture, and on compliance*

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<sup>141</sup> *Governing Values: risk and opportunity – a guide to board leadership in purpose values and culture* (City Values Forum with Tomorrow's Company, 2016).

<sup>142</sup> *A duty to care? Evidence of the importance of organisational culture to effective governance and leadership* (Chartered Institute of Personnel and Development, 2016).

<sup>143</sup> *Organisational Culture: Evolving approaches to embedding and assurance* (Chartered Institute of Internal Auditors, 2016).

<sup>144</sup> The current author firmly disagrees with these statements.

<sup>145</sup> *Annual Review 2015/2016* (Banking Standards Board, 2016).

Firms frequently used the word ‘culture’ during their assessment. It was, however, clear that different firms meant different things by this ...

Where failures of compliance and of culture had occurred in the recent past, firms also differed in the extent to which they appeared to recognise and ‘own’ responsibility for this.’

The 2017 Review again reported a mixed picture:<sup>146</sup>

‘There are ... many examples of good practice and positive developments across the sector, and of firms and individuals committed to serving their customers well and raising standards of behaviour and competence. At the same time, however, there are areas where change is needed, and where deep-rooted attitudes and behaviour detrimental to the interests of customers and clients (as well as the majority of people working in banks and building societies) still exist.

Responsiveness, accountability, personal resilience and openness are all areas where, looking across the sector, progress needs to be made. Firms need to speak honestly and bravely about what they need to do, what they are doing, why they are doing it and how they will know they are succeeding. And they need to do this not just around the board table or in senior executive meetings, but with everyone in the firm; and everyone in the firm needs to be able to see that executives and board members live up to what they say they are trying to do. Actions speak louder than words; they also need to be saying the same thing.’

Although many firms are reported to have embarked on work to change their cultures, including creating a culture of challenge, escalation and providing a safe environment for staff to speak up, they have found it challenging to find appropriate ways of measuring culture.<sup>147</sup> Further, it was unclear to what extent the SM&CR regime had been linked to culture.<sup>148</sup> In other words, the regime might be a barrier. Much of the focus has been on trying to address a firm’s culture of risk-taking, but this tends to ignore the critical role of systemic, structural factors in shaping individual firms’ internal cultural norms and attitudes toward legitimate business conduct.<sup>149</sup>

The FCA has been notably less prescriptive than some authorities in attempting to ‘regulate’ culture. It has contributed two sets of essays by bankers themselves and others, on what they are doing in relation to culture in 2018<sup>150</sup> and in 2020 on the issue of embedding purpose.<sup>151</sup> But the implications of how to embed ethical culture in the structure and operations of a modern corporation, and exactly what needs to change, have not been widely understood. The FCA’s 2018 discussion paper on culture begins by noting that in the 10 years since the financial crash,

‘record fines, increasing investigations and an expanding compliance industry’ have failed to curb misconduct. It then asks: ‘Why? What have we not learned?’<sup>152</sup>

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<sup>146</sup> *Annual Review 2016-2017* (Banking Standards Board, 2017). Only 65% of employees agreed that there was no conflict between their firm’s stated values and the way that the firm does business. 14% did see such a conflict, with this being more marked in systemically important institutions, and the remainder neither agreeing nor disagreeing. Nearly three in ten employees across all firms would be worried about the negative consequences for them if they raised concerns, and one in seven do not feel comfortable challenging a decision made by their manager. One-third said that people in their organisation become defensive when their views are challenged. Almost three in five employees across all firms said they felt under considerable pressure to perform at their work, and more than a quarter said that working in their firm has a negative impact on their health and wellbeing. 12% saw instances where unethical behaviour was rewarded, 13% saw it as difficult to get ahead in their careers without flexing their ethical standards, and 18% saw people in their organisation turn a blind eye to inappropriate behaviour.

<sup>147</sup> *Senior Managers and Certification Regime Banking Stocktake Report* (Financial Conduct Authority, 2019).

<sup>148</sup> *Ibid.*

<sup>149</sup> ST Omarova, ‘[Ethical Finance as a Systemic Challenge: Risk, Culture, and Structure](#)’ (2018) 27(3) *Cornell Journal of Law and Public Policy* 797.

<sup>150</sup> *Transforming Culture in Financial Services* (Financial Conduct Authority, 2018), DP18/2.

<sup>151</sup> *Transforming culture in financial services. Driving purposeful cultures. Discussion paper* (Financial Conduct Authority, March 2020), DP20/1.

<sup>152</sup> *Transforming Culture in Financial Services* (Financial Conduct Authority, 2018), DP18/2.

That rhetorical question was clearly intended to focus on the need to address the culture of financial institutions. In the 2018 publication, various contributors to the discussion paper note that traditional ‘economic tools of influence, such as rules and enforcement ... are ineffective or create unintended consequences’<sup>153</sup> and that ‘regulators are moving away from using strictly rule-based methods and incorporating behavioural science for assessing, understanding and influencing behaviour’<sup>154</sup>.

There is a clear contradiction between the messages of the more enlightened essays that a rules-based approach and a punitive enforcement approach do not work, and the references to the 5 new Conduct Rules and the Senior Managers and Certification Regime (SMCR). If rules do not work, why are more rules being made aimed at the heart of senior managers’ behaviour, and why are they being threatened with criminal penalties for the behaviour of others that they could not control? An informative essay by the FCA’s John Sutherland explains how the FCA interrogates firms and senior managers about the extent to which they take care to ensure that the Prescribed Responsibilities are met, including the adoption and development of the firm’s culture. But if there is no agreed methodology by which a firm’s culture can best be adopted or developed (if there were, this discussion paper would not be necessary), how can the FCA demand or rate answers to such questions? This is not to criticise the good work done in requiring firms to have better procedures for selecting staff (Sutherland gives the example of a director being appointed because he belonged to another board or golf club). But there is a strong feeling that the regulator’s actions are driven by frustration that leads to an attempt to run the business, through adopting old ‘command and control’ methods that have long been discredited.<sup>155</sup>

Virtually all of the essays written by people in financial institutions show that they grasp that reality and illustrations are given of how they have changed the way how their firms operate so as to support an ethical culture and ethical behaviours. There is in fact a great deal of change and even experimentation by firms in relation to their cultures, but this is not widely known. It does not appear that any of these changes have been effected as a result of direct regulatory interventions in relation to creation of an ethical culture, or how it should be done, let alone supervised. These points are illustrated in the following extracts:<sup>156</sup>

Nationwide Building Society: a culture of care, ‘in which we have sought to reduce or eliminate those things that can compete with making caring and thoughtful decisions – such as forced performance rankings or individual financial inducements linked to performance targets.’ ‘Care comes from the heart. Care cannot be imposed by law..’

Monzo Bank Ltd: ‘we set culture through what we do as leaders, the way we talk about our customers, the behaviours we reward or punish. .. Our compassion comes through in the quality of service our customers get. ... for us there’s no inherent tension between short-term success and long-term goals. Ours is a long-term mission and, put simply, putting customers at risk of harm would never be a price worth paying to make short-term profits. To grow and be successful, we need to attract great people, and build trust with our customers. That takes years to cultivate and we could lose it in a second.’

Metro Bank: As Peter Drucker said: “culture eats strategy for breakfast.” Our culture, built on transparency, fairness and customer focus, sits at the heart of how we deliver our vision and strategy. It is the essence of who we are. And it starts and ends with our people. ... Culture needs to be pervasive, immersive, and consistent and align colleagues to the outcomes that you want to deliver to your customers. In our case, this means creating an amazing customer experience across every channel. People sometimes look for cultural silver bullets and quick fixes. There aren’t any. Pop up banners and posters espousing “integrity” “respect” and “ethics” to signal the organisation’s values have no impact. A million small things sit at the heart of culture.

Investec Group: a self-reflective capability that depends to a large degree on the extent and quality of dialogue that takes place in the organisation around issues of meaning. An Organisation Development team distinct from

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<sup>153</sup> Ibid, 11.

<sup>154</sup> Ibid, 13.

<sup>155</sup> Roger Steare stated that the coercive regulatory culture has failed to prevent systemic fraud (DP, p 66).

<sup>156</sup> Similar contributions were made by Credit Suisse and BNL Paribas.

HR, whose purpose is to ensure that dialogue takes place, is sufficiently self-reflective and robust, and pays obeisance to the values.

TSB Bank: ‘...when we set up TSB in 2013 we wanted to build a different kind of bank; we wanted to reset the relationship between banks and society by creating a bank that put customers and communities before short-term profit. ... we made the bold decision to scrap all sales targets, sales linked rewards and access to comparative sales data at a branch and area director level. Instead, we chose to reward our staff based purely on the service they give to customers.

... [we] made all our employees Partners in the business. ...

At TSB, Partner performance is assessed by reviewing their skill, attitude and behaviour, as opposed to any outputs. And we don’t measure customer service in just one way. At a Partner level we conduct testing to ensure that our customers receive the best outcomes from Partner interactions. We also measure the effectiveness of complaints handling and take on board customer feedback. When it comes to deciding the TSB Award pool these measures are scaled up to focus on fair customer outcomes, Net Promoter scores and complaints resolution across the whole bank. This ensures that customer outcomes are at the centre of what we do, and builds a culture whereby everyone at the bank works in partnership to deliver great service for our customers.

By rebalancing reward at TSB to focus on customer outcomes, we believe that we have delivered a model where every Partner is invested in the long-term, sustainable growth of our bank, rather than short-term risk taking. We believe that we have developed a culture based on what customers truly want from their bank.

And our approach is working. ... customers are voting with their feet to join TSB, with 1,000 new customers opening accounts every day.

UBS Investment Bank: Employees had to see that culture was being taken seriously, was being role modelled by the most senior leaders in the firm and that there was alignment across UBS. ... But providing purposeful leadership that models the culture from the top down is not enough. You cannot simply order people to embrace culture. It has to be owned and driven at all levels. A strong, sustainable culture only occurs when people’s experiences in the way the organisation works together consistently match the defined values and behaviours. This requires a culture of ownership.

So each Business Division created its own initiatives and activities to embed the pillars, principles and behaviours.

The Monetary Authority of Singapore (MAS) has been engaging with the idea of culture in banks, and the need to change cultures. MAS set up a Culture Steering Group in 2019, involving 14 specially selected banks (unclear which, possibly local banks rather than international ones). By spring 2020, four meetings of the Steering Group had been held. It includes heads of ‘front line’ customer management, compliance, HR and others. However, the Group does not include CEOs, which may be relevant since the evidence is that CEOs and boards have to be fully behind culture, or it will not work.<sup>157</sup>

MAS published in March 2019 a survey of changes to the remuneration structures of various banks.<sup>158</sup> It sets out an expectation that performance evaluation should include both ‘what’ people do and ‘how’ they do it. The inclusion of the ‘how’ part is a highly significant change away from mere *ex ante* incentivisation, and sole focus on profit and targets, although those are clearly expected to continue as part of ‘what’ elements. However, the document does not identify exactly what techniques and approaches are used by banks, and with what results: perhaps it is too soon for this, but evaluation of outcomes and best practice is important.

In February 2020, MAS published an Information Paper on *Private Banking Sales and Advisory Practices* that reported on inspections of private banks,<sup>159</sup> and included a number of illuminating comments on the observations of front office staff, who reported lacking clarity on KPIs, being under pressure to achieve targets, relationship managers being appraised against their peers, lack of familiarity

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<sup>157</sup> R Barrett, *The Values-Driven Organization: Cultural Health and Well-Being as a Pathway to Sustainable Performance*, 2nd ed (Routledge, 2017); C Hodges and R Steinholtz, *Ethical Business Practice and Regulation: A Behavioural and Values-Based Approach to Compliance and Enforcement* (Hart, 2017).

<sup>158</sup> *Incentives Structures in the Banking Industry – Fostering Sound Behaviour and Conduct* (Monetary Authority of Singapore, 2019).

<sup>159</sup> *Private Banking Sales and Advisory Practices* (Monetary Authority of Singapore, 2020).

with or understanding of how values translated into day-to-day behavioural expectations, over-focus on demerit points and penalties rather than positive behaviour reinforcement.

These developments are still at an early stage. A survey of executives in 2019 found that although 93% said they were attuned to company culture issues and had taken steps to strengthen it, 69% did not actually measure culture.<sup>160</sup> Equally, the survey found that while executives thought they were clearly communicating with employees, just 51% of employees said they understood the vision and goals of their organisation. While 76% of executives said their organization had a defined value system that was understood and well communicated, 31% of employees believed this to be true. The UBS ‘rogue trader’ Kweku Adoboli who lost the bank £1.4bn, told the BBC that banking was still riven by conflicts of interest and that traders were pushed to make profits ‘no matter what’, so ‘It could happen again’.<sup>161</sup>

It is salutary to note to what extent fear remains *within* organisations. This was highlighted by Jonathan Davidson summarising discussions with stakeholders reported in the FCA’s 2020 discussion paper on culture and purpose:<sup>162</sup>

‘A common theme in these discussions was fear. Fear of the short-term focus on profit and expectations of shareholders, elevated in importance by financial KPIs and short time horizons for reporting. Fear of regulators, and the potential for inadvertently breaching an obscure rule, making regulation a distraction. And fear of being the first mover to do the right thing and getting left behind a pack not yet willing to make a collective bold and purposeful move.’

Overall, financial institutions have clearly made sometimes considerable changes in their approaches to one or several of the issues of purpose, compliance, recruitment, training, remuneration and culture. There is extensive diversity but a lack of transparency and clarity on what is done and how effective it is. There remains a need for sharing of experience, evaluation of experience and clarifying best practice.

## IV. DISCUSSION

### Rebuilding Trust from All Stakeholders

Francis Fukuyama identified the importance of trust in his 1995 book, which identified that high-trust societies with plentiful social capital—Germany, Japan and the United States—had the ability to create large, successful and resilient private business organisations.<sup>163</sup> He noted that both communities and commerce were more successful if built on cultural roots evidencing the social virtues (including honesty, reliability, cooperatives, and a sense of duty to others).

A 2012 meta-review of the evidence suggested that higher levels of integrity are correlated with commercial success in many contexts.<sup>164</sup> The case that corruption is bad for markets and businesses was developed in a more recent paper, drawing together a range of evidence.<sup>165</sup> Nicholls’ overview review also found that the weight of evidence suggests that higher levels of integrity are correlated with commercial success in many contexts.<sup>166</sup> Companies with anti-corruption programmes and strong

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<sup>160</sup> *Return on Culture. Proving the connection between culture and profit* (Grant Thornton and Oxford Economics, 2019).

<sup>161</sup> Kamal Ahmed, ‘UBS rogue trader: ‘It could happen again’ BBC, 1 August 2016.

<sup>162</sup> *Transforming culture in financial services. Driving purposeful cultures. Discussion paper* (Financial Conduct Authority, March 2020), DP20/1.

<sup>163</sup> F Fukuyama, *Trust: The Social Virtues and the Creation of Prosperity* (Penguin Books, 1995).

<sup>164</sup> PM Nichols, ‘The Business Case for Complying with Bribery Laws’ (2012) 49(2) *American Business Law Journal* 325-368 at <http://onlinelibrary.wiley.com/doi/10.1111/j.1744-1714.2012.01134.x>/ abstract

<sup>165</sup> M Jenkins, *The relationship between business integrity and commercial success* (Chr. Michelsen Institute, 2017). U4 Helpdesk Answer 2017:14.

<sup>166</sup> PM Nichols, ‘The Business Case for Complying with Bribery Laws’ (2012) 49(2) *American Business Law Journal* 325.

ethical guidelines are found to suffer up to 50% fewer incidents of corruption than those without such programmes, indicating integrity programmes are an effective means of minimising losses which can be incurred as a result of corruption, especially where it is detected.<sup>167</sup> U.S. scholars asserted in 2017 that strengthening ethical culture makes a firm more competitive and this could be done by measuring stakeholder trust.<sup>168</sup>

Exclusive focus on shareholder wealth creates organisations typically characterized by a culture of compliance and control.<sup>169</sup> Employees, particularly those with high aspirations, are likely to find the culture constraining, and the culture itself tends to stifle innovative thinking from the lower ranks.<sup>170</sup>

Kay observed that the most profitable businesses are not the most profit-oriented and argues that happiness is not achieved through the pursuit of happiness ('Happiness is not a red Ferrari').<sup>171</sup> Similarly, Mayer points out that shareholder value is an outcome, not an objective.<sup>172</sup> An analysis of 57 US and 15 non-US companies found that those that operate as 'firms of endearment' by adopting a comprehensive approach to delivering the needs of *all* their stakeholders had financial results far better than the S&P rate over 15 years.<sup>173</sup> McKinsey's 2017 study of 600 firms showed that those who focused on the long-term clearly performed better than those chasing short-term profit, with average economic profit 81% better.<sup>174</sup>

A widening of issues to which corporations need to be concerned has been occurring for some time, such as sustainability, community, environment and human rights issues required by the ten principles of the United Nations Global Compact,<sup>175</sup> the OECD Guidelines for Multinational Enterprises,<sup>176</sup> the ISO 26000 Guidance Standard on Social Responsibility,<sup>177</sup> and the United Nations Guiding Principles on Business and Human Rights.<sup>178</sup>

A major Statement on the Purpose of a Corporation was issued in August 2019 signed by 181 CEOs of major U.S. corporations.<sup>179</sup> This constitutes a highly significant restatement, moving away from a profit-maximising capitalist model to a purpose-driven stakeholder-regarding model encompassing customers, staff, suppliers, communities and long-term value for shareholders. It states:

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<sup>167</sup> PricewaterhouseCoopers. 2007. *Economic Crime: People, Culture and Controls: The Fourth Biennial Global Economic Crime Survey*, 33. [https://www.whistleblowers.org/storage/documents/pwc\\_survey.pdf](https://www.whistleblowers.org/storage/documents/pwc_survey.pdf).

<sup>168</sup> P Nichols and P Dowden, *Improving Ethical Culture by Measuring Stakeholder Trust* (SCCE April 10, 2017) at <http://complianceandethics.org/improving-ethical-culture-by-measuring-stakeholder-trust/>

<sup>169</sup> J Buckingham and V Nilakant, 'Introduction: Globalizing Corporate Social Responsibility—Challenging Western neo-Liberal Management Theory' in J Buckingham and V Nilakant (eds), *Managing Responsibly. Alternative Approaches to Corporate Management and Governance* (Gower, 2012).

<sup>170</sup> CC Manz and HP Simms, *Business Without Bosses* (New York, John Wiley, 1993).

<sup>171</sup> J Kay, *Obliquity* (London, Profile Books, 2010). See 'Unilever: In search of the good business' *The Economist*, August 9 2014, 69.

<sup>172</sup> C Mayer, *Firm Commitment: Why the corporation is failing us and how to restore trust in it* (Oxford, Oxford University Press, 2013), 167.

<sup>173</sup> R Sisodia, J Sheth and D Wolfe, *Firms of Endearment. How World-Class Companies Profit from Passion and Purpose* 2<sup>nd</sup> edn (Upper Saddle River, NJ: Pearson Education, 2014).

<sup>174</sup> D Barton, J Manyika, T Koller, R Palter, J Godsall and J Zoffer, *Measuring the Economic Impact of Short-Termism* (McKinsey & Company, 2017).

<sup>175</sup> <https://www.unglobalcompact.org>. *Guide to Corporate Sustainability: Shaping a Sustainable Future* (United Nations). See *Impact. Transforming Business, Changing the World. The United Nations Global Compact* (United Nations DNV GL, 2015).

<sup>176</sup> <http://www.oecd.org/daf/inv/mne>.

<sup>177</sup> <http://www.iso.org/iso/home/standards/iso26000.htm>.

<sup>178</sup> J Ruggie, *The Special Representative of the Secretary-General, Report of the Special Representative of the Secretary-General on the issue of human rights and transnational business corporations and other business enterprises, Guiding Principles on Business and Human Rights: Implementing the United Nations "Protect, Respect and Remedy" Framework*, A/HRC/17/31, 21 March 2011.

<sup>179</sup> [www.opportunity.businessroundtable.org/wp-content/uploads/2019/09/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures-1.pdf](http://www.opportunity.businessroundtable.org/wp-content/uploads/2019/09/BRT-Statement-on-the-Purpose-of-a-Corporation-with-Signatures-1.pdf)

Americans deserve an economy that allows each person to succeed through hard work and creativity and to lead a life of meaning and dignity. We believe the free-market system is the best means of generating good jobs, a strong and sustainable economy, innovation, a healthy environment and economic opportunity for all. Businesses play a vital role in the economy by creating jobs, fostering innovation and providing essential goods and services. Businesses make and sell consumer products; manufacture equipment and vehicles; support the national defense; grow and produce food; provide health care; generate and deliver energy; and offer financial, communications and other services that underpin economic growth.

While each of our individual companies serves its own corporate purpose, we share a fundamental commitment to all of our stakeholders. We commit to:

- Delivering value to our customers. We will further the tradition of American companies leading the way in meeting or exceeding customer expectations.
- Investing in our employees. This starts with compensating them fairly and providing important benefits. It also includes supporting them through training and education that help develop new skills for a rapidly changing world. We foster diversity and inclusion, dignity and respect.
- Dealing fairly and ethically with our suppliers. We are dedicated to serving as good partners to the other companies, large and small, that help us meet our missions.
- Supporting the communities in which we work. We respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.
- Generating long-term value for shareholders, who provide the capital that allows companies to invest, grow and innovate. We are committed to transparency and effective engagement with shareholders.

Each of our stakeholders is essential. We commit to deliver value to all of them, for the future success of our companies, our communities and our country.

This is a remarkable switch. It rejects the historical ‘maximise shareholder value’ imperative of corporations, assumed by economic theory, and declares that the objective is to maximise the interests of *all* stakeholders, not just contributors of capital.

### **The Initiative to Change Culture Rests with Firms**

The Australian Royal Commission misunderstood the point and called for regulators to *supervise* culture:<sup>180</sup>

There is, therefore, an important role for regulators to supervise culture – that is, to:

- assess the entity’s culture;
- identify what is wrong with the culture;
- ‘hold up a mirror’ to the entity,<sup>181</sup> and educate the entity about its own culture;
- agree what the entity will do to change its culture; and
- supervise the implementation of those steps.

It also said:

#### **Recommendation 5.7 – Supervision of culture and governance**

In conducting its prudential supervision of APRA-regulated institutions and in revising its prudential standards and guidance, APRA should:

- build a supervisory program focused on building culture that will mitigate the risk of misconduct;
- use a risk-based approach to its reviews;
- assess the cultural drivers of misconduct in entities; and
- encourage entities to give proper attention to sound management of conduct risk and improving entity governance.

<sup>180</sup> Ibid, section 6.

<sup>181</sup> Exhibit 7.152, April 2018, Refocusing Risk Culture Pilot Reviews, 3.



These conclusions were misunderstandings. The reality is that the ability to create and sustain a culture of a firm – and hence the responsibility of creating an ethical culture, rests firmly with the firm itself. Culture by definition cannot be imposed on an organisation from outside, although it will be influenced by both internal and external factors. In order to be consistent with, and acceptable to, the values of the society within which the firm operates, and the values of the workers, customers and other stakeholders involved, the firm’s culture has to correspond to the values held by the people in that community, workforce, market and so on. In other words, the ideal culture has to be ethical. That point was clearly stated by various essayists in the FCA’s 2018 discussion paper.<sup>182</sup> The point was recognised in 2016 by the then Deputy Governor of the Bank of England:<sup>183</sup>

‘Culture has a major influence on the outcomes that matter to us as regulators. My assessment of recent history is that there has not been a case of a major prudential or conduct failing in a firm which did not have among its root causes a failure of culture as manifested in governance, remuneration, risk management or tone from the top. ... As regulators, we are not able, and should not try, to determine the culture of firms. We cannot write a regulatory rule that settles culture. Rather, it is the product of many things, which regulators can influence, but much more directly which firms themselves can shape.’

New approaches, such as the Regulatory Sandbox approach to evaluating new ideas, will require trust and full cooperation between firms and regulators.<sup>184</sup>

### Evidence of Outcomes

It is well known that the financial industry gave rise to many serious disasters prior to the global financial crisis. Between the late 1970s and 2000 a World Bank study identified 112 systemic financial crises in 93 countries.<sup>185</sup> Major events around the GFC were the inappropriate securitisation of US subprime mortgages and the collapse of this mortgage-backed securities market in August 2007,<sup>186</sup> the run on Northern Rock in September 2007,<sup>187</sup> and the bail out of Bear Stearns in March 2008, developed into an international banking crisis with the bankruptcy of Lehman Brothers in September 2008, and resulted in the Euro area sovereign debt crisis.

In the UK, major events were the collapse of significant institutions, such as in the 1970s secondary banking crisis, BCCI in 1991,<sup>188</sup> Barings in 1995<sup>189</sup> and Equitable Life.<sup>190</sup> There were repeated cycles

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<sup>182</sup> *Transforming Culture in Financial Services* (Financial Conduct Authority, 2018), DP18/2. It is most clear in the essays by Azish Filabi, Eric Levy, and Linda Trevino and colleagues.

<sup>183</sup> Andrew Bailey, Deputy Governor, Prudential Regulation, Bank of England and Chief Executive Officer, Prudential Regulatory Authority, ‘Culture in financial services – a regulator’s perspective’ speech at City Week Conference, 9 May 2016, [www.bankofengland.co.uk/publications/Pages/speeches/2016/901.aspx](http://www.bankofengland.co.uk/publications/Pages/speeches/2016/901.aspx)

<sup>184</sup> HJ Allen, ‘Regulatory Sandboxes’ (2019) 87 *Geo Wash L Rev* 579.

<sup>185</sup> *Finance for growth: Policy Choices in a Volatile World* (World Bank, 2001).

<sup>186</sup> M Hellwig, ‘Systemic Risk in the Financial Sector: An Analysis of the Subprime-Mortgage Financial Crisis’ (2009) 157(2) *De Economist* 129-207; GB Gorton, ‘Questions and Answers about the Financial Crisis’ National Bureau of Economic Research, Working Paper No 1578 (2010).

<sup>187</sup> *The Nationalisation of Northern Rock* (National Audit Office, 2009). *Review of HM Treasury’s management response to the financial crisis* (HM Treasury, March 2012).

<sup>188</sup> *Report of the Inquiry into the Supervision of the Bank of Credit and Commerce International* (1991) HC 192.

<sup>189</sup> Strong criticism of the Bank of England was made in *A New Approach to Regulating and Developing Singapore’s Financial Sector* (Singapore, Monetary Authority of Singapore, 1997); Board of Banking Supervision, *Report of the Board of Banking Supervision Inquiry into the Circumstances of the Collapse of Barings* (London, Bank of England, 1995).

<sup>190</sup> The Equitable Life Payments Scheme, and various progress reports, information at <https://www.gov.uk/government/collections/equitable-life-payment-scheme-documents>; *Administering the Equitable Life Payment Scheme* (National Audit Office, 2013).



of mis-selling consumer products, and persistent failures to comply with suitability rules,<sup>191</sup> such as pension transfers and opt-outs,<sup>192</sup> payment protection insurance (PPI)<sup>193</sup> and endowment mortgages with interest-only loans.<sup>194</sup> A 2011 trawl of 1,200 mystery shopping sites conducted across 27 EU Member States found that only 43% of retail investment products were deemed to be broadly 'suitable' under a relatively simple rubric (i.e. basically fulfils shoppers' needs in terms of investment liquidity and risk level) while the remaining 57% were assessed as broadly 'unsuitable'.<sup>195</sup> Mis-selling of interest rate hedging products also affected businesses, particularly SMEs.<sup>196</sup>

The problem is that serious issues continue to have arisen since 2008. These include systemic manipulation by banks of the London Inter-Bank Offered Rate (LIBOR)<sup>197</sup> and EURIBOR.<sup>198</sup> As a

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<sup>191</sup> N Moloney, 'The legacy effects of the financial crisis on regulatory design in the EU' in E Ferran, N Moloney, JG Hill and JC Coffee, Jr, *The Aftermath of the Global Financial Crisis* (Cambridge University Press, 2012). See *Guidance Consultation. Assessing Suitability* (FSA, 2011), outlining failures to assess the risks that consumers are prepared to sustain.

<sup>192</sup> J Black and R Nobles, 'Personal Pensions Misselling: The Causes and lessons of regulatory Failure' (1998) *Modern Law review* 789.

<sup>193</sup> P McConnell and K Blacker, 'Systemic Operational Risk: The UK Payment Protection Insurance Scandal' (2012) 7 *Journal of Operational Risk* 79; E Ferran, 'Regulatory Lessons from the Payment protection Insurance Mis-selling Scandal on the UK' (2012) 13 *European Business organization Law Review* 247. See recently *Finalised guidance. Payment protection products. FSA/OFT joint guidance* (FSA/OFT, 2013), FG13/02/OFT1474 ; *Payment protection insurance customer contact letters (PPI CCLs) - fairness, clarity and potential consequences: Guidance consultation* (FSA, March 2012); *Press release: Commitment to help consumers agreed at PPI summit* (BBA, 23/04/2012); *Treasury Committee publishes correspondence with FSA and FOS on mis-selling* (House of Commons Select Committees, 23/05/2012); *Payment protection insurance customer contact letters (PPI CCLs) - fairness, clarity and potential consequences* (FG12/17: FSA, July 2012); *PPI Complaint Handling - FSA fine*, 4 January 2013; *Assessing the quality of investment advice in the retail banking sector. A mystery shopping review* (FSA, February 2013); *TR13/7 - Payment protection insurance complaints: report on the fairness of medium-sized firms' decisions and redress* (FCA, August 2013); *Rogue PPI Claim Companies Targeted by Fines and Toughened Regulations* (Ministry of Justice, 21 November 2013).

<sup>194</sup> J Gray, 'The Legislative Basis of Systematic Review and Compensation for the Mis-Selling of retail Financial Services and Products' (2004) 25 *Statute Law Review* 196; *Dealing fairly with interest-only mortgage customers who risk being unable to repay their loan* (Financial Conduct Authority, May 2013).

<sup>195</sup> *Consumer Market Study on Advice within the Area of Retail Investment Services-Final Report* (Synovate Ltd, 2011), [http://ec.europa.eu/consumers/rights/docs/investment\\_advice\\_study\\_en.pdf](http://ec.europa.eu/consumers/rights/docs/investment_advice_study_en.pdf)

<sup>196</sup> *Interest Rate Hedging Products. Pilot Findings* (FSA, 31 January 2013); Letter from Clive Adamson to anonymous banks on Interest Rate Hedging Products Review, and associated Agreements, 29 January 2013, available at <http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/news/treasury-committee-publishes-agreement-between-fca-and-banks-on-irhp-review/>.

<sup>197</sup> see Financial Times, LIBOR Scandal at <https://www.ft.com/libor-scandal>. S Miller, 'The Libor Scandal: Culture, Corruption and Collective Action Problems in the Global Banking Sector' in J O'Brien and G Gilligan (eds), *Integrity, Risk and Accountability in Capital Markets. Regulating Culture* (Hart Publishing, 2013) (referring to institutional corruption). See *LIBOR, Public Inquiries and FSA Disciplinary Powers* (House of Commons Library, SN/BT/6376, July 2012); *The Wheatley Review of LIBOR: initial discussion paper* (HM Treasury, August 2012); *Fixing LIBOR: some preliminary findings* (House of Commons Treasury Select Committee - HC 481-I, August 2012), Volume I: Report, together with formal minutes and Volume II: Oral evidence; *The Wheatley Review of LIBOR: final report* (Martin Wheatley, September 2012); *Wheatley Review of LIBOR - Written Ministerial Statement* (HM Treasury, October 2012); *LIBOR, Public Inquiries and FSA Disciplinary Powers - Commons Library Note* (SN/BT/6376: House of Commons Library, November 2012); *Internal Audit report: A review of the extent of awareness within the FSA of inappropriate LIBOR submissions* (FSA, March 2013); Press release, *LIBOR Becomes a Regulated Activity* (BBA, 02/04/2013).

<sup>198</sup> Five traders were convicted: K Ahmed, 'Trader Tom Hayes has Libor rate-rigging sentence cut to 11 years', *BBC News*, 21 December 2015, [www.bbc.co.uk/news/business-35152839](http://www.bbc.co.uk/news/business-35152839); B Thompson, 'Two former star traders jailed in Euribor rigging case. Former Barclays and Deutsche Bank staff sentenced in Serious Fraud Office case', *Financial Times*, July 19, 2018, [www.ft.com/content/3f15a63c-8b4e-11e8-b18d-0181731a0340](http://www.ft.com/content/3f15a63c-8b4e-11e8-b18d-0181731a0340); A Verity, 'Former Barclays traders jailed over Euribor rate-rigging' *BBC News*, 1 April 2019, [www.bbc.co.uk/news/business-47779993](http://www.bbc.co.uk/news/business-47779993)

result of the FGC, general business practices were strongly criticised (various banks, including Barclays),<sup>199</sup> such as allegations of intentionally putting business customers into default so as to reap increased fees (RBS).<sup>200</sup> U.S.-based Wells Fargo created millions of unauthorised accounts between 2002 and 2016 as a result of pressure from managers on staff to meet ‘unrealistic sales goals’ and consequences included \$60 million senior executive claw-backs<sup>201</sup> and a fine of \$3 billion.<sup>202</sup> Reviewing a number of scandals, Saule Omarova commented on the disconnect between legal rules and ethics:

‘One of the most troubling revelations in this respect was that, in the vast majority of these cases, banks’ and their employees’ socially harmful and ethically questionable business conduct was perfectly permissible under the existing legal rules.’<sup>203</sup>

A 2020 review by the FCA itemised a lengthy list of actual or potential harms across all of the sectors it regulates.<sup>204</sup>

In Australia since 2018:

Note enforcement activism by ASIC<sup>205</sup> - but what happened to all those enforcement initiatives?

Nov 2019 – Westpac – money laundering (Philippines)

Dec 2019 – NAB – charging fees for services never received

Commonwealth Bank – underpaying employees + No 2019 beach of law banning unsolicited insurance calls

Aust operations of several global investment banks under investigation for criminal cartel

#### ASIC increase regulation

Banking Executive Accountability Regime (BEAR)<sup>206</sup> <sup>207</sup> but shift to FAR?

On 22 January 2020 the Australian Government released its proposal paper for extending the Banking and Executive Accountability Regime (BEAR) in Australia to entities regulated by Australia’s prudential regulator, APRA. The extension, known as the Financial Accountability Regime (FAR) is another step in implementing some of the commitments set out in the Government’s Financial Services Royal Commission Implementation Roadmap released in August 2019 following Australia’s Royal Commission into banking conduct.

The executive accountability regime governing banker conduct and pay will soon be expanded to include superannuation funds, insurers, the Australian Securities Exchange, AMP and potentially private health insurers and other big companies playing a crucial role in the financial system.

On 10 March 2020, ASIC published a new regulatory framework for foreign financial services providers providing financial services to wholesale clients in Australia.<sup>208</sup>

<sup>199</sup> *The Salz Review of Barclays’ Business Practices report to the Board of Barclays PLC.* (April 2013)

<sup>200</sup> *Independent Lending Review. Terms of Reference* (RBS, 2013); Sir A Large and Oliver Wyman, *Independent Lending Review* (25 November 2013); *Press release: RBS to act on SME lending review findings*, 1 November 2013; L Tomlinson, *Banks’ Lending Practices: Treatment of Businesses in distress* (December 2013).

<sup>201</sup> *Banking Conduct and Culture. A Permanent Mindset Change* (Group of Thirty, 2019).

<sup>202</sup> Press release, ‘Wells Fargo Agrees to Pay \$3 Billion to Resolve Criminal and Civil Investigations into Sales Practices Involving the Opening of Millions of Accounts without Customer Authorization’, Department of Justice, February 21, 2020, [www.justice.gov/opa/pr/wells-fargo-agrees-pay-3-billion-resolve-criminal-and-civil-investigations-sales-practices](http://www.justice.gov/opa/pr/wells-fargo-agrees-pay-3-billion-resolve-criminal-and-civil-investigations-sales-practices).

<sup>203</sup> ST Omarova, ‘Ethical Finance as a Systemic Challenge: Risk, Culture, and Structure’ (2018) 27(3) *Cornell Journal of Law and Public Policy* 797.

<sup>204</sup> *Sector Views* (Financial Conduct Authority, 2020).

<sup>205</sup> *ASIC Enforcement Update, January to June 2019* (ASIC, 2019).

<sup>206</sup> See: <https://www.apra.gov.au/banking-executive-accountability-regime>  
<https://www.pwc.com.au/consulting/assets/publications/ten-minutes-perspectives-banking-executive-accountability-regime-may17.pdf>

<sup>207</sup> <https://www2.deloitte.com/content/dam/Deloitte/au/Documents/audit/deloitte-au-audit-bear-reform-240419.pdf>

<sup>208</sup> See: <https://asic.gov.au/about-asic/news-centre/find-a-media-release/2020-releases/20-058mr-following-consultation-asic-releases-new-regulatory-framework-for-foreign-financial-services-providers/>

Plus implements new regs for wholesale clients<sup>209</sup>

See: <https://asic.gov.au/about-asic/news-centre/speeches/ceda-keynote-address/>

Refer to ASIC's review of how boards are grappling with the management and oversight of non-financial risk, which found that oversight was overall less mature than needed.<sup>210</sup>

Refer to a major revision of the *Banking Code of Practice*, in which banks made a commitment to 'their customers, to ethical behaviour, to fair and responsible lending practices and to the protection of your privacy.'<sup>211</sup>

**Litigation – are there EXAMPLES?**

**What evidence of adverse consequences?**

There is anecdotal evidence that the result of SMR and BEAR is that managers are frightened to accept jobs, or do anything that is outside their strict responsibilities, and so commercial risk and lending are being adversely affected.

**Effect on recruitment, lending .....**

Recent research has noted examples in which the approach to regulatees<sup>212</sup> and to enforcement<sup>213</sup> of ASIC was adversely compared with the more supportive approach of a different regulator, AFSA.

In the UK, high profile prosecutions by the Serious Fraud Office arising out of a \$3bn loan by Barclays to Qatari investors in 2008 as part of £11.8bn emergency fundraising in 2008 to maintain independence from a government take-over were dismissed by the Crown Court in 2018,<sup>214</sup> and the former CEO and other managers were acquitted in 2020.<sup>215</sup>

Based on this evidence, it is difficult to conclude that deterrence is effective in controlling the activities of financial institutions so as to reduce the risk or incidence of occurrence of major disasters or breaches of the law.

## V. REBASING POLICY AND PRACTICE ON EVIDENCE

The evidence discussed above reveal that there is inconsistency and confusion on the part of both regulators and financial institutions about how to proceed. It will be apparent that the Legal and Culture

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<sup>209</sup> see: <https://www.lexology.com/library/detail.aspx?g=d65eb793-76b5-42f2-84f7-2845809fba61>  
<https://thenewdaily.com.au/finance/superannuation/2019/12/25/asic-new-powers-super-funds/>

<sup>210</sup> *Corporate Governance Taskforce - Director and officer oversight of non-financial risk report* (ASIC, October 2019).

<sup>211</sup> *Banking Code of Practice* (Australian Banking Association, December 2019).

<sup>212</sup> EJ Streten, *Practitioners' Perspectives: Experiences Adhering to Legal and Ethical Regulatory Standards*. Doctoral Thesis, Queensland University of Technology, 2019. This included the following quotation, amongst others from practitioners: 'I think ASIC don't do a particularly good job at regulation. I've seen two different regulators. I'm lucky to have the benefit of seeing two different models. I think the AFSA model of an education review process and encouraging people through education and rather than coming and hitting people on the head like ASIC will do for not lodging a form in time, and there's really no real effect on stakeholders whether you lodge a form on time or not. It really doesn't. Whereas AFSA have a much more inclusive mentoring approach to regulation and I would suggest that is probably more effective than ASIC. Everyone is so scared of ASIC no one will talk to them or engage with them. I just think that heavy handed approach doesn't necessarily change behaviours in the profession. I think the educative review process AFSA has will change behaviours, important behaviours ...'.

<sup>213</sup> C Robinson, 'An Early Response to Regulatory Changes under the Insolvency Law Reform Act 2016 (Cth): A Survey of Registered Liquidators and Registered Trustees' (2019) 27 *Insolvency Law Journal* 211: 'ASIC needs to improve transparency in respect of two key areas of regulating misconduct: taking enforcement action; and its operation and approach to enforcement'.

<sup>214</sup> M Cross, 'Blow for SFO as court throws out Barclays case' *Gazette* 21 May 2018.

<sup>215</sup> M O'Kane, 'Barclays acquittals show SFO's 'waste and incompetence' *Financial Times* 3 March 2020.

Models are mutually inconsistent, yet both of them are currently being pursued. This lack of clarity will merely generate poor outcomes and will not avoid the occurrence of major disasters. Pursuing deterrence, and instilling fear, against people in banks who think they are trying to do the right thing will lead to a lack of open sharing of information, failure to identify and solve problems, and failure to reflect on risks and how to avoid them. Deterrence is wholly inadequate as an enforcement tool and therefore a regulatory assumption. The fundamental goal should be to affect behaviour, thereby to promote compliance with society's rules and to encourage business success.

The solutions are to be found in the science of how humans behave, individually and in organisations, rather than in theories. The evidence leads us to basing organisations and policy on ethical values, demonstrated through the purposes of individuals and organisations, business model,<sup>216</sup> governance, transparency and culture of organisations, and measuring outcomes and impacts, and will prove to be both commercially and socially successful.

In this section we analyse three ways forward: the true meanings of accountability and responsibility, the need to draw lessons from historical and recurrent problems and some early pointers, and the perennial issue of targets and incentives.

### **Accountability and Responsibility**

There have been multiple references in documents cited above to the words 'accountability' and 'responsibility'. These terms have a number of meanings, which mask the ongoing confusion between the two Models. Given that the objective is to affect the policy outcomes of protection and business growth,<sup>217</sup> the following possible aspects arise:

- a) Allocating responsibility for particular roles or achieving certain tasks;
- b) Accepting responsibility for fulfilling a role or achieving certain tasks;
- c) Performance and delivery of tasks, roles, targets, outputs, outcomes and impacts;
- d) Evaluation of the achievement of role, tasks, outcomes
- e) Giving an account of the extent of such performance and delivery, including what was done or not done, and the extent to which unintended, especially adverse, outcomes occurred;
- f) Imposing consequences for the success or failure of such delivery.

The first two aspects are prospective, requiring systems, functions, roles, tasks or outcomes to be allocated to particular individuals, so that the delivery of those objectives and outcomes is effectively overseen and more likely to be achieved. Choices must be made as to how this is done. One approach is to define and attribute a role, which was a central reason for introducing a Senior Managers Regime. A different approach is to set performance targets, on the mantra 'what gets measured, gets done'. However, a targets regime, especially if linked to reward through remuneration, can incentivise focus solely on their achievement, at the expense of other desired achievements, such as balanced ethical outcomes.

The last three aspects are retrospective. Giving an account of what happened is the literal meaning of accountability. It is a communication function, requiring honesty, accuracy and completeness. The final aspect features strongly in popular parlance after things are perceived to have gone wrong. 'Who is accountable?' here means 'Who is going to be blamed?' and 'Who is going to be punished?' The

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<sup>216</sup> The G30 statement said: 'Culture is closely aligned with business model. Management, boards, and supervisors should carefully consider whether the business model reinforces a healthy culture. Business strategies and models that focus on sales rather than customers, short-term results rather than long-term value, growth rather than sustainability, and low cost rather than efficiency, can create unhealthy cultures. It can be very difficult to change the culture without also changing the business model. *A New Paradigm. Financial Institution Boards and Supervisors* (Group of 30, October 2013).

<sup>217</sup> *Regulators' Code* (Department for Business, Innovation & Skills, 2014).

feelings underlying those responses are desires for protection and retribution, as blame and punishment of an individual. An example of this was the Australian Royal Commission's quotation of the head of APRA that 'No one has actually taken responsibility for issues'.<sup>218</sup> The regulators' descriptions of the SM&CR quoted above make clear that imposition of sanctions is a major driver for this mechanism. Equally, enforcement policies habitually use the language of 'misconduct' to describe the origin of any adverse event, irrespective of its root cause.

But various problems arise. As noted above, scientific research clearly establishes that people who live in fear of being blamed will not share information.<sup>219</sup> That fact is a fundamental pillar of 'open culture' in civil aviation and the EBP and EBR concepts. For one thing, an individual manager may have been wholly unable to have prevented the adverse event (or wrongdoing), or might not have been aware of it, or might not have been the effective root cause of the problem. Those thoughts have led to requiring systems, such as compliance systems, and the idea of being responsible for the culture of a team. But there is no guarantee that the actions of an individual team member could have been controlled (examples are the German Wings pilot with mental health problems, or a criminal or psychopathic individual). There should be little surprise if it proves difficult to recruit people to accept this blame risk (unless they are lured by excessive remuneration). Values-based cultures aim to raise the level of internal questioning about what is done that may appear to be normal but is in fact unethical (mis-selling, fixing rates) and to identify issues or individuals quickly through speaking up or other techniques.

It is important to understand the essential aviation concept of 'just culture'. It is a significantly more sophisticated approach to reducing future risk than the theory that sanctions will affect future behaviour. In a just culture, everyone has a social duty to give a complete and full account of any relevant information, safe in the knowledge that they will not attract blame, but that leaders will be able to carry out a comprehensive risk assessment and that *consequences will be implemented that will reduce the future risk*. Open culture is based on avoiding blaming any individual, but asking how any individual behaves within a system, so that improvements can be made that reduce the future risk of any individual's behaviour might give rise to avoidable risk. Consequences might be redesign of the system; introduction of better instructions, training or controls; removing certain individuals from certain roles (a physician who deliberately kills patients needs to be incarcerated,<sup>220</sup> and an operator who lies to regulators should have a licence revoked<sup>221</sup>).

The differentiating factor is intention, specifically whether the intention was ethical or not. In a 'just culture' there is a clear response where people *deliberately* break rules, internally and externally. The underlying points are not that the rule was broken but why, and whether those who were instigators

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<sup>218</sup> *Royal Commission*, section 3.3, quoting Transcript, 30 November 2018, Wayne Byres, 7443.

<sup>219</sup> Examples from diverse situations are: M Tamuz, 'The Impact of Computer Surveillance on Air Safety Reporting' (1987) *Columbia Journal of World Business* 69; M Tamuz, 'Learning Disabilities for regulators. The Perils of organizational learning in the Air Transportation Industry' (2001) 33(3) *Administration & Society* 276 (fear or prosecution); W Sykes, C Groom, P Desai and J Kelly, *Coming clean: the experience of cleaning operatives* (Equality and Human Rights Commission 2014), 16 (fear of losing job); *Report on legal and cultural issues in relation to ATM safety occurrence reporting in Europe: Outcome of a survey conducted by the Performance Review Unit in 2005-2006* (Eurocontrol Performance Review Commission, 2006) (fear of censure or embarrassment); TH Gallagher, AD Waterman, AG Ebers, et al, 'Patients' and physicians' attitudes regarding the disclosure of medical errors' (2003) 289 *JAMA* 1001. D Studdert, D Piper and R Iedema, 'Legal aspects of open disclosure II: attitudes of health professionals-findings from a national survey' (2010) 193 *Med J Australia* 351 (fear of litigation, damage to reputation and embarrassment amongst clinicians).

<sup>220</sup> Dr Shipman killed 215 of his patients over a period of 24 years: *Fifth Report of the Shipman Inquiry, 'Safeguarding Patients: Lessons from the Past - Proposals for the Future'* (Department of Health, 9 December 2004).

<sup>221</sup> One example concerns a clear mistake by an air traffic controller in unusual circumstances in which two planes nearly collided, but it was unthinkable to talk of 'misconduct', sanctioning the individual or removing remuneration from him. Instead, an expert investigation identified systemic changes that would prevent any recurrence of such a mistake anywhere.

have abused others trust. In aviation, the principle is: ‘A wilful violation is not acceptable. An honest mistake is.’<sup>222</sup> Standards of behaviour require professional competence, openness, sharing, and taking responsibility for one’s mistakes by correcting them and improving.<sup>223</sup> A ‘just culture’ means that people know that a root cause analysis will determine why things happened, that people will be treated fairly (and so encouraged to speak up without being unfairly blamed), but that a ‘level playing field’ will be maintained for everyone, that will include serious sanctions on people who acted criminally and cannot be trusted.

There needs to be fresh debate on what the appropriate and just consequences should be in response to different types of actions, with differentiation based on the level of ethical intention. It should also be asked to what extent people or organisations should be punished if a mistake results in unexpectedly large harm. It would be fair that those who cause harm repair it, but redress is a civil matter not a sanction. The most important response to harm that may be serious, recurrent or systemic is to address the culture and the mechanisms for future prevention of recurrence.

Enforcement policies should be published that suggest elements of evidence as mitigating or aggravating factors that will be taken into account in decisions on enforcement and penalties by regulators and courts. Supervisory action needs to be transparent. It is fine to reach fair and proportionate agreements on what needs to happen in response to breaches of rules and of trust (such as owning up, identifying root causes, implementing agreed actions, making redress, and monitoring to see if further changes are needed. But all the points agreed should be published so that they can be publicly scrutinised and monitored.

### **Analysing Root Causes of Specific Problems**

We know incontrovertibly that various adverse outcomes have occurred, caused by behaviours such as rate rigging, mis-selling of unnecessary products, over-pricing, and so on. We should ask why these behaviours occurred. Only if we have accurately identified the essential causes of a problem can we prescribe an effective solution to reducing future recurrence. What we now know from scientific research into how people behave and what drives behaviour (rather than pure theories) should drive our responses. Thus, the Legal Model assumes that a corporate entity has responsibility and ‘its’ behaviour and breaches can be sanctioned and controlled. This anthropomorphises an organisation,<sup>224</sup> treating it as a human being. The Legal Model and classical economics also assume that organisations and individuals are driven essentially by personal greed in every situation. This leads to classifying events as illegal, wrongdoing or misconduct.

It would be logical to examine systematically what affects the behaviour of, first, individuals (such as values, influences, incentives and barriers (good and bad)) and, second, organisations (such as purpose, long-term sustainability, governance, values, culture). Which of these levers actually works?

Eugene Soltes’ interviews with a range of white collar criminals, from Jérôme Kerviel to Bernie Madoff, delving into their motivations, found that fear of punishment was rarely if ever mentioned as having been in their minds.<sup>225</sup> The overwhelming feeling by perpetrators was that they felt pride that their actions were sustaining their firms during difficult or challenging circumstances. ‘None of the former executives I spoke with saw himself as a fraud...the person they saw in the mirror was successful, entrepreneurial and ambitious.’ Soltes concluded that they were victims of their own self-deception. The absence of a challenging social environment was a consistent feature. These businessmen were not ‘operating within a single small community surrounded by family and friends’ where misconduct would

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<sup>222</sup> S Dekker, *Just Culture* (Ashgate Publishing, 2007), 15.

<sup>223</sup> D McCune, C Lewis and D Arendt, ‘Safety Culture in Your Safety Management System’ in AJ Stolzer, CD Halford and JJ Goglia, *Implementing Safety Management Systems in Aviation* (Ashgate, 2011), 195.

<sup>224</sup> *Discussion Paper. Corporate Criminal Responsibility* (Australian Law Reform Commission, 2019), DP 87.

<sup>225</sup> E Soltes (2016) *Why do they do it: Inside the Mind of the White-Collar Criminal* (PublicAffairs, 2016).

be identified and disapproved of. Soltes suggested that what is needed is ‘uncomfortable dissonance’ to stimulate a re-evaluation of people’s initial intuitive judgments. He cited psychological research indicating that the effect of time and the process of defending a viewpoint ‘can often lead us to re-evaluate and improve our judgments.’ Hence, he concluded that the need is to address ever-widening psychological distance.

We know that reliance on performance goals, such as achievement of performance or time targets or cost control, and maintaining safe or ethical operation, raises conflict between them. This can expose employees to irreconcilable stresses, often under intense time pressure.<sup>226</sup>

Dennis Gentilin, who was a whistleblower in an Australian bank, investigated the scientific reasons why the Legal Model is hopelessly inadequate as an explanation of humans in ‘organisational wrongdoing’.<sup>227</sup> His book highlights misleading tendencies to search for scapegoats and incorrectly infer causation, cognitive dissonance,<sup>228</sup> the polarisation of groups,<sup>229</sup> and the importance of the social aspects of the work environment. He begins simply by quoting Solzhenitsyn:

‘If only there were evil people somewhere insidiously committing evil deeds, and it were necessary only to separate them from the rest of us and destroy them. But the line dividing good and evil cuts through the heart of every human being.’<sup>230</sup>

The Culture Model recognises that actions are usually controlled by human beings, but both individual and group behaviour can be significantly affected by creating an ethical culture. The ‘open culture’ approach recognises that creating a culture of blaming humans will prevent open sharing of important information and that serious protective sanctions should be reserved for human actions that are intentionally unethical.

Scientific investigations into cause and effect uses the technique of root cause analysis.<sup>231</sup> As discussed, root cause analysis is at the heart of aviation safety. This is not the place for an extensive analysis of either the extensive scientific findings or the evidence from investigation of major disasters, but some examples are as follows. The Australian cricket ball tampering scandal was attributed to a culture that focused solely on winning.<sup>232</sup> A ‘climate of fear and mistrust’ driven by autocratic top management in Volkswagen was identified as a root cause of the inability of engineers and managers to speak out that set tasks could simply not be done, and that defeat device technology was unethical.<sup>233</sup> The G30 cited examples outside financial services, including conduct by Uber, Apple and Facebook/Cambridge Analytica, as well as Wells Fargo, and concluded that culture is a driver of sustainability.<sup>234</sup>

It would be logical to analyse the root causes of the most frequent types of problems and the effects, positive and negative, of the elements of business model, governance, incentives especially remuneration, and barriers. We need much more detailed understanding of the motivations of different (types of) staff, and the effects of different incentives and influences on them, ranging from social issues and health to remuneration issues.

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<sup>226</sup> D McCune, C Lewis and D Arendt, ‘Safety Culture in Your Safety Management System’ in AJ Stolzer, CD Halford and JJ Goglia (eds), *Implementing Safety Management Systems in Aviation* (Farnham, Ashgate, 2011), 143.

<sup>227</sup> D Gentilin, *The origins of Ethical Failures. Lessons for Leaders* (Routledge, 2016).

<sup>228</sup> DC Matz and W Wood, ‘Cognitive dissonance in groups: The consequence of disagreement’ (2005) 881(1) *Journal of Personality and Social Psychology* 22.

<sup>229</sup> DG Myers and H Lamm, ‘The group polarization phenomenon’ (1976) 83(4) *Psychological Bulletin* 602.

<sup>230</sup> AI Solzhenitsyn, *The Gulag Archipelago* (New York, Harper & Row, 1973).

<sup>231</sup> D Okes, *Root Cause Analysis: The Core of Problem Solving and Corrective Action* (ASQ Quality Press, 2009).

<sup>232</sup> *Australian Cricket: A Matter of Balance* (The Ethics Centre, 2018).

<sup>233</sup> J Ewing, *Faster, Higher, Farther. The Inside Story of the Volkswagen Scandal* (W W Norton & Company, 2017).

<sup>234</sup> *Banking Conduct and Culture. A Permanent Mindset Change* (Group of Thirty, 2019).



Large organisations are complex polities composed of departments, programmes and teams. Compliance by an organisation ‘depends on the mobilization and engagement of diverse members across the organisation’s hierarchy, which may be far more complicated than is often imagined when we think about the organisation as a single regulated actor.’<sup>235</sup>

An important area for research, therefore, is analysis of the drivers of non-compliance and culture risks in particular departments or functions in an organisation. An informed study was published by Robert Mass, formerly of Goldman Sachs.<sup>236</sup> He noted the relevance of human emotions and concluded that it is important to aim at creating ‘C5 effects’: compliance, correction, certainty, consistency, and consensus. He also emphasised the importance of focusing on the ethics of four core social practices: mutual promising (contact), play games fairly (trading), persuade honestly (sales), exercise guardianship and care for others (asset management).

At a general level, Huising and Silbey have summarised the state of evidence on ‘the levers used at the coalface to achieve compliance in organisations.’<sup>237</sup> They categorised four levers: nudging individuals (limited efficacy), bureaucracy of organisations (the challenge being to ‘infiltrate normalisation’ into managerial processes and decision-making moments), relational governance (dependent on ‘sociological citizens’<sup>238</sup>), and organisational culture (needs a comprehensive approach).

An important analysis was published by the Fixed Income, Currencies and Commodities Market Standards Board of the causes of 390 enforcement cases in 26 jurisdictions over 225 years, which identified 25 core misconduct patterns that could be grouped into seven broad categories of behaviour: price manipulation, circular trading, collusion and information sharing, inside information, reference price influence, improper order handling, and misleading customers.<sup>239</sup> This information should form the basis of designing suitable risk reduction safeguards and interventions.

A retired Swiss General Counsel commented on the challenges arising from the size and internal structures of large organisations:<sup>240</sup>

‘But one of the key challenges of legal risk management is to get aberrant behavior under better control. This goes far beyond requirements for a proper tone at the top, codes of conduct, or compensation schemes that set the right incentives. It extends to the question of how to change people’s behaviour in a reliable and sustainable way.’

‘Everyone who has worked in big organisations knows how many things fall into the cracks between unclear reporting lines; or become victims of fights between functional and geographic responsibility or conflicting instructions from line management and functional officers. There are simply too many places to hide, too many teams and committees with unclear accountability, too many cooks in the kitchen.’

Various tools measure the cultures throughout an organisation. The Barrett Cultural Values Assessment, based on categorisation of the stages in the maturity of an organisation, also identifies the existence of limiting and positive values so that the former can be addressed and the latter supported.<sup>241</sup> Ruth

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<sup>235</sup> GC Gray and SS Silbey, ‘Governing inside the organization: interpreting regulation and compliance’ (2014) 120(1) *Am. J. Sociol.* 96–145.

<sup>236</sup> R Mass, ‘A banker’s code of ethics’ (2017) 33(2) *Oxford Review of Economic Policy* 257.

<sup>237</sup> R Huising and SS Silbey, ‘From Nudge to Culture and Back Again: Coalface Governance in the Regulated organization’ (2018) *Annual Review of Law and Social Science* 14:91-114.

<sup>238</sup> SS Silbey, R Huising and SV Coslovsky, ‘The “sociological citizen” relational interdependence in law and organizations’ (2009) *Ann. Sociol.* 201–29.

<sup>239</sup> *Behavioural Cluster Analysis. Misconduct Patterns in Financial Markets* (Fixed Income, Currencies and Commodities Market Standards Board, 2018).

<sup>240</sup> P Kurer, *Legal and Compliance Risk: A Strategic Response to a Rising Threat for Global Business* (Oxford University Press, 2015), 72 and 73.

<sup>241</sup> See <https://www.valuescentre.com/tools-assessments/cva/>. R Barrett, *The Values-Driven Organization: Cultural Health and Well-Being as a Pathway to Sustainable Performance*, 2nd ed (Routledge, 2017).



Steinholtz has set out two frameworks—one for culture and leadership, and the other for ethics and compliance—that will form the basis of building sustainable EBP.<sup>242</sup>

Principles and rules need to be simple. A study of 81,266 rule-level observations from 1,011 health inspections of 289 Californian restaurants found that rule complexity was associated with higher probabilities of rule compliance. However, at a deeper level, increases in the number of connections (functional links between a focal rule and other rules in the same system) were associated with higher probabilities of repeated non-compliance, whereas increases in the number of components (the sections that compose a given rule) were not.<sup>243</sup>

### **Targets and Incentives**

Once we have analysed the root causes of particular adverse events, it should be possible to prescribe evidence-based preventative mechanisms. Although there is neither space nor sufficient evidence yet available, it is likely that major factors will be the absence of challenge to individual or group behaviour, the existence of stress that triggers defensive behaviour, the existence of targets that focus attention on certain outcomes at the expense of others, and the lack of time to evaluate options and the consequences of actions. Incentives and barriers play a major role.

Remuneration is a large elephant in the room. The theory behind financial incentives is based on two assumptions: first, that businesses only exist to make profits (maximising shareholder value) at the expense of any other consideration and, second, managers need to be incentivised by aligning their remuneration with the interests of shareholders (agency theory). These theories have led to payment of very considerable bonuses supposedly based on performance, and of overall levels of remuneration to top managers that are many times the pay of most people. It is striking that remuneration levels and differential ratios were modest until the mid-1970s, after which they increased far in excess of company profits or market value.<sup>244</sup>

The contrasting position is that such incentivisation is entirely unnecessary over a predictable and fair wage. Psychologist Magda Osman has said:<sup>245</sup>

The common position is that self-set goals are the most likely to be achieved, because people have intrinsic (internally valued) motivations for achieving them, rather than extrinsic (external values) motivations. There is good evidence that there is a general preference for intrinsically motivating activities, and that rewards such as money and other tokens work less well; we do things because we enjoy them and they are rewarding in and of themselves. Simply, this means we prefer the journey over the destination.

An analysis of 57 US and 15 non-US companies found that those that operate as ‘firms of endearment’ by adopting a comprehensive approach to delivering the needs of *all* their stakeholders had modest executive salaries, above average remuneration and benefits for employees, fair prices for suppliers and customers, generally flat structures with few levels of management, and financial results far better than the S&P rate over 15 years.<sup>246</sup>

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<sup>242</sup> C Hodges and R Steinholtz, *Ethical Business Practice and Regulation: A Behavioural and Values-Based Approach to Compliance and Enforcement* (Hart, 2017).

<sup>243</sup> DW Lehman, B Cooil and R Ramanujam, ‘The Effects of Rule Complexity on Organizational Noncompliance and Remediation: Evidence From Restaurant Health Inspections’ *Journal of Management* <https://doi.org/10.1177/0149206319842262>

<sup>244</sup> *Performance-Related Pay: What does Business Think?* (High Pay Centre, 2014); SA Bank, BR Cheffins and H Wells, ‘Executive Pay: What Worked?’ *Journal of Corporation Law*, UCLA School of Law, Law-Econ Research Paper No. 16-11, University of Cambridge Faculty of Law Research Paper No. 38/2016.

<sup>245</sup> M Osman, *Future-Minded. The Psychology of Agency & Control* (Palgrave Macmillan, 2014), 4 & 7.

<sup>246</sup> R Sisodia, J Sheth and D Wolfe, *Firms of Endearment. How World-Class Companies Profit from Passion and Purpose* 2<sup>nd</sup> edn (Upper Saddle River, NJ: Pearson Education, 2014).

Is it possible to balance the objectives of making money and behaving ethically? Can the interests of all stakeholders always be taken into account? Do the imperatives of maintaining a sustainable business inevitably prevent acting on the basis of the right thing to do? Is regulation doomed? Recent research into an extensive database of corporate accounting scandals from 26 countries from 1800 to 2015 found that they were an antecedent to regulation over long stretches of time, suggesting that regulators are typically less flexible and informed than firms.<sup>247</sup> Secondly, it found that regulation was positively related to the incidence of future scandals, suggesting that regulators are not fully effective, that explicit rules are required to identify scandalous corporate actions, or that new regulations have unintended consequences. Thirdly, there exist systematic differences in these lead-lag relations across countries and over time suggesting that the effectiveness of regulation is shaped by fundamental country characteristics like market development and legal tradition.

On the other hand, it can be observed that many more sectors than aviation do not give rise to the number or severity of problems that have occurred in the financial services sector. So what is different about the that sector that seems to give rise to a systemic problem? Awrey and Judge diagnose a fundamental mismatch between the nature of finance and current approaches to financial regulation, especially imbalances in information and regulatory processes.<sup>248</sup> Omarova, however, diagnoses ‘the financial industry’s persistent reluctance or inability to internalize macroprudential constraints on its risk-taking as a matter of its public duty’.<sup>249</sup> She describes a multi-layered phenomenon involving individual bankers and traders nested inside financial services firms whose organizational cultures determine much of their risk-taking behaviour, which are in turn influenced by the incentives and norms generated in specific markets and industry sectors, further influenced by the financial systems, economies and politics in which they operate. A similar concentric system of influences has been identified by Hodges and Steinholtz.<sup>250</sup> On this analysis, expectations, incentives, influences and so on need to be understood and aligned at all levels. This train of thought leads ultimately leads to ideas not only that the values, purposes and incentives of individual workers and of firms need to be aligned with the public interest of maintaining financial stability (as Omarova argues) but also that overriding characteristics of the polity (such as self-interest, individualism and individual freedom, as opposed to community-minded motivations) should be seen as fundamental cultural risk and addressed.<sup>251</sup> In which countries did major systemic risk occur? Part of the answer appears to lie in ideology and nurture.

## VI. CONCLUSIONS

The Legal Model and the Culture Model conflict. They cannot both be effective, and maintaining two systems will certainly not work. The evidence indicates that pursuing the Legal Model will be both unsuccessful and harmful. The Culture Model has already been highly successful in some situations, but, if its success is to be replicated generally, the full implications of what it requires need to be understood and complied with if they are to deserve and attract the trust of stakeholders. Organisations should not underestimate the scale of changes that are needed to put themselves in order. A series of systemic reforms may be needed to be able to work ethically and to remove impediments to doing that. This paper has identified the need to fundamentally align ethical values, organisational purpose, long-term focus, business models, governance, engagement with all stakeholders, transparency, incentives and rewards, and hence culture. We have not analysed the deep implications for remuneration and bonus

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<sup>247</sup> L Hail, A Tahoun and C Wang, *Corporate Scandals and Regulation* [European Corporate Governance Institute \(ECGI\) - Law Working Paper No. 367/2017](#)

<sup>248</sup> D Awrey and K Judge, ‘[Why Financial Regulation Keeps Falling Short](#)’ *Columbia Law and Economics Working Paper No. 617* [Cornell Legal Studies research Paper No. 20-03](#) [European Corporate Governance Institute - Law Working Paper No. 494/2020](#).

<sup>249</sup> ST Omarova, ‘[Ethical Finance as a Systemic Challenge: Risk, Culture, and Structure](#)’ *Cornell Journal of Law and Public Policy*, Vol. 27, No. 3, p. 797, 2018 [Cornell Legal Studies Research Paper No. 18-37](#)

<sup>250</sup> C Hodges and R Steinholtz, *Ethical Business Practice and Regulation: A Behavioural and Values-Based Approach to Compliance and Enforcement* (Hart, 2017).

<sup>251</sup> P Collier, *The Future of Capitalism* (Allen Lane, 2018).

schemes here. Issues such as quarterly reporting and maximising shareholder returns are parts of the problem. Companies need to take the initiative here. All of this will take time.

There is a choice between continuing in a deterrence-based paradigm or a culture-based paradigm. In the former, the basic ideas are that compliance with rules is the sole objective and it is to be achieved as one would improve the engineering on a piece of machinery, by imposing corrective punishment as you go along. But important information is not openly shared, or therefore evaluated, so we do not learn or improve performance. The cycle of things going wrong and sanctions being imposed just continues with no improvement. In the latter paradigm, information is shared, lessons are learned and corrections are applied. Problems will still occur, but they are identified and addressed earlier. The differentiating features of these two paradigms depend on the strength of purpose, values, blame and culture.

The Australian approach based on deterrence runs counter to the direction of travel adopted by some leading financial services regulators in other parts of the world. Continuing with the deterrence policy will condemn Australian banking to perhaps a decade of running down a dead end, namely one that is based on imposing deterrent fines and other sanctions that only serve to undermine the creation of an ethical culture in the industry, and fail to achieve behaviour control through the supposed operation of deterrence. This will do little for improving either the prudential or conduct regulation of the Australian banking system, the ability of banks to lend, or the country's economic prosperity. There is a risk that more scandals will continue to occur rather than reduce in incidence.

If the mechanism of leveraging the presence of an ethical culture in an organisation is to be effective, it must be allowed to work and not undermined by other approaches. The decision to consciously foster an ethical culture, and its achievement, can only come from profound support and leadership from within an organisation. The leaders have to believe in the necessity for the organisation to be driven by well-chosen core values that are meaningful to its staff and to consistently demonstrate those values in their own behaviour. In that way they will engage and harness the commitment of all staff to an open and just culture. Good culture works both for business success and observing the norms of society.

Hence, the appropriate concept is better described not as 'regulating culture' but as 'regulating through culture'. The critical point is that it is not possible for regulators to impose or 'regulate' the culture of another organisation. Culture is indeed created within an organisation. This realisation is the essence of the EBP and EBR models. Organisations should decide if they wish to base all their activities on ethical values, and then work on demonstrating that they do so,<sup>252</sup> building up evidence of this over time. All their stakeholders—staff, customers, suppliers, investors, regulators, communities—will respond to relevant evidence and treat the organisation accordingly.

Regulators can encourage (or discourage) organisations that they regulate to adopt an ethical culture. They should treat regulatees as adults. It is incorrect that regulators are able to 'supervise culture', but they can encourage financial institutions to improve it. Only the regulated organisations themselves can transform their cultures. There may be an understandable desire for policy-makers and regulators to determine what culture they think will cause people in financial entities to do the right thing, and then asking people whether they perceive them in their organisation's culture. It would be more productive to find out what in the culture of a given organisation will support its individuals to do the right thing, and what will get in the way. By adopting a technique of asking people first to choose the values/behaviours they are experiencing day to day and then using the profile that emerges to conduct a series of facilitated conversations, people are engaged in a totally different way than if they were asked to answer a long questionnaire.<sup>253</sup> By asking what cultural values people desire to see in their organisation, management is given the beginnings of the answers to any issues existing in the culture so that the engagement is a positive learning experience rather than just a dispiriting exercise (if there are lots of issues) that also gives management information about what matters to their employees and

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<sup>252</sup> Tools such as the Barrett Cultural Values Assessment tool are designed to do just this.

<sup>253</sup> This is the approach of techniques such as the Barrett Cultural Values Assessment.

staff, so that when they go about choosing the core values around which to design their cultural transformation they will know if the values matter to the very people who will have to live them.<sup>254</sup>

Regulating through culture has the potential to transform outcomes and impacts. But it will take commitment, effort and time. How it can be achieved is not yet widely understood, but the expertise is available. The basic ideas are to ask ‘Are we doing the right thing?’ and ‘What evidence do we need to prove that we are doing the right thing and so deserve to be trusted?’

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<sup>254</sup> The Royal Commission’s Recommendation 5.6 is, therefore, on the right lines but Recommendation 5.7 would pose an impossible task for regulators. How is it possible for an external regulator to assess the specific cultural drivers of misconduct in multiple functions, departments, tasks and people across large and complex organisations?