MAY 2021

Culture & Conduct Risk in the Banking Sector

Why it matters and what regulators are doing to address it
Our social connections are greater than the current need for social distancing. Amidst the COVID-crisis, we wish our readers good health and the comfort of knowing that we’re all in this—together.
ABOUT STARLING

Starling is an applied behavioral sciences company that helps customers to create, preserve, and restore value. Combining machine learning and network science, Starling’s proprietary algorithms generate Real-time Operational Insights that allow organizations to optimize performance before opportunity is lost, and to identify and mitigate culture and conduct risks before they cascade into crises. Delivered across Starling’s Predictive Behavioral Analytics platform, intuitively actionable insights allow users to anticipate, and to shape, the drivers of behavior among staff and teams. Starling enables management through foresight.

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Stephen Leacock is the award-winning graphic designer and illustrator who has handled the layout and design of Starling’s Compendium since its inception, shaping it in to the enjoyable and easy-to-use reference that it has become. Learn more about him at leacockdesign.com.

Our thanks go also to those who helped to craft past issues of this annual report, Jeff Kupfer, Anne Chiou, Grigory McKain and Klien Hilliard, without whom this series of reports would not have become what it is.

Our greatest appreciation goes also to this year’s editor, Erin Sweeney, and to the many deeply-informed industry experts who were kind enough to review draft material in the preparation of this report — it is substantially improved by their input.

Our thanks go to: Jon Frost (BIS, Basel); Shigeki Kimura (past-ministry of Finance, Tokyo); Jesper Koll (Globis Insights, Tokyo); Ted MacDonald (UK FCA, London); Greg Medcraft (OECD, Paris); Roger Miles (UK Finance Academy, London); Pei Hong Mok (MAS, Singapore); Thomas Noone (NY Fed, US); Manesh Samtani (Regulation Asia, Hong Kong); Andy Schmulow (Univ. of Wollongong, Australia); Tamara Scicluna (Rhizome Advisory, Sydney); Wieke Scholten (&Samhoud, Amsterdam); Kershia Singh (FSCA, South Africa); Peter Smith (DFSA, Dubai); John Sutherland (UK FCA, London); Ciaran Walker (Eversheds Sutherland, Dublin); and Jocelyn Yiew (Monetary Authority of Singapore).

Lastly, special thanks go to MAS Managing Director Ravi Menon for the remarks contributed here and for the support he and his staff have provided in the production of this report since its inception.

To learn more about Starling, please visit us at www.starlingtrust.com.
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GARY COHN
Gary Cohn is Vice Chairman of IBM and Co-Chairman of Cohn Robbins Holding Corp. Prior to serving as Director of the U.S. National Economic Council (2017-18) he was President and Chief Operating Officer of Goldman Sachs.

“We need reliable forward-looking metrics for non-financial risk governance, allowing for more meaningful horizontal reviews. That capability becomes all the more important in light of the current pandemic, which has dislocated our workforce, made the future of work less clear, and which makes misconduct within firms all the more damaging.”

SIEW KAI CHOY
Siew Kai Choy was a Managing Director at Singapore’s sovereign wealth fund (GIC) where he was Director of the Data & Analytics Department, Head of Governance and IT in the Public Markets Group, and founder of GIC Innovation Labs.

“Regtech firms have shown it is possible to distill signal from standard company data sets that tie to mission critical outcomes – including risk and governance related outcomes that are of key concern to boards, shareholders, and supervisors. This is sure to be of interest to anyone looking to better address the issues outlined in this report.”

MARK COOKE
Mark Cooke joined HSBC in 2014 serving as Group Head of Operational Risk, before taking a sabbatical in 2020. He also served as Chairman of ORX, the financial services industry association for Operational Risk Management.

“An over-reliance on surveillance & monitoring and systems of record has not resulted in desired nonfinancial risk management outcomes. It is clear that new approaches are needed, and this makes Starling’s annual Compendium a must read for operational risk managers – in financial services or any sector struggling with behavioral risk.”

JAMES H. FREIS, JR.
Jim Freis was the longest-serving Director of the U.S. Financial Crimes Enforcement Network (FinCEN) and, subsequently, Chief Compliance Officer and Anti-Money Laundering chief for the Deutsche Börse Group.

“To promote the integrity of financial institutions and markets, three things are critical: appropriate governance structures, the right people, and a readiness to leverage insights made available through evolving technologies. Summarizes global trends in this direction, Starling’s annual Compendium is a valuable industry resource.”
THOMAS CURRY

Thomas Curry was US Comptroller of the Currency and served as ex-officio member of the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) and the Financial Stability Oversight Council.

“Managing the operational risk associated with culture and conduct remains an ongoing area of concern to bank management and their supervisors. For both constituencies, Starling’s Compendium is a valuable resource, offering ideas and capturing emerging best practices for those working to better assess and mitigate such risks.”

RICHARD KETCHUM

Richard Ketchum served as Chairman & CEO of FINRA, CEO of NYSE Regulation, Chief Regulatory Officer of the NYSE, President at both the NASDAQ and NASD, and Director of the Division of Market Regulation at the SEC.

“The emphasis a firm’s leadership places on measuring compliance with their proclaimed cultural values tells you a lot about whether they’re committed to assuring that employee behavioral norms are consistent with the proverbial tone-from-the-top. Starling’s Compendium outlines good guidance for those seeking to move beyond mere window-dressing.”

JOHN SEELY BROWN

"JSB" was Chief Scientist at Xerox and director of its renowned Palo Alto Research Center (PARC). He has served on the boards of Amazon, In-Q-Tel, and the MacArthur Foundation. JSB has published over a hundred scientific papers, nine books, and holds 11 honorary degrees.

“Invisible networks of social ties within organizations facilitate the flow of critical but intangible dynamics, like trust, identity, and social capital. These dynamics shape how we think, what we believe, and how we behave. By making such forces visible and actionable, we may work proactively to optimize organizational performance and mitigate risks.”

NICHOLAS A. CHRISTAKIS

Nicholas A. Christakis is the Sterling Professor of Social and Natural Science at Yale University, where he directs the Human Nature Lab and Co-Directs the Yale Institute for Network Science. He is widely known for his research in social networks and public health, and is author of Blueprint: The Evolutionary Origins of a Good Society.

“People are connected, and so their behaviors are connected. This fundamental fact has tremendous relevance for diverse management challenges, as both good and bad behaviors spread contagion-like within and between organizations. Combining these ideas with the right data sets, computational social science tools allow us to forecast ‘epidemics of behavior.’”
“The move away from hierarchical forms of authority to more horizontal and networked ways of managing businesses makes trust ever more central to their success. The trust of clients or customers is rarely seen when trust is lacking internally. And because internal trust dynamics shape performance outcomes materially, they warrant management tools and attention.”

-- Amy Edmondson

“Psychological safety is present when colleagues trust and respect each other and feel able – even obligated – to be candid. A psychologically safe workspace encourages staff to speak up about concerns and to offer their best ideas, making it highly relevant to the culture and conduct risk supervisory agenda summarized in Starling’s Compendium.”

-- Betsy Levy Paluck

“Research has demonstrated that we are profoundly influenced by the many social networks within which we reside: among friends and family, work colleagues, civic and voluntary organizations, churches and temples. Those networks shape our beliefs and our behaviors — and those networks can be managed with a view to shaping intentional behavior change for the better.”

-- Thomas Malone

“What I call ‘superminds’ are very powerful in shaping the cultures of firms. A kind of collective intelligence, they go unrecognized in most management circles. But superminds not only exist, they are observable and measurable, which implies that they may also be managed meaningfully. This may be of particular value in the culture and conduct risk management context.”

-- Karen Cook

“Research has demonstrated that we are profoundly influenced by the many social networks within which we reside: among friends and family, work colleagues, civic and voluntary organizations, churches and temples. Those networks shape our beliefs and our behaviors — and those networks can be managed with a view to shaping intentional behavior change for the better.”

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-- Betsy Levy Paluck
Key Takeaways

1 Social Capital - Broad us-them antagonisms were replete in the past year, many exacerbated by the COVID-19 crisis, leading to a heightened demand that we rebuild our ‘social capital.’ Many look to the business-sector to take the lead. Mitigating misconduct, and the social harm it may cause, is not enough there is now insistence that firms demonstrate an ability to do social good.

2 ESG Imperatives - Social and economic tensions and imbalances laid bare by the Covid-crisis have very clearly contributed to calls for ‘reimagining capitalism,’ and this is seen in the growing emphasis on ESG interests across global markets. Concern for good governance and beneficial social outcomes, such as improved DE&I, are now especially prominent amidst the culture and conduct risk reform agenda.

3 Governance, Audit & Regulatory Failures - The last year brought stark examples of governance failures at firms in many industries, compounded by startling lapses on the part of the auditors and regulators relied upon to assure the integrity of market participants. The audit profession and many bank regulators now face calls for the urgent reform of their own culture and conduct risk governance.

4 Outcome vs. Intent - Against the backdrop of the Covid-crisis, we see the heightened significance of firm culture for regulators. Their emphasis has shifted from an examination of the inputs of good culture, governance and risk management to the outputs of relevant control measures. Firms are expected to demonstrate an ability to assure good outcomes ex ante.

5 Personal Liability - The steady march of executive ‘accountability regimes’ saw continued expansion over the past year, increasing the individual liability for executives who preside over misconduct scandals. With this comes a marked shift away from the traditional ‘detect and correct’ approach to conduct risk management towards a ‘predict and prevent’ imperative.

6 Forward-Looking Metrics - Past consumer, investor and social harms, coming as a consequence of overt misconduct and/or well-intended risk management failures, has led to a call for the development of leading indicators of such outcomes. These predictive metrics must move beyond assessment of risk management systems and processes to examine the cultural norms and ‘people dynamics’ within a firm.

7 Behavioral Science - In recent years, bank regulators have looked to behavioral science to better assess conduct norms, propensities and risks among firms. Now, many firms have begun to turn their own attention to behavioral science, in the context of operational risk management, but also with a view to improving the performance of business units and corporate functions.

8 Psychological Safety - Among others, bank regulators are asking whether employees feel free to issue challenges when faced with questionable management instructions or peer conduct. They argue that firms must promote an atmosphere of ‘psychological safety’ if such a ‘speak-up culture’ is to prevail. This element of firm culture will see greater attention from supervisors, investors, and media.

9 Work-Life Balance - Work-from-Home protocols have blurred definitions of ‘the workplace,’ and the established parameters for the ‘work day,’ even as staff are left feeling cut off from the social support structures they previously enjoyed on the job. The result is a new range of culture, conduct and performance risks for which we struggle to devise effective management.

10 RegTech - The RegTech ecosystem has achieved greater maturity in many key financial markets. We now see more regular and coherent collaboration with RegTech pioneers among regulators, central bankers, industry associations and standard setting bodies, investors, board directors and firm leadership, at a pace accelerated by Covid-challenges.
CONTRIBUTORS

In the production of this annual report, we strive to curate and present information without imposing our own views on such—except in those sections cleverly entitled Our View.

Despite best efforts to be neutral observers and reporters, bias will inevitably intrude in any such reporting exercise, if only in the choices we make about what to include and exclude from this report. In an effort to mitigate such bias, we solicit direct input from those whose views we seek to convey.

This we do in two ways:

• first, by forwarding a questionnaire Appendix pg. 294 to relevant figures in all major global financial centers, to better assure that we capture their views as fully and accurately as possible; and
• second, by inviting their specific remarks, appearing throughout the report, and more fulsome contributed commentary and interviews that appear in the many In Focus segments herein.

For this, our fourth annual Compendium, we made a concerted effort to include voices that were not as well-heard as we would have liked in our earlier reports. We are delighted that this year’s report includes contributions from Japan, New Zealand, and South Africa, for instance. And we are particularly proud to have had contributions from so many women.

We also felt it would be of value to include voices from leaders working within the industry itself, and you will find a number of them featured here in what we have called the Ground Breakers series. Also new this year are invited experts from The Academy, who contribute uniquely well researched perspectives on the matters we address herein.

We hope that this 2021 update to our annual report will help to prompt further informed discussion among banking industry executives, regulators and supervisors, central bankers and international standard setters, among other stakeholders. We are proud that so many of them have trusted us with the curation of this important dialogue and our sincerest thanks go to all those who have taken the time to offer views for inclusion here to the benefit of their peers.

As always, we welcome any questions, comments, or criticisms, along with suggestions as to how we may improve next year’s report. Please reach us at info@starlingtrust.com.
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Culture & Conduct Risk in the Banking Sector
There are many reasons why events in 2020 will be etched into the history books. The global pandemic has resulted in huge numbers of casualties, with millions of lost lives and hundreds of millions of lost livelihoods. The scars of these losses will be felt for many generations to come. And these losses have been highly unevenly distributed across society, with the heaviest burden often felt by the young, the poor, the least-skilled and minorities. Pre-Covid inequalities of incomes and life-chances, already large and widening, have been made worse by the events of the past year.

Yet all crises bring opportunities and this one will be no exception. As the world begins the process of recuperating from the Covid crisis, it is important we focus on those opportunities and, indeed, rebuild our economies and societies in ways which benefit from them. For all of their collateral damage, crises allow a re-evaluation, a rethink and a refresh many of our behaviours and practices, whether as individuals, businesses, communities, or nation states.

The social distancing policies introduced during the pandemic served their purpose in securing physical separation. Interestingly, though, they did not in fact enforce social distance. To the contrary, there is plenty of evidence they instead engendered a greater sense of collective and community togetherness. From small acts of neighbourliness to the surge in voluntary activity, social capital appeared to accumulate, not depreciate, during the pandemic. The social fabric, which in many countries had shown signs of fraying pre-Covid, began to be rewoven from the bottom-up. The key, now, is to continue that process of social capital accretion long after Covid has abated.
What is true of communities is also true of firms. During the pandemic, many businesses found themselves appreciating the multiple stakeholders essential for their success and, indeed, survival. Those stakeholders included, crucially, their staff. That is why the Covid crisis has spawned renewed interest in occupational health and a rethink of the way workers can most productively contribute. A redrawing of the social contract between employers and employees is underway in many organisations, balancing individual worker needs for flexibility and agency with the collective business benefits of team proximity and skill and social capital-building. This, too, is a welcome shift in behavioural and business norms.

And it is true too of companies’ relationships with their other stakeholders, including customers, clients, creditors and communities. In the teeth of the crisis, many businesses showed how a co-operative approach to engaging with these stakeholders - the building of social capital - could deliver benefits for both parties, strengthening the bonds of trust between companies and those they supply and serve. This bucks pre-Covid trends towards business being seen as untrustworthy and not serving all of its stakeholders. This more purposeful approach to doing business - a model of stakeholder capitalism - is one we should welcome and hope to build on in the years ahead.

Before Covid struck, issues of ESG (Environmental, Social, Governance) were rapidly rising up the agenda of many companies. Of these, the E had perhaps progressed furthest and fastest – though arguably not as far or as fast as most would wish – due to the exigencies of the climate crisis and a growing awareness and activism among the investor base of these companies. With COP26 later this year in the UK, the E will be given a welcome further nudge. Taken together, it is plausible to think a tipping point has now been reached in business and societal attitudes towards achieving net zero.

Until the Covid crisis struck, it is fair to say the S and G in ESG had made far less progress. The Covid crisis may be the prompt which allows these two elements to share a more equal billing with the E, both at the individual company level and, potentially, at the national level too. For businesses, a useful starting point would be greater reporting and transparency of the different dimensions of success in company accounts – for example, companies’ contribution to natural, human and social, as well as physical and financial, capital. Progress has been made, but there is a distance to travel.

The same is true at the national level. Progress has been made by statistical agencies in better capturing measures of natural and social capital over recent years. But, as the Dasgupta Review for the UK Government recently made clear in respect of natural capital, we are still in the foothills when it comes to fully-integrated national accounting of the full set of capitals relevant for societal success. To that end, some countries internationally, such as New Zealand and Iceland, have recently started putting subjective measures of the well-being of their citizens centre-stage when keeping score of success and when setting public policy. What better time than now for more countries, and indeed more companies, to be following suit.

The scars of the Covid crisis are deep and wide and will take time to heal, economically and societally. But the reset and re-evaluation this crisis has prompted – among individuals, companies and countries – could provide just the nudge we need to reorient our working, business and policy practices. A nudge towards putting issues of co-operation, trust, relationships and well-being at the centre, not just of discussion, but decision-making, deeds as well as words. Were that to happen, then some significant societal good could become the true lasting legacy of this pandemic.
“Money equals business which equals power, all of which come from character and trust.”

**J. P. MORGAN**

“Perhaps nothing in our history has been so short-lived as trust in power.”

**HANNAH ARENDT**
Introduction

In this, the fourth in our series of annual reports, we have again sought to remain neutral chroniclers of events that have transpired over the last year, curating information from around the world regarding an increasingly coherent and robust regulatory and supervisory reform agenda aimed at persistent culture and conduct related risks in the financial sector. Once again, we have endeavored to identify emerging consensus views, key points of departure, and to speculate about what we might expect to see in the year ahead. Above all else, it has been our hope that this series of reports might serve as a platform across which leading industry participants may address one another usefully. With nearly three dozen contributed items from leading global figures featured in this year’s report, we hope that readers will find it to be our most valuable to date.

What a year it’s been ...

In the introduction to last year’s report, I spent some time discussing how and why misconduct in the banking sector was relevant in a much broader social context. I argued that these misconduct scandals had worked to erode our already perilously depleted stocks of ‘social capital’ and to further extend a marked decline in the public’s trust in our core institutions. This, I continued, might in turn foment social unrest and a severing of the essential ties that bind successful societies and market-economies. I wondered, hopefully, whether the shared peril of COVID-19 might help to usher in an era of greater social solidarity. And I suggested that the banking sector might be presented with a redemptive opportunity, as governments directed financial succor to pandemic-ravaged businesses and households through the banking system.

These views reflected deeply held personal convictions that lie at the very heart of our founding story at Starling, and I confess that, as I wrote, I worried that I might be accused of having strayed too
far from our adopted posture of ‘neutral chronicler of events.’ But, at the time, I felt that we had reached a tipping point with regard to concerns for social capital, civic discourse, ‘corporate purpose’, and deteriorating trust in core institutions. I thus concluded that it would be insufficient to remark on the topics at the center of this series of reports without setting them snugly into the context of broader social issues at play. Given how events were subsequently borne out, I hope readers will agree with that editorial decision.

Social Capital

Commentary that I feared might be a bit ‘edgy’ a year ago has now become commonplace.

“The Real Pandemic Danger Is Social Collapse,” Foreign Affairs warned in its March 2020 issue, adding, “the most important role economic policy can play now is to keep social bonds strong under this extraordinary pressure.” An analysis from BlackRock’s Philipp Hildebrand and Brian Deese concluded that firms with a better record on social issues and governance were shown to have been more financially resilient during the coronavirus market crash. Norway’s trillion-dollar ‘oil fund’ indicated that it would give corporate governance increased attention going forward. “A company’s ability to navigate environmental and societal disruptions, combined with governance practices, can have a profound effect on its ability to mitigate downside risk and create long-term value,” agreed Aegon Asset Management. “Good governance is not a ‘nice-to-have’, it’s a must-have,” argued the UK’s Institute of Directors. And the World Economic Forum (WEF) argued that the pandemic had served to highlight the importance of “integrated corporate governance” informing the strategy and operations of companies.

“In 2019 the E of ESG (environmental, social and governance) dominated investing for those who value these issues,” said Schroders’ head of sustainability, Sarah Bratton. “In 2020 we have seen a massive swing to people valuing the social issues.” After worldwide protests last summer, triggered by the death of George Floyd, a black American, under the knee of a white police officer, WEF founder Klaus Schwab warned that a “generational shift” in attitudes regarding social issues would mean that businesses would be forced to change their behaviors. A survey by Deloitte found that the pandemic had engendered a strong sense of individual responsibility among the young, with three-fourths saying the pandemic had made them more sympathetic toward others’ needs and more likely to work toward achieving a positive impact in their communities. A paper from the European Bank for Reconstruction and Development warned that the experience of an epidemic in the course of an individual’s “impressionable years” (ages 18 to 25) has persistent negative effects on confidence in political institutions and leaders.
Perhaps unsurprising that the disenchanted young are thus stepping up pressure on employers to ‘do the right thing,’ to take leadership on social issues, and to prioritize ‘stakeholder capitalism.’

In the conclusion to last year’s report, we cited Bank of England Chief Economist Andy Haldane, who had called out the increased importance of ‘social capital’ amidst the pandemic. At that time, Haldane sounded an optimistic tone, buoyed by countless instances of voluntary social support that he had witnessed amidst the pandemic’s ravages. But, after nearly a year of work-from-home protocols, Haldane grew concerned that a lack of face-to-face contact with colleagues and others might lead to social capital being lost or depleted among firms, while “creative sparks” critical to innovation were being “dampened.”

“Yet all crises bring opportunities and this one will be no exception,” Haldane reminds us in the Preamble to this report that he was kind enough to offer. “For all of their collateral damage, crises allow a re-evaluation, a rethink and a refresh of many of our behaviours and practices, whether as individuals, businesses, communities, or nation states.”

For the banking sector, Citigroup Chairman John Dugan opined, the coronavirus crisis offered an unlooked-for opportunity to “change the narrative” and to improve the industry’s reputation. “This time banks can be and will be ... part of the solution rather than being the problem,” said KBC Bank Ireland CEO Peter Roebben. “Financial services have been part of the solution, rather than the problem,” Jonathan Davidson of the UK’s Financial Conduct Authority later agreed. “This crisis has shown that the financial services sector can be trusted to fulfil its purpose of providing support to consumers and small businesses and keeping the economy going,” he added.

Davidson offers related thinking in this year’s report where he discusses the significance of corporate purpose in a supervisory context. He defines purpose as “what constitutes success” within a firm’s cultural context. For many, this has been called into question in the course of the pandemic. “What should be the goal of the business corporation?”, asked Martin Wolf of the Financial Times as 2020 drew to a close.

In a speech early last year, former Bank of England Governor Mark Carney provided some guiderails: “The market is a social construct whose effectiveness is determined partly by the rules of the state and partly by the values of society,” Carney argued. “It requires the right institutions, a supportive culture and the maintenance of social licence.” Corporate purpose must be consistent with that social license. Carney thus warns company leaders against an over-emphasis on self-interested and transactional economic thinking, which might lead to
ruinous outcomes for individual firms and for whole economies. “Are we consuming the social capital necessary to create economic and human capital,” he asked, “In moving from a market economy to a market society”?

A newly formed Council for Inclusive Capitalism argued that corporate purpose must extend beyond mere profits. The Council received sponsorship from the Vatican late last year, with Pope Francis insisting that a fair and trustworthy economic system is “urgently needed” if we are to address humanity’s deepest challenges successfully. Notably, the new Council’s founding members include the managers of $10.5 trillion in assets, groups representing more than 200 million workers around the world and companies with a combined market capitalization of more than $2 trillion.

Echoes of such sentiment reverberate throughout the items contributed by global industry leaders that appear in this year’s report.

“Trust is the most valuable currency for a financial institution,” says Ravi Menon, Managing Director of the Monetary Authority of Singapore. Menon is cited by Director of the Association of Banks in Singapore Ong-Ang Ai Boon who writes herein about an inaugural study into the public trust enjoyed by banks in Singapore. The study finds that the high levels of trust enjoyed by Singapore banks reflects a combined faith in government and financial sector leadership. “Banks must spare no effort to earn, build and guard the trust that stakeholders place in them,” writes DBS Singapore CEO Shee Tse Koon. “We must never forget that banks exist to serve real people, support real businesses, develop real economies and contribute to real communities,” he adds, calling this the “soul of banking.”

Lost in Space and Wrinkles in Time

“Humankind is now facing a global crisis. Perhaps the biggest crisis of our generation,” wrote the influential historian Yuval Noah Harari in March last year. “The decisions people and governments take in the next few weeks will probably shape the world for years to come,” he added. “They will shape not just our healthcare systems but also our economy, politics and culture.”

Harari is known for making such of grand, sweeping pronouncements – and he occasionally takes criticism for it. In this instance, however, it’s hard to argue that he over-shot the mark. COVID-19 has claimed a horrific toll in terms of human life and well-being, with grim statistics remorselessly continuing to climb. We may need the better part of a decade to fully tally the pandemic’s economic toll. When numbers grow this large, they become an abstraction – people struggle to apprehend events fully at such scale.

Some have called the pandemic “the great accelerator” due to its amplification of pre-existing economic, political and cultural trends. But towards
what are we accelerating? Increased pace of change is not an unalloyed good, and particularly so when we’re still deeply unclear about what changes are desirable and which are not. The crisis will have affected health and prosperity differently on an immediate personal basis, but we have all been confronted by similar distortions to previous beliefs about our space and time: What is the ‘work-place’? Are we working from home, or living at work? What is the ‘work-day’? Is Tuesday any different from Saturday? If so, how, why – and how do I dress for it?

Spatial dislocation was perhaps the most immediate initial challenge to be confronted, as firms were forced to learn how to work remotely. After implementing successful work-from-home protocols, some have since come to celebrate an envisioned future characterized by a “hybrid” workspace that is “more dynamic” than the pre-Covid mundane norm.25 Others are less sanguine. “Without that day-to-day interaction among employees being concentrated in one physical space, much is lost,” Gary Cohn warns. > p. 263 “Figuring out what to do about that is something all firms are now contending with,” Cohn adds, “I think they’re doing the best they can, but the simple fact is that their processes and systems are not designed for this new work context.” > p. 235

By last summer it became clear that the switch to remote working would be long lasting. “We have proven that working from home is possible for most roles,” said UBS group head of human resources, Stefan Seiler.26 Perhaps. But Goldman Sachs CEO David Solomon calls remote working an “aberration.”27 He aims to see US and UK staff back in the office this summer.28 Yet Goldman may be an outlier. True, Morgan Stanley has just announced intent to bring staff back into the office.29 But Wells Fargo and Bank of America have announced a continuation of remote work through at least the autumn.30 And while it has called for many of its staff to return to the office at some point late in the year31, J.P. Morgan appears to have grown comfortable with a hybrid work model and may in fact shutter some of its back-office locations altogether.32 In the UK, Standard Chartered has announced that 90% of its 85,000-strong workforce may be afforded flexible work options.33 HSBC envisions a 40% reduction in office space post-Covid.34 Lloyds plans for a 20% reduction.35 In Australia and New Zealand, where COVID impact has been less severe in terms of the number of lives lost, bank bosses seem eager for a return to the office.36 But European firms are feeling far more cautious.37 In Asia, Singapore looks to be more inclined towards a tentative approach.38 And the view in Hong Kong, where HSBC is looking to slash office space39, is decidedly mixed. So, it seems clear that we won’t be returning to pre-COVID working conditions on a broad basis any time soon.

Bank regulators and supervisors have struggled with these new working conditions40 and will continue to face challenges moving forward. “Risks from misconduct may be heightened or increased by homeworking,” the UK’s Financial Conduct Authority observed earlier this year. “This includes increased use of unmonitored and/or encrypted communication applications (apps) such as WhatsApp for sharing potentially sensitive information connected with work,” the FCA added. “Use of such apps can present challenges and significant compliance risks, since firms will be less able to effectively monitor communications using these channels.”41 Morgan Stanley fell afoul with regulators over precisely this issue late last year.42 The FCA has advised firms to record all work-related calls made from home by its employees43 and warns firms that they are expected to apply the same compliance standards among their remote-working staff as they do for those in the office, raising thorny privacy issues for many.44

Such spatial dislocations should lead firms to give greater thought to their culture, as both an asset and a source of potential risk. A recent Harvard Business Review article urges us to rethink the workplace as a culture space, “providing workers with a social anchor,
facilitating connections, enabling learning, and fostering unscripted, innovative collaboration.” But temporal dislocations must also be addressed.

With the workspace being redefined, many are struggling to set parameters around what constitutes the workday. And many remote employees – for whom the workday no longer has clear boundaries – have found themselves working around the clock. In consequence, burnout risk has become a critical concern and devising remedies for such mental health challenges and employee well-being is now a priority at many firms. Last month, HSBC contractor Jonny Frostick received worldwide attention after a LinkedIn post went viral. “I’d be finding myself there on a Friday at 8 o’clock at night exhausted, thinking I need to prep up something for Monday and I haven’t got time, and I started then to actually work weekends.” In his post, Frostick blamed such overwork for a heart attack he had just suffered.

The issue of burnout received further heightened attention in mid-March this year, after a group of Goldman Sachs first-year analysts produced a survey of peers that featured a litany of complaints about unrealistic deadlines, 95-hour work weeks, “inhumane” working conditions and abusive practices that had led to deteriorating mental and physical health. “We want a workplace where people can share concerns freely,” said CEO David Solomon, pledging that staff could take Saturdays off. Shortly thereafter, Citigroup CEO Jane Fraser called for “Zoom-free Fridays” and a reset of work-life balance. HSBC has just recently announced plans to do likewise to help combat “pandemic fatigue.” Credit Suisse offered junior employees raises and $20,000 “one-time, cash lifestyle allowances.” It is too soon to know whether this new tone from the top will hear a meaningful echo from the bottom.

“Whether as individuals or organisations, our ways-of-working ‘toolkit’ is heavier now than the one we carried with us into early 2020,” writes Alison Cottrell, CEO of the UK Financial Services Conduct Board (formerly the Banking Standards Board). “Building and maintaining a good organisational culture is a core responsibility of boards and leadership teams,” she adds – especially given current challenges – “and one that they owe to their customers, clients, investors, stakeholders and employees.”

Setting a new tone

“Corporate culture refers to the norms and values that drive behaviors within an organization,” the U.S. Office of the Comptroller of the Currency stated in its 2019 Comptroller’s Handbook. “This starts with the board, which is responsible for setting the

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**Analyst Treatment (1 / 3)**

All respondents feel as though work hours have negatively impacted their relationships with friends and/or family. The majority of 1st year analysts feel they have been the victim of workplace abuse and have or considered seeking help due to deteriorating mental health.

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<thead>
<tr>
<th>Question</th>
<th>Percent</th>
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<tr>
<td>Have your work hours negatively impacted relationships with family and/or friends?</td>
<td>Yes 100%</td>
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<tr>
<td>Do you feel like you’ve been a victim of workplace abuse?</td>
<td>Yes 77%</td>
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<tr>
<td>Have you sought or considered seeking counseling, therapy or any additional services for your mental health due to the stress of this job?</td>
<td>Yes 75%</td>
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Source: Survey of first-year analysts, 13 respondents

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tone at the top and overseeing management’s role in fostering and maintaining a sound corporate culture and risk culture.” Such efforts to establish a new tone returns us to the topic of company purpose, values and culture.

“The FSCA at times observes a disconnect between the culture and values espoused publicly by banks and on-the-ground realities in terms of customer treatment and service,” writes Katherine Gibson, a member, South African Financial Services Conduct Authority Transitional Management Committee. p. 203 “In short, professed cultural norms and values do not always align with the actual customer experience.”

“Corporate values statements are nearly universal, but do they matter?”, asked an MIT Sloan Management Review article last summer. Official corporate values matter only in as much as they meaningfully shape the unofficial cultural norms broadly adopted and reinforced by staff.

“We understand ‘organisation culture’ to mean the corporate values, attitudes and conduct of an organization,” writes OCBC General Counsel Loretta Yuen herein. p. 251 “Clearly articulated corporate values will help guide employees to behave in a manner that is desired by the organization,” she adds. “That said, having good paperwork is no longer sufficient.” Nor is going it alone. “A positive culture movement cannot be achieved through individual bank effort; it requires industry consensus, cooperation, and collaboration.”

For Chris Whitehead, CEO of the Financial Services Institute of Australasia (FINSIA) setting an effective firm culture is a matter of professionalism. “It is when a community of professionals is successfully established and committed to higher standards that greater self-regulation becomes a real possibility,” he writes herein. p. 185 “Professionalism has the potential to deliver enormous benefits to the banking and finance industry. Among other things, it can ease legislative and regulatory burdens, contribute to improved customer outcomes, enhance the industry’s reputation, and create a sense of pride and belonging among practitioners.”

**Diversity, inclusion and psychological safety**

Increasingly, a focus on firm culture, and its relevance to risk and performance outcomes, involves a closely related inquiry into matters of diversity, equity and inclusion (DE&I) – conversations which have become a priority among banking sector regulators, drawing in bank leaders from both human resources and compliance.

“Incorporating cognitive diversity into decision making processes drives increased innovation, productivity and overall performance, while also helping to mitigate risks – conduct risk among them,” writes Kathy Matsui, former head of Goldman Sachs for Japan. p. 173 “For a global financial services firm, human capital is the single most critical resource, so in order to attract and retain the highest-quality talent globally, one needs to create a culture that is open to persons with diverse backgrounds and perspectives.”
“Under the moniker of ESG, investors are demanding increased visibility into human capital management,” observe the authors of a recent Stanford corporate governance study. With reference to SEC human capital disclosure requirements, updated in November last year, they note that investors lack adequate metrics by which to monitor a company’s human capital management performance meaningfully, to assess such performance relative to industry peers, or to form a view as to how investment in human capital produces desired ROI. The most vocal calls, the authors note, have been for more diversity related data disclosures. But what to disclose?

Under the SEC’s revised rules, companies are required to “provide a description of the registrant’s human capital resources, including in such description any human capital measures or objectives that management focuses on in managing the business, to the extent such disclosures would be material to an understanding of the registrant’s business taken as a whole.” But what about diversity is demonstrably ‘material’ in this context?

“Diversity in capital markets matters,” declared SEC Commissioner Allison Herren Lee in a September 2020 speech. “It matters for fairness, it matters to consumers, and it matters in realizing the full potential of our talent base,” she added. “All of that translates to performance and matters to investors.”

Perhaps, but this does not tell us what needs measuring, beyond counting noses.

In December last year, the Australian Prudential Regulation Authority (APRA) criticized Westpac for a risk culture that was “immature and reactive.” Mark Roe is Head of ‘Risk Culture’ at APRA – a term he defines as, “the norms of behaviour for individuals and groups that shape the ability to identify, understand, openly discuss, escalate and act on an entity’s current and future challenges and risks.”

By this definition, the UK FCA may have identified the key to a successful risk culture in a 2018 discussion paper: a “psychologically safe” work environment that encourages employees to speak-up and issue challenge. This is clearly essential if misconduct is to be called-out. But it is also important in promoting desirable outcomes: innovation, engagement and retention, productivity, etc. “Diversity doesn’t work without psychological safety,” say the authors of a recent study appearing in the Harvard Business Review. “People only contributed unique ideas to the group when they felt comfortable enough to speak up and present a contrarian view.”

So perhaps it is psychological safety that needs measuring if we are to learn where diversity contributes materiality?

It was Harvard’s Amy Edmondson who conducted the early related research and who coined the term psychological safety. “The desire to belong is perhaps the greatest driver of behavioral choice. The subtle fear of exclusion due to a failure to fit in to a dominant culture, or from saying the wrong thing, inhibits the expression of dissenting views or novel ideas,” Edmondson explains. “Diversity is valuable – but it is inclusion that really drives performance,” she adds. “This flows from psychological safety and the trust dynamics among employees and teams.”

James Freis was made CEO of German payments company Wirecard after uncovering an internal fraud that led to the company’s collapse last year. “The most notable lesson here on the topic of culture is the failure of individuals to speak up,” he argues. “Particularly as many likely knew enough to have formed dissenting views.” Freis, who was the longest serving director of the U.S. Treasury’s Financial Crimes Enforcement Network (FinCEN), believes this lesson to be particularly salient as we move into a post-COVID economy. “The pandemic has afforded the industry a much-needed opportunity to win an uptick in reputation and public trust,”
Freis suggests. By engendering psychological safety internally, firms may make the most of this opportunity.\(^\text{65}\)

**Behavioral Science**

“People are social creatures that want to belong to and identify with a group. They look for ‘social cues’ to determine which behaviour is appropriate and which is not,” writes Mirea Raaijmakers, ING’s head of Behavioral Risk Management.\(^\text{P. 247}\) “In recent years it has become increasingly clear that studying behaviour has a predictive quality with regard to future performance. Early intervention can mitigate risks in a more timely way and help to prevent future problems,” she adds. “Where people used to look back more, nowadays, there is more value attached to looking ahead, and people are increasingly aware that the capacity to examine behavioural risk is an important asset in this respect.”

As discussed in our past year’s reports, behavioral science has been in the ascendant among financial sector regulators and supervisors for the last several years. “A sound organisational culture strengthens alignment of attitudes and behaviours within an organisation to positive corporate values,” argues Ho Hern Shin, Deputy Managing Director in charge of Financial Supervision at the Monetary Authority of Singapore.\(^\text{P. 153}\) MAS is currently working to develop a framework to assess firms’ organizational culture in a structured and consistent manner. “The framework and supporting methodology will leverage behavioural science and organisational psychology concepts and techniques, accompanied by an intervention framework to guide supervisory actions in addressing cultural risks in a financial institution,” she adds.

An article appearing in the journal Science last spring\(^\text{66}\) echoes the argument made by Raaijmakers and the new emphasis on behavioral science at MAS. *Homo sapiens* is an obligatorily gregarious animal.\(^\text{67}\) The forced isolation experienced by many in the course of pandemic-mandated lockdowns has resulted in a ‘craving’ for social interaction that engages much of the same neural circuitry involved in cravings for food, sleep and addictive drugs. Isolation from peers is painful. Neurological (fMRI) research has shown specific regions of the brain to light up when ‘social pain’ is experienced – the very same regions that light up when we experience physical pain – and social pain can be triggered when someone experiences rejection or ostracism at work.

As such, human beings are wired by evolution to do just about whatever it takes to “fit in” with their peers.\(^\text{68}\) Ask any parent who has warned their child about hanging around with other kids who may be a ‘bad influence.’ It’s not much different for those parents themselves in the context of their involvement with colleagues and associates at work – and most particularly among those peers upon whom they rely and in whom they have invested their trust. “Because people are highly reactive to the choices made by others, especially trusted others, an understanding of social norms that are seen as new or emerging can have a positive impact on behavior,” conclude researchers in an April 2020 paper appearing in *Nature Human Behavior*.\(^\text{69}\)\(^\text{P. 227}\)
As Stanford’s Karen Cook and MIT’s Tom Malone discuss herein, p. 55 “Our social networks, and the norms of reciprocity and trustworthiness that arise from them, are essential to the functioning of any organization, whether in the civic, social or economic context, and this implies that social networks are significant to the performance outcomes achieved in any commercial enterprise.”

“What is the secret to organizational change?” asks Damon Centola, Director of the Network Dynamics Group at the University of Pennsylvania. p. 231 “Most people think that the key to change is identifying ‘influencers’ who can advocate for an initiative. But, change is not about finding the right people. It’s about having the right contagion infrastructure,” Centola argues. “My research shows that, as people consider whether to adopt a new belief or behavior, they are guided – much more than anyone realizes – by their social networks.”

Such observations have led to the adoption of behavioral science teams in firms across most major industries and across the world, most particularly in very recent years, and in the banking sector.70

Some have come to argue that we should approach culture, ethics, and conduct risk as design problems. “Common myths suggest that ethical behavior stems from a person’s beliefs; changing behavior therefore requires changing beliefs,” argue behavioral scientists Nicholas Epley, Director of the Center for Decision Research at the University of Chicago Booth School of Business, and David Tannenbaum, in the Department of Management at the University of Utah.71

“Behavioral science, however, indicates that the immediate context (such as an organization’s norms and accepted procedures) exerts a surprisingly powerful influence on behavior,” Epley and Tannenbaum add. “Behavioral science repeatedly demonstrates that people mostly conform to what others around them are doing.” p. 215

“We do not relate to others as the persons we are; we are who we are in relating to others,” wrote James P. Carse, the late professor of history, literature, and religion at New York University. “Since a culture is not anything persons do, but anything they do with each other, we may say that a culture comes into being whenever persons choose to be a people,” he added.
Organizational culture provides both a framework for explaining conduct risk in financial institutions and a way to assess and identify organizations where problems may be developing,” writes London School of Economics professor Tom Reader.

“Institutional norms – whether for integrity, open communication, risk management, reporting of mistakes, or performance target pressures – collectively shape organizational behavior that leads to the success or failure of conduct risk management efforts.”

“Management is an infinite game, and people present managers with ceaselessly wicked problems. This demands a reformulation of the risk and compliance function, and the adoption of new tools,” they conclude.

Accountability for outcomes

“For natural reasons, firms and policy makers often prefer hard and fast rules,” writes Chris Woolard, past Acting-CEO at the UK Financial Conduct Authority.

For regulated entities, “this offers the sense that ‘I complied with the rule, so I must be safe’ while, for regulators, rules provide clear evidence that they are trying to manage a situation,” Woolard explains. “But they [rules] need to be subordinate to the overall purpose the rules intend to serve.” It is not clear that such purposes are being well met.
The future of supervision was a central theme at the 21st International Conference of Banking Supervisors in October last year. “The world has changed profoundly since the outbreak of Covid-19 seven months ago,” observed Pablo Hernández de Cos, Chair of the Basel Committee on Banking Supervision and Governor of the Bank of Spain, in his keynote speech. “The uniqueness of the sudden stop to the global economy in response to the tragic health crisis is only matched by the sheer uncertainty about the outlook. To borrow a sports metaphor, we still do not know if we are in the first inning, quarter or half of this crisis. Uncertainty is the only certainty there is.” This requires that we ask whether banking supervision will be “fit for purpose in the new normal environment after the pandemic.” ★ P. 61

Broadly speaking, banking sector regulators and supervisors seem to feel that, in their efforts to address culture and associated conduct risks, it may be more effective to emphasize ‘principles’ more so than ‘rules.’ In a December 2020 report, Beverly Hirtle, Director of Research and EVP at the NY Fed, observed that much of the academic literature in banking uses the terms ‘supervision’ and ‘regulation’ interchangeably. While economists have analyzed the regulation of banks and the banking industry extensively, Hirtle noted, they have devoted less attention to supervision as a distinct activity. “The theoretical literature examining the motivation for supervision (monitoring and oversight) as an activity distinct from regulation (rulemaking) is just now emerging and has considerable room to grow,” she adds.

“Laws and regulations are insufficient to address the root causes of misconduct,” argues Hirtle’s colleague Michael Held, General Counsel and EVP of the NY Fed’s Legal Group. ★ P. 91 Laws may provide the “outer guardrails for what is ok and not ok,” Held suggests, but law and regulation are poorly suited to this realm of executive judgement. Therefore, while distinguishing legal from illegal conduct may be an essential aspect of the job for corporate counsel, “it is not the limit of a lawyer’s responsibility.”

“Good conduct risk management will not be achieved by a compliance implementation programme alone, because it is about how leaders and employees behave over time,” writes Clare Bolingford, Director of Banking and Insurance at New Zealand’s Financial Markets Authority. ★ P. 197 “For an industry within a jurisdiction that has been used to a more legalistic approach, this requires a change of mindset and a move from the compliance-led programmes that have been implemented in the past to conduct-led programmes that are better able to monitor the real outcomes of actions.”

Yet the law may well be “a uniquely well-positioned vehicle for scrutinizing the risks associated with misconduct in the banking sector,” writes Wharton legal scholar Christina Parajon Skinner. ★ P. 45 “Inherently inter-disciplinary, and often international, the law provides scholars the capacity to weave together many disparate bodies of work which all have bearing on misconduct risk: corporate law and governance, financial regulation, business ethics, and macroeconomics, to name just a few key areas.”

“While considerable efforts have been made globally by banking supervisors and senior management of banks in enhancing governance and risk management framework in recent years,” the Hong Kong Monetary Authority offers, “it is increasingly recognised that much more needs to be done to promote a sound culture at all levels of banks.” ★ P. 75

In this direction, whether with appeal to rules or principles, financial sector regulators in most markets are increasingly holding individuals accountable for the outcomes achieved under their leadership. We see this in several government and regulator led actions in the past year.
In Australia, for instance, early indicators are that the Banking Executive Accountability Regime (BEAR) – soon to be extended to cover a broader swath of the financial industry as the renamed Financial Accountability Regime – has already achieved impact. “The BEAR has undoubtedly brought a greater clarity about who is accountable for what,” said Macquarie professor Elizabeth Sheedy.

In a speech earlier this month, Irish Minister of Finance Paschal Donohoe spoke of a forthcoming Central Bank (Amendment) Bill, “intended to drive greater accountability in the financial sector, [and] raising the standards of expected behaviour for individuals and firms, in order to achieve better outcomes for consumers and improve the sustainability of the financial system.”

The Bill will introduce a Senior Executive Accountability Regime (SEAR) akin to Australia’s BEAR, to set out clearly where responsibility for decision-making lies, and to put forward “Conduct Standards” for both individuals and firms.

Australia’s BEAR and Ireland’s SEAR are modeled on the UK’s Senior Managers & Certification Regime (SM&CR). The regime has been in force since March 2016 for banks, building societies, credit unions and some investment firms that are regulated by both the Financial Conduct Authority and Prudential Regulation Authority. In December 2019 it was extended to cover all FCA solo-regulated financial services firms, though a December 2020 implementation deadline was extended due to the COVID-crisis through March this year.

Here again, early indications are that the SM&CR has had some desired impact on the industry. A December 2020 PRA evaluation of the SM&CR found it had “brought about positive changes to behaviours, and nearly all firms reported integrating to some extent the SM&CR with internal practices.” With early successes in evidence in other markets, in September last year, Singapore introduced a set of industry “guidelines to strengthen culture of responsibility and ethical behaviour in the financial industry.”

Last May the FCA banned three individuals from working in the financial services industry – notably, for non-financial misconduct – but the regulator faced criticism as the year drew to a close with the FCA having sought fines against only 10 wrongdoers in the course of 2020, the lowest number of such actions since it was established. It is likely that this reflects a preoccupation with Brexit, COVID, and a change of leadership, so it might be unsurprising to see greater enforcement activity under the SM&CR in the course of 2021.

The U.S has no similar accountability regime in place, yet it is there that some of the most dramatic instances of personal accountability exposure were in evidence over the past year.
Regulators had already acted aggressively to hold Wells Fargo executives accountable for the false-accounts scandal that rocked the firm in 2016. Former CEO John Stumpf was fined $17.5 million and banned from the industry for life in January last year. In November he faced a further $2.5 million fine in reaching a settlement with the SEC while, separately, the SEC brought a civil suit against former consumer-bank head Carrie L. Tolstedt. The SEC seeks a court judgment ordering Tolstedt to pay fines and barring her from serving as an officer or director of a public company. The OCC had sought a $25 million civil money penalty and lifetime ban from the industry for Tolstedt early last year, in an action that named four others. In January this year the OCC fined Wells Fargo’s former General Counsel $3.5 million and, in April, it took aim at three additional former Wells Fargo executives.

“As a leader, the only thing you lead is people. You can’t ‘lead’ working capital, buildings, inventory etc. Leaders lead people – that’s all,” maintains former HSBC CEO John Flint. “Boards typically recognize that they are responsible for the strategy of the firm, but too often they are passive when it comes to their responsibilities for holding the executive accountable for creating the appropriate environment for staff to deliver on their strategy.”

The past year has seen unprecedented action on the part of bank boards with a view to holding executives personally accountable for misconduct fines and reputational damage to which firms and their shareholders had been exposed. This past January, Citigroup cut executive’s bonuses after the firm was reprimanded by the OCC for risk management lapses. The following month, incoming CEO Jane Fraser announced the creation of a new operating team tasked with addressing these regulatory concerns. “A key element of our transformation work is to hold our business leaders accountable not only for the performance of their own teams, but for how we collectively operate our firm and deliver the outcomes for which we are responsible,” Fraser said.

Perhaps most noteworthy, the board of Goldman Sachs demanded accountability of current and past senior executives, cutting pay and clawing back past bonus pay outs after the firm entered into a Deferred Prosecution Agreement with the US Department of Justice and agreed to a $2.9 billion settlement for its role in the 1MDB scandal. “The Board’s announcement is an important reminder that we are all responsible for each other’s actions, including our collective failures,” Goldman CEO David Solomon said.

Regtech Adoption

Like pilots flying through a heavy fog, in our struggle to come to grips with the mass disorientation that COVID has wrought, we have had to lean increasingly on technology in order to get our bearings. This has accelerated the advancement of digital tools and the adoption of RegTech solutions.

“While most respondents believed their institutions are extremely or very effective at managing financial risks,” a Deloitte risk management survey found, “substantially fewer said the same about nonfinancial...”
risk types and aspects such as operational resilience, cybersecurity, and conduct and culture, which have become more prominent in the COVID-19 period. Deloitte’s survey results, produced in February this year, also noted that pressure on revenues from the pandemic downturn had added to a desire to reduce risk management expenses at firms – costs that have grown continually since the global financial crisis. As such, many are now looking to emerging technologies with a view to how they may help to reduce risk management costs by automating manual tasks, while at the same time increasing the effectiveness of their risk management controls. A Thomson Reuters study earlier this year finds that more than half of survey respondents say they are looking to RegTech with a view to enhancing strategic decision-making in their risk and compliance functions.

“Three of the four top risks facing banks are not financial at all, they involve strategic, operational, and compliance risks,” writes Brian Brooks, a recent past Acting Comptroller of the Currency. “The best RegTech eliminates burden of data entry and retrieval, minimizes risk of human error, and helps identify patterns and indicators that may go undetected by the human eye,” Brooks adds. In a November appearance before Maxine Waters’ House Financial Services Committee, Brooks spoke of efforts at the OCC to expand technology trials and adoption. “Currently, I also am working to support our Office of Innovation in developing capabilities to evaluate emerging technologies and developments to reduce regulatory uncertainty.” And to promote responsible innovation, Brooks added.

Regulators and supervisors have also taken note of RegTech’s promise to provide more reliable, and even predictive risk intelligence, to permit more timely, efficient, and effective interventions. “RegTech holds great promise for supplementing the training, judgment, and expertise of bank examiners and supervisors,” argues Brian Brooks in his contributed remarks here. His predecessor, Tom Curry, agrees. “Financial regulators will also be looking to technology to enhance their oversight programs, increasingly so,”

What would you like regtech to be able to do for your firm?

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<tr>
<th>Feature</th>
<th>Percentage</th>
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<tr>
<td>Enhanced strategic decision making for the risk &amp; compliance function</td>
<td>52%</td>
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<tr>
<td>Increased accuracy of regulatory reporting</td>
<td>47%</td>
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<tr>
<td>Facilitate compliance function tasks (e.g. horizon scanning training)</td>
<td>44%</td>
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<tr>
<td>Creation of more insightful management information</td>
<td>41%</td>
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<tr>
<td>Improved line of sight to risk management processes</td>
<td>40%</td>
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<tr>
<td>Improved record keeping</td>
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<tr>
<td>Evidence accountability regime compliance</td>
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<tr>
<td>Enhanced strategic decision making for the firm</td>
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<tr>
<td>Improved customer experience (e.g. account opening, sales processes, complaints handling)</td>
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<td>Informed input to policy formulation</td>
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<tr>
<td>Better product development and innovation</td>
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<td>Other</td>
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Source: Thomson Reuters Regulatory Intelligence Fintech, Regtech and the Role of Compliance in 2021, by Susannah Hammond and Mike Cowan

“DIGITALIZATION”

In Japan, under Prime Minister Suga, a new ‘Digital Agency’ is being formed. “Japan’s Financial Services Agency (JFSA) is working on upgrading its data strategy and analytical capabilities to gain a more accurate picture of the financial situation at firms across the country,” writes Matsuo Motonobu, Secretary General of Japan’s Securities and Exchange Surveillance Commission. P.167 “RegTech and SupTech will play an essential role in this connection, as we look to develop practical monitoring methods in specific fields.” The Digital Agency should begin operations this year, “aiming to become the ‘control tower’ from which the country’s many digitalization efforts will be directed.”

“It is now abundantly clear that COVID-19 has acted as a catalyst for digitization,” Deloitte writes in a 2021 banking and markets outlook report.99 The consultancy argues that the crisis has served as a “litmus test” for banks’ digital infrastructure. “While institutions that made strategic investments in technology came out stronger, laggards may still be able to leapfrog competitors if they take swift action to accelerate tech modernization.”

Global banking stocks plunged in September last year, when the International Consortium of Investigative Journalists (ICIJ) leaked the so-called ‘FinCEN Files’ – a trove of more than 2100 Suspicious Activity Reports filed by banks with the U.S. Treasury’s Financial Crime Enforcement Network (FinCEN) from 1999 to 2017.100 The leaked confidential filings describe more than 200,000 suspicious transactions, involving the movement of over $2 trillion across multiple global financial institutions, offering what BuzzFeed News called an, “unprecedented view of global financial corruption, the banks enabling it, and the government agencies that watch as it flourishes.”101

In a contemporaneous statement released by the Institute of International Finance (IIF), President and CEO Tim Adams said, “The findings of today’s reports once again emphasize the need to pursue intelligence-led changes for financial crime risk management – driven by meaningful improvements to public-private sector cooperation and cross-border information sharing, coupled with the use of technology – to enhance the global anti-financial crime framework.”102

“The digital age presents a renewed need for regulatory coordination and for refreshing regulatory mandates.” Adams writes herein, “We are at an interesting juncture – perhaps an inflection point – for how we approach international coordination and cooperation in regulation of financial services and beyond.” P.259

Financial industry critics may point to the leaked FinCEN Files to support their conclusion that banks are ready to turn a blind-eye to nefarious or criminal actors, if it’s profitable. In an October interview, U.S. Senator Sherrod Brown reacted to the FinCEN leak saying, “I think if some bankers go to jail, that stuff stops happening.” Brown, who currently chairs the Senate Banking Committee. “One or two big-deal bankers going to jail, and the world will change a bit,” he added.103 But interestingly, in a February 2021 poll104, a majority of banking industry executives said that they believe the FinCEN leak will have a positive outcome in the fight against money-laundering, and that they would be supportive of an investigation into the matter.105

Rather than standing as evidence of complicity or complacency, they see the leaked files as illustrating the complexity of a multi-jurisdictional fight against bad actors in an increasingly digital banking system that lacks sufficient international coordination and,
especially, inadequate technology tools. Nearly 90% of the bankers responding to the poll referenced above said that they expect the FinCEN Files leak to result in increased adoption of technological tools that can improve compliance controls and/or free up resources. But the industry will need to collaborate with regulators to innovate successfully.

Global financial regulators can – and must – play a leading role in helping to assure that policies and practices keep pace with a fast-changing financial ecosystem that is increasingly digital in form and function, Adams argues. This will require global cooperation among regulators, central banks and international standard setting bodies. And such coordinated engagement is made all the more imperative by the blurring of the lines between traditional financial institutions and data technology firms that now play roles – of increasing systemic significance – which had been confined previously to well-understood financial actors, principally banks.

What’s good for the goose ...

“Regulators have been saying consistently that culture shapes conduct,” former FINRA head Rick Ketchum notes.  "The protections of a strong risk and compliance culture are clearly even more important in the supervisory context today. So, it just stands to reason that, going forward, regulators will pay even more attention to these cultural issues in the current environment."

But what’s good for the goose is good for the gander, as the saying goes. Regulators are also coming under scrutiny and are facing questions – from legislators and voters – about the outcomes that they permit to take place on their watch, and how their own cultures contribute to the success or failure they achieve in safeguarding public interests.

In remarks at the Second G20 Finance Ministers and Central Bank Governors Meeting last month, Financial Action Task Force (FATF) President Dr. Marcus Pleyer called for a change in regulatory culture. “We keep hearing about criminals exploiting the Covid-19 pandemic,” Pleyer remarked. “This is happening partly due to a widespread failure in effective supervision and compliance of anti-money laundering measures,” he argued. Pleyer complained that, while supervisors and compliance officers are meant to understand and mitigate financial crime risks, they mostly take a tick-box approach to the task. “They make sure forms are filled in correctly but don’t focus on the real risks,” Pleyer said. “As a result, fraudsters, scammers and criminals often get away with their crimes.”

U.S. regulators have taken harsh punitive action when firms experience systems failures. Scorn was heaped upon Citigroup when it made an erroneous payment of $900 million to Revlon last summer, attributed to “human error.” The incident is believed to have contributed to a $400 million fine and orders by the Office of the Comptroller of the Currency and the Federal Reserve to take “comprehensive corrective actions” to improve “enterprise wide risk management.” In February this year, Citi lost in a court effort to reclaim the mistakenly transferred funds.

But in February, the Federal Reserve was forced to explain how a majority of its payment systems suffered an outage. The Fed’s electronic payments network allows some 9,300 financial institutions to transmit billions of dollars daily through the U.S. financial system. “Our technical teams have determined that the cause is a Federal Reserve operational error,” the central bank said in a post on its website. And in September last year, as Citi was dealing with fallout from its mistaken $900 million transfer of funds, the U.S. Treasury Department’s Office of the Inspector General (OIG) issued a report examining how it was that the OCC “missed opportunities,” between 2010 and 2014, to analyze and address incentive scheme issues at Wells Fargo that were later found to have contributed to the firm’s 2016 false accounts scandal. Under questioning by
the OIG, OCC examiners explained that “the bank’s historically solid reputation gave them confidence in the bank’s explanation for the rise in complaints and the corrective actions taken by bank officials.” As such, perhaps the examiners didn’t look as deeply as might have been expected.  

Incidents like these have led some to ask whether bank regulators and supervisors are holding themselves to a lower standard of operational risk management than that which they enforce among the firms they oversee. Over the past year, we have seen that governments are prepared to step in and to hold regulators to account for their own perceived lapses, cultural challenges, and failures of system, process and people, when these result in stakeholder harm or a diminishing of the public’s faith in its institutions.

UK FINANCIAL CONDUCT AUTHORITY

Among other criticism from Parliament and the British public, the FCA and its former head, Andrew Bailey – now Governor of the Bank of England – faced scathing criticism in the last year for a perceived failure to “effectively supervise” minibond issuer London Capital & Finance (LCF), which collapsed in 2019. A report detailing the findings of an independent investigation into the FCA’s supervision of LCF concluded in November that victims of the firm’s failure “were entitled to expect, and receive, more protection” from the regulator than that which they experienced.  

In a discussion of individual “responsibility” for the outcome, investigators explained that they had used the term in a manner consistent with its use in the FCA’s own Statements of Responsibility and its Management Responsibilities Map. “In short, it refers to a sphere of activities or functions of the FCA for which a senior manager bears ultimate accountability,” the report indicated. Notably, in an exploration of “root causes,” the report argues that the FCA had failed to consider LCF’s business holistically. “Instead, FCA staff analysed LCF’s breaches as though they were isolated issues. In particular, they did not consider whether, and if so how, these issues were indicative of broader concerns with LCF’s business.” More pointedly still, the report faults the FCA for not “considering whether the pattern of conduct [at LCF] was indicative of poor culture or systems and controls…”

Appearing before a Treasury select committee in Parliament in March this year, FCA chairman Charles Randall told MPs that senior FCA staff would see bonuses withheld and face salary cuts in the wake of the LCF scandal. “We decided that the consequences that flow from this should be collective,” Randall said. “It was clearly the case that the FCA wasn’t sufficiently joined up across its various activities,” he added. “In the past there are areas where we could have been faster, where we could have shared data more efficiently, where we could collaborate across departments,” newly installed CEO Nikhil Rathi said, appearing before the Parliament’s Treasury Committee. “And we are investing in our systems, our controls, to enable us to use technology better with better capability to enable us to move in a more agile way in the future,” he added, referencing a broad digital “Transformation Programme” under his personal leadership.

AUSTRALIAN SECURITIES & INVESTMENTS COMMISSION

In his opening remarks during a webinar hosted by the Australia and New Zealand School of Government last August, ASIC chairman James Shipton spoke of regulation, trust and social licence. “Trust is crucial to the efficient functioning of every part of society,” Shipton said. “Economists talk in terms of ‘confidence’ and the need for it for economic resilience and growth,” he added. “Put another way, ‘confidence’ is having faith or trust in something. So, our economic system, in large part, relies on trust and confidence,” Shipton concluded.
In late October, Shipton suffered a loss of that public confidence, when it was learned that ASIC had paid KPMG some AUD $120,000 to cover the cost of preparing the chairman’s personal tax returns. The Australian public, and the Treasury, had already suffered some loss of confidence in ASIC, following the harsh criticisms levied against it in the course of the 2017-2019 Hayne Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. Critics seized upon what appeared to be an improper use of public funds to urge an overhaul at ASIC. Though Shipton maintained that he had done nothing wrong in the tax fee payment scandal – and indeed he was later absolved of any wrongdoing – he agreed to step down as ASIC chair.

**BAFIN – GERMANY’S FEDERAL FINANCIAL SUPERVISORY AUTHORITY**

The collapse of German fintech darling Wirecard is covered in some detail in this report, with attention to its impact on long-time auditor EY, and we offer some discussion of the political backlash that has shaken BaFin – the Bundesanstalt für Finanzdienstleistungsaufsicht – to its foundations.

Cast as an accounting scandal last June, the German government initially launched an overhaul of accounting regulation after Wirecard’s collapse, transferring to BaFin the powers of the country’s accounting industry oversight body – the Financial Reporting Enforcement Panel (FREP). But by July, BaFin itself had been sued by aggrieved Wirecard shareholders who alleged that the supervisor had turned a blind eye to well evidenced trouble at Wirecard. “BaFin grossly neglected its duties and powers by refusing to investigate Wirecard AG for market manipulation,” lawyers said, “while taking biased action against journalists and short sellers.”

In November, the European Securities and Markets Authority (ESMA) took aim at both FREP and BaFin, raising questions about BaFin’s political independence and perceptions of “a heightened risk of influence by the Ministry of Finance.” While allowing that, “discovering fraud is not to a prime responsibility of the financial supervision of financial reporting,” ESMA chairman Steven Maijoor offered that “a better supervisory process could have increased the chances of discovering this earlier.”

Already criticized for having done too little, too late, in January this year it was learned that BaFin had received several warnings about Wirecard from Commerzbank, in early 2020. BaFin chief Felix Hufeld, however, maintained the belief that Wirecard was the victim of a plot by short-sellers (and the Financial Times), pointing to the “homogeneous cultural background” of suspect parties – principally British and Israeli – in a memo to the Finance Ministry.

In late January this year, Hufeld was forced to step down from his leadership of BaFin. “The Wirecard scandal has revealed that Germany’s financial supervision needs a reorganization,” the Finance Ministry said in a statement. This past February it was announced that Frankfurt prosecutors were opening a criminal investigation of BaFin.

Finance Minister Olaf Scholz is facing criticism as well, with German lawmakers suggesting that his Ministry had failed to oversee BaFin sufficiently well. “Consequences for the finance ministry are now overdue,” CDU parliamentarian Hans Michelbach said. Scholz rejected these criticisms last month, appearing before a Bundestag inquiry panel. “The government does not bear responsibility for this large-scale fraud,” Scholz argued, accusing Wirecard’s auditor EY for negligence. “The most important task is to restore confidence in Germany as a financial centre,” he added.

Space constraints are such that these are very partial histories: much essential detail and nuance goes without mention in this cursory account of complex events. Politics is, of course, a rough-and-tumble
sport, and it is surely the case that political cross-currents, sharp elbows, and ambitious egos were at play in the course of the tempests that surrounded the FCA, ASIC and BaFin in the past year. It is not our intent, nor our place, to suggest that the criticisms leveled against these agencies or their leaders are with merit. That is for others and for history to decide.

But it is incumbent upon us to observe that these criticisms have been raised, and to note how closely they echo many of the criticisms that regulators have sounded themselves in recent years with regard to the risk management lapses, misconduct and poor stakeholder outcomes that firms have permitted to take place, and also with regard to the remedial steps that regulators have called upon firms to take: vis-à-vis their purpose, culture, diversity and inclusivity; the degree of psychological safety that characterizes their workplace; how that may help to minimize or exacerbate the likelihood of risk governance lapses; and whether the use of innovative data technologies may facilitate more proactive risk mitigation and help to preserve market integrity and trust in the industry.

In short, the regulators and the regulated appear to suffer from some of the very same ills. Perhaps they might benefit by engaging more closely towards a shared goal of developing new remedies? Towards that end, we hope that this Compendium may provide a number of good jumping-off points to facilitate a productive and collaborative industry dialogue.

Stephen Scott
Founder & CEO, Starling
15 May 2021
The Academy
An Evolving Legal Literature on “Misconduct Risk” and Bank Culture

By CHRISTINA PARAJON SKINNER

Over the past ten years the study of misconduct in financial services institutions—and among banks and bankers in particular—has grown into a distinct field of legal academic analysis.¹

To be sure, numerous academic disciplines have long-considered issues implicated by, or adjacent to, financial misconduct: management scholars examine organizational behavior and anthropologists outlay organizational cultures, to name just a few modalities of scholarly work that touch upon this subject. More recently, legal academics have begun to examine questions about bank misconduct and its relationship to culture.² Legal research regarding ‘misconduct risk’ now stands as an independent, substantive subset in the legal literature on financial regulation.

The law may well be a uniquely well-positioned vehicle for scrutinizing the risks associated with misconduct in the banking sector. Inherently inter-disciplinary, and often international, the law provides scholars the capacity to weave together many disparate bodies of work which all have bearing on misconduct risk: corporate law and governance, financial regulation, business ethics, and macroeconomics, to name just a few key areas. By drawing these bodies of work together, a legal researcher has some ability to shed new light on the core parameters of the problem of misconduct and culture in banks.

This insert to Starling’s annual Compendium provides a summary map of where legal scholarship has, so far, guided a general understanding of misconduct risk. In doing so, it provides a high-level overview of my forthcoming book on conduct and culture in global banking. To get a general sense of the extant legal literature, one can consider it as evolving in two distinct—though iterative—phases.

Legal Research Phase I: Root Causes, Industry Structures, Externalities

When the study of misconduct risk was first opened circa 2015, legal academics and concerned regulators started on the diagnostic front. In the wake of high-profile rate-fixing scandals, which themselves came on the heels of a massive global financial crisis, there was a strong sense that misconduct in financial services could not be viewed merely as isolated (even cluster) incidents that were amenable to spot-treatment; but rather, these researchers began to consider a broader pattern of suboptimal conduct norms that had developed, and spread, throughout certain pockets of the industry. The legal and regulatory literature that developed thus sought to answer two inter-related questions: first, what is the nature of “misconduct risk” and what are some possible causes at its root?³

In early work, I considered three possible structural causes of misconduct risk—which I loosely defined as widespread business norms that, while perhaps not illegal, were sufficiently unethical as to generate outcomes for customers, clients, counterparties, or other stakeholders that were manipulative or
otherwise concretely harmful. The three structures that I focused on were (i) compensation schemes that incentivized short-termism (albeit today, they are an increasingly dying breed); (ii) weak mechanisms for accountability at middle-management levels; and (iii) fluid-labor markets combined with insufficient gates to halt the importation of poor business norms from one firm to another. Given the homogenous and competitive nature of the (large) banking sector, these features were not specific to individual firms but rather industry-wide structures. This structural diagnosis suggested careful reflection—as a matter of bank governance—on how these features of the banking sector might be contributing to a firm’s (and, in turn, the industry’s) exposure to misconduct risk.

Simultaneous to this root-cause analysis, my early legal scholarship also sought to understand the public dimension of misconduct risk. Certainly, misconduct risk poses potential costs to an individual financial institution—reputational harm from scandal and, perhaps more concretely, legal risk associated with enforcement actions. But, as with other forms of financial institution risk, there are social costs—negative externalities—to consider. Here again, academics like myself reasoned that misconduct in the financial system could eventually undermine the public’s trust and confidence in banks and other financial institutions, with potential long-term implications for the health and resilience of the financial system. The public’s trust in banks is critical, not only because of banks’ special role in our economy—which rests on social license—but also because of the delicate balance between banks and capital markets and the extent to which ephemeral things like ‘trust’ are so important to the smooth and orderly functioning of these markets. ▲ P. 17 In some quarters, bank regulators expressed similar concerns.4

A final component of this diagnosis was international. The locus of the problematic misconduct (insofar as misconduct had potential to generate significant social cost) was among large, internationally active institutions. Given the cross-border nature of their operations and management, misconduct risk seemed to indicate the need for internationally agreed soft law norms and practices, which could be supplied by international regulatory networking bodies like the Basel Committee on Banking Supervision or the Financial Stability Board. Indeed, the beauty and the genius of these bodies is their ability to generate norms among domestic regulators that could be appropriately imported into domestic supervisory dialogue and custom.5 Helpfully, legal academics also have much to contribute on this score, with longstanding research on the power and authority of international economic and financial institutions and tribunals, and the potential for soft-law norm generation through the networking effects of regulatory cooperative bodies.6

Phase II: Prescriptions and Public-Private Partnership

After five years of research and study in that first, diagnostic phase, the second phase of academic work—only now beginning to emerge—will necessarily shift from diagnostic to prescriptive. More specifically, while diagnoses are focused on misconduct risk, prescription will turn to questions of bank culture. As I have and will continue to urge, the solution, like the problem itself, will involve both public and private aspects.

Several ideas are taking shape. In the first instance, most of these issues should be handled by and through the firms themselves, by incorporating a cultural focus into their corporate governance structures, and by committing to culture via ongoing professional training and onboarding introductions to the firm and its core values. The industry as a whole can accelerate progress toward a more sustainable and ethical culture by leveraging the work of industry bodies that are dedicated to bank culture. Only with collective effort, and perhaps undertaken through
third parties, can the banking services industry develop an ethical esprit de corps—a reimagined professionalism in banking. \( \text{\textbullet\ P. 185} \) Here, the U.S. banking system might learn from its European counterparts, where groups like the Chartered Banker Institute and the Banking Standards Board have taken innovative steps in this direction. \( \text{\textbullet\ P. 133} \)

Bank regulators, in the U.S. and elsewhere, are understandably interested in banking culture as it directly shapes bank conduct. However, whether regulatory intervention is appropriate will depend on the progress made by industry and—more importantly—the unique legal framework that constrains each financial regulator in each respective jurisdiction. In the U.S., for instance, regulatory intervention into bank culture seems appropriate only on a narrow margin where, for instance, the microprudential supervisory tools of Federal Reserve Banks might involve dialogue with bank managers regarding their governance arrangements to mitigate misconduct risk. Even softer still, bank supervisors might use their convening power to facilitate best practice development. The New York Fed has, in this regard, and using forward thought, used its convening power to accomplish what an industry body might—bringing together industry and academic experts to discuss best-practices and to innovate strategies for improving ethics and governance among the large banks in that jurisdiction. \( \text{\textbullet\ P. 91} \)

Inasmuch as this prescriptive work involves suggestions for how to operationalize good culture goals, it will also naturally situate these conversations about bank culture in some of the broader debates that are presently shaping the course of banking in the next ten years. For one, much ink has been spilled debating the purpose of a corporation. \( \text{\textbullet\ P. 129} \)

Ideally a firm will pursue projects that maximize its value in a socially responsible way—that is, pursuing profit-making projects without sacrificing ethics. \( \text{\textbullet\ P. 129} \)

But regardless of where one comes down on this debate, ethical culture seems a key ingredient. As Milton Friedman clearly stated, corporate decisions taken in fealty to shareholders must always observe ethical rules of the road; \( \text{\textbullet\ P. 129} \) and certainly, the interests of a bank’s stakeholders—customers, clients, the public markets themselves—can only flourish when there is strong ethical culture. Culture, then, seems to be the common denominator in this purpose debate, and so it may well be a first-order issue for us to pin down.

Additionally, policymakers, regulators, and corporate managers continue to seek answers about how best to incentivize bankers to be compliant with applicable law and regulation. \( \text{\textbullet\ P. 247} \) Incentives to arbitrage the letter of the law in favor of profit are difficult to eliminate. A strong culture, however, can create counterbalancing motivation to comply with the spirit of the law even at the sacrifice of apparent profit. Ethical culture, that is, can go a long way to inspiring good judgment among bankers about how to make decisions in the grey areas of the law and when under considerable time pressure.

Finally, conversations about bank culture put front and center the ongoing tug-of-war between private governance and bank regulation. \( \text{\textbullet\ P. 247} \) A conduct problem in a bank can, as just discussed, generate
externalities. But that does not mean a regulatory intervention is required (or tell us to what degree, where intervention appears appropriate). There is evidence that the private sector is already wrestling with its conduct problem. Certainly, regulators should stay vigilant for conduct-related externalities that go unaddressed. But, as stated at the outset, misconduct risk is a distinct kind of risk; its remedies may also be unique. Unlike credit or market risk, banks may well have within their control the ability to reduce misconduct risk and the incentive to carry out that work. Still, it is a joint endeavor. Ideally, motivated banks will continue to mitigate their misconduct risk by leaning on the expertise of industry bodies and the convening power of the bank supervisor.11

Christina Skinner is Assistant Professor of Legal Studies & Business Ethics at Wharton.

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3 See sources cited, supra note 1; see also Group of 30, Banking Conduct and Culture: A Permanent Mindset Change (Nov. 2018).
5 For a general discussion of how these bodies, and how international financial regulation, can translate into domestic law, see David Zaring, The Globalized Governance of Finance (2020).
8 See Christina Parajon Skinner, Canceling Capitalism?, 97 Notre Dame L. Rev. (forthcoming 2021). The notion that companies should pursue profits in a socially responsible way resonates with what is now referred to as enlightened shareholder value.
10 For legal academic work on executive compensation, see, for example, Lucian A. Bebchuk & Holger Spamann, Regulating Bankers’ Pay, 98 Georgetown L.J. 247 (2010).
11 The convening power of the supervisor is perhaps itself a grey area—while it is not the deployment of formal or hard law, it may have soft law consequences of influencing firm behavior. Therefore, while the convening power is useful in incentivizing socially desirable firm behavior, one must be mindful of the rule-of-law issues always operating as a background constraint to the exercise of such power.
Deeper Dive
Misconduct Costs

According to a late 2020 study¹, three countries – the U.S., Australia, and Israel – accounted for 97% of the nearly €12 billion in bank fines issued last year.² Notably, costly conduct scandals also threatened to further a recently shake up in the leadership ranks of European firms.³ In the Netherlands, ABN Amro reached a €480 million anti-money laundering settlement with Dutch prosecutors just last month.⁴ Between them, European and American firms have faced some $400 billion in misconduct fines since the Financial Crisis.⁵ In Asia, risk governance and compliance costs are estimated to have increased by some 20% year-on-year in 2020.⁶

The Operational Risk Exchange (ORX) – an industry association of operational risk leaders at the world’s largest financial institutions – estimates that its member firms experienced operational risk related losses of €482 billion in the period 2014 through 2020, misconduct counting for much of that cost. An exhaustive accounting of misconduct costs experienced across the industry globally in the last year falls outside the scope of this report. But there are particular instances of note that warrant attention here.

Last September, Australia’s Westpac Banking Corp paid the largest fine in Australian corporate history, AUD $1.3 billion, to settle charges brought by financial crimes regulator AUSTRAC, the Australian Transaction Reports and Analysis Centre. AUSTRAC head Nicole Rose said the size of the penalty reflected the “serious and systemic nature” of Westpac’s breaches.⁷ In October the firm announced a $1.2 billion hit to its earnings driven by misconduct.
costs. And in December, the Australian Prudential Regulation Authority (APRA) required that Westpac increase cash reserves after a review of the bank’s risk management found it had incorrectly calculated several key capital ratios through 2019 and 2020, reflecting “weaknesses in risk management and oversight, risk control frameworks and risk culture.” The firm agreed to a court-backed enforceable commitment with APRA, pledging to address “long-standing weaknesses” in its risk controls and poor risk oversight. In a statement, APRA concluded that Westpac had failed to deliver expected risk governance improvements despite almost two years of remediation.

In September, JP Morgan entered into a Deferred Prosecution Agreement with the Department of Justice and agreed to pay a $920 million fine to settle criminal charges relating to claims that it had sought to defraud precious metals and U.S. treasuries markets. “For nearly a decade, a significant number of JP Morgan traders and sales personnel openly disregarded U.S. laws that serve to protect against illegal activity in the marketplace,” said Assistant Director in Charge William F. Sweeney Jr. of the FBI’s New York Field Office. “JPMorgan engaged in two separate years-long market manipulation schemes,” said U.S. Attorney John H. Durham of the District of Connecticut. “Not only will the company pay a substantial financial penalty and return money to victims, but this agreement requires JPMorgan to self-report violations of the federal anti-fraud laws and cooperate in any future criminal investigations.” In November, JP Morgan faced a $250 million fine from the OCC for “deficient” risk management practices and insufficient controls in its asset and wealth management business.

### Bank Governance Conduct Deficiencies

**Governance Issues Have Resulted in Record Fines, Regulatory Scrutiny**

<table>
<thead>
<tr>
<th>Date of Most Recent Fine</th>
<th>Bank</th>
<th>Fine/Restitution</th>
<th>Governance/Conduct Deficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oct 20</td>
<td>Deutsche Bank</td>
<td>$196m</td>
<td>Deficient risk management/internal controls; market manipulation/spoofing</td>
</tr>
<tr>
<td>Oct 20</td>
<td>Goldman Sachs</td>
<td>$5.1b</td>
<td>Deficient risk management/internal controls</td>
</tr>
<tr>
<td>Sept 20</td>
<td>JPMorgan</td>
<td>$920m</td>
<td>Market manipulation/spoofing</td>
</tr>
<tr>
<td>Sept 20</td>
<td>Citigroup</td>
<td>$400m</td>
<td>Deficient risk management/internal controls</td>
</tr>
<tr>
<td>Aug 20</td>
<td>Capital One</td>
<td>$80m</td>
<td>Deficient risk management/internal controls</td>
</tr>
<tr>
<td>Aug 20</td>
<td>Bank of Nova Scotia</td>
<td>$127m</td>
<td>Market manipulation/spoofing</td>
</tr>
<tr>
<td>Aug 20</td>
<td>TD Bank</td>
<td>$122m</td>
<td>Customer welfare; inadequate disclosure regarding consumer debit card</td>
</tr>
</tbody>
</table>

*Source: Fitch Ratings*
Regulators increasingly appear to be arguing that poor risk governance and compliance controls create conditions for unacceptable levels of both financial and non-financial risk. Because the management of financial risk involves staff responsible for maintaining related controls in a timely, efficient and effective manner, cultural issues and behavioral norms that interfere with or undermine financial risk control measures would imply that non-financial risks are financial risks, and that misconduct concerns are all the more so a systemic risk factor for the industry.

In October, U.S. regulators chastised Citigroup over “longstanding deficiencies” in its risk and control systems. In a Consent Order agreed to by the bank, the Federal Reserve found that Citi “has not taken prompt and effective actions to correct practices previously identified [in] compliance risk management, data quality management, and internal controls”. The firm was ordered to upgrade its processes and its technology. Along with the Fed’s action, the Office of the Comptroller of the Currency (OCC) issued a similar order and levied a $400 million fine against the bank, demanding it take corrective actions including “the thorough redesign of data architecture, re-engineering of processes, and modernization of system applications and information technology infrastructure.” The regulatory actions are said to have contributed to CEO Mike Corbat moving up a planned 2021 retirement so that current CEO Jane Fraser could decide and oversee implementation of the necessary risk governance reform effort.

Again in October, Goldman Sachs entered into a DPA with the Department of Justice, admitting to wrong-doing and agreeing to pay $2.9 billion for its role in Malaysia’s 1MDB scandal. In all, the 1MDB scandal has cost the firm some $5 billion, leading its board to take the unprecedented step of clawing back $174 million in past payments to the firms’ senior-most leadership. Goldman has pledged to heighten scrutiny of those senior executives engaged in high risk areas of its business. Notably, the DPA commits the firm to ensuring that, based on any future analysis of any misconduct, it will “conduct a thoughtful root cause analysis and timely and appropriately remediate to address the root causes.” It is as yet unclear but perhaps reasonable to anticipate that a Biden DOJ will expect firms to take firm culture into account when inquiring into the root causes of misconduct and risk governance failures.

In May of last year, it was reported that Wells Fargo had lost some $220 billion in market value as a consequence of an ‘asset cap’ imposed by Janet Yellen, then Chairman of the Board of Governors of the U.S. Federal Reserve (and now Secretary of the Treasury). In August, reports suggested that the asset cap had cost the firm $4 billion in lost profits that its shareholders might otherwise have enjoyed had the cap not been in place, making it one of the most expensive bank penalties ever imposed.

Current CEO Charlie Scharf announced dramatic cuts to the firm’s consultancy spend after an internal backlash against outlays that had reached some $1bn-$1.5bn yearly, with most of that going to remedial efforts aimed at satisfying the Fed’s concerns so that it might see fit to lift the asset cap. According to SEC filings, Wells Fargo has spent nearly $12 billion on consulting fees since 2017 alone.

In its 2020 annual “Cost of Compliance” report, Thomson Reuters finds that, among the most significant compliance challenges boards expect to face are balancing budgets in the face of increasing compliance costs, driving demonstrable cultural change, and increasing personal accountability. Around a third of the firms surveyed by Thomson Reuters reported that they had discarded potentially profitable business opportunities out of concern for culture or conduct-related risks. Another recent study estimates that compliance costs in 2020 consumed some 5% of overall firm revenues. “With the impacts of COVID-19 and the challenges of a
remote workforce, investment in compliance will continue to be a top priority for financial services firms this year,” the report concludes.

Despite such levels of compliance spend, US banks are thought to have racked up some $200 billion in punitive fines in the last 20 years due to misconduct and risk governance failures. It is little wonder that the Operational Risk Exchange finds conduct risk among the top concerns reported by its member firms. “For eight years now, we have collected a library of top operational risk scenarios from the financial institutions we work with, and employee conduct is a subject that comes up every year,” said Steve Bishop, Head of Risk Information at ORX.

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Our View
Social Capital & Superminds

by KAREN COOK & TOM MALONE

The social distancing mandated by the coronavirus pandemic, along with its other dislocations, has highlighted for many the importance of ‘social capital.’ Bank of England Chief Economist Andy Haldane defines the term as referring to “the network of relationships across communities that support and strengthen societies.”¹ Unsurprisingly, Haldane’s sociological emphasis is consonant with that of the sociologist Nan Lin who, in turn, adopts an economics-oriented stance: “The premise behind the notion of social capital is simple and straightforward: investment in social relations with expected returns,” he writes.²

For the economist and the sociologist alike, social capital is an umbrella term that emphasizes three key factors: the networks, trust, and norms for behavior that bind groups in reciprocally collaborative and beneficial ties.

NETWORKS, TRUST & NORMS

Viewed in this socio-economic light, Haldane considers social capital to be a key contributor to the success of capitalism itself – as central to its full functioning as are the more traditionally emphasized human, financial and physical forms of capital. While the Covid-crisis may have savaged our shared stocks of economic capital (per traditional measures), Haldane strikes a tone of optimism in arguing that our shared stocks of social capital have in fact risen during the pandemic. Though largely unrecognized by mainstream commentators, this has had an economic impact that Haldane encourages us to acknowledge. “The need to change how societies and companies keep score, to better recognise all of the capitals and all of the paid and unpaid contributions citizens make, is surely a lasting lesson of this crisis,” he concludes.

David Brooks, of the NY Times, is less optimistic. He observes that, on a regular if episodic basis, societies appear to be gripped by “moral convulsions.” Brooks argues that we are in the midst of one now – he calls it a “doom loop.” And while these upheavals may appear unique to their time and circumstance, he sees them as sharing certain common features: “People feel disgusted by the state of society. Trust in institutions plummets. Moral indignation is widespread. Contempt for established power is intense.” And, Brooks warns, “when people in a society lose faith or trust in their institutions and in each other, the nation collapses.”³

While Brooks is comparatively pessimistic vis-à-vis Haldane, the two thinkers are aligned in emphasizing the socio-economic importance of social capital and the collaborative networks, trust and norms it reflects.

Over 20-years ago, Harvard’s Robert Putnam produced what is perhaps the most detailed study of social capital in America since Alexis de Tocqueville. In Bowling Alone, he chronicles the steady erosion of this social capital, evidenced between 1960 and 2000, and discusses its causes and consequences.
Putnam’s study emphasizes social capital theory and posits its core idea with a refreshingly blunt simplicity: “social networks have value.”

There are many reasons for this but perhaps the central one is that social networks allow us to get things done, to collaborate productively, and to generate shared prosperity. They allow us to overcome collective action problems that require some “institutional mechanism with the power to ensure compliance with the collectively desirable behavior,” Putnam writes. In all human endeavors and institutions, this power to compel behavioral compliance resides primarily within our social networks: they tell us how we must behave if we wish to remain a member of the group and allow us to trust that other group members will also behave accordingly.

Our social networks and “the norms of reciprocity and trustworthiness that arise from them” are essential to the functioning of any organization, whether in the civic, social or economic context, and this implies that social networks are significant to the performance outcomes achieved in any commercial enterprise. Indeed, as Putnam observed, “Civic engagement and social connectedness can be found inside the workplace, not only outside it. Thus our workplace agenda should include new means of social-capital formation on the job.”

THE GREATER WHOLE

Most firms invest heavily in human capital rather than social capital. Yet the ‘social cognitive neuroscientist’ Matthew Lieberman has found that it is the social capital element which equates more highly to desirable performance outcomes at firms. Central to this finding is the ‘social pain’ people experience when subject to rejection or ostracism from peers. Through fMRI research, Lieberman has shown that specific regions of the brain light up when social pain is experienced – in fact, the very same regions that light up when we experience physical pain. This allows Lieberman to conclude that we are more Homo socialis than Homo economicus.

Lieberman contributes neuro-physiological confirmation to what social scientists have long argued: throughout the history of the human experience, the whole has regularly been seen to be greater than the sum of its parts.

The success of our species is derivative of our capabilities as groups, not as individual actors. Remarkably, just as individual IQ can be assessed, so too can the IQ of groups, which reveal a form of ‘collective intelligence’ (at least sometimes). And just as individual intelligence predicts many kinds of real-world performance outcomes for individuals, collective intelligence predicts this same kind of real-world performance outcomes for groups.

Across all domains of human activity, groups of different structure and character can be identified. Reflecting the ‘greater whole’ idea at work, we may refer to these groups as Superminds. The history of humanity is largely the history of such Superminds – or groups of individuals acting collectively in ways that evidence some degree of collective intelligence – and we can recognize immediately some of their more common forms: hierarchies, markets, democracies and, perhaps most centrally, communities have accomplished things that no individual human could ever have achieved acting alone.
Hierarchies are perhaps the most obvious form of Supermind, mobilizing large numbers of individuals to achieve the goals of whomsoever directs the hierarchy. The standard org chart is based on the idea that the workplace is organized hierarchically and operates under the direction of designated persons.

Markets may also be viewed in Supermind terms, as they are comprised of countless actors – to include individual firms, individual persons, and in many instances, individual ‘intelligent’ machines – whose combined buying, selling, and other activities produce economic outcomes that would not otherwise have been made manifest.

Democracies, in which group decisions are made through voting mechanisms, are also Superminds and may be found among not only governments but also clubs, associations, corporate and industry bodies, and others. All are groups acting collectively to achieve shared goals that are arrived at (more or less) democratically.

Communities are, at their most basic, comprised of social networks where shared trust and shared norms for behavior create a mechanism for group coordination and collaboration towards desired ends. Hierarchies, markets and democracies almost always arise from and depend upon communities.

In sum, Superminds are identifiable, describable, and measurable. They exist within all human societies, institutions and organizations, and carry out various collaborative functions, however well or poorly.

**TRUST MATTERS**

Trust among individual actors within any Supermind serves as a ‘super lubricator’ that works to reduce the coordination costs that such groups experience in their collaborative undertakings. In general, the higher the degree of trust within a group, the higher the degree performance it may achieve, at lower cost. No Supermind works well unless it is embedded in and comprised of communities of trust.

Late last year, to mark his 100th birthday, George Schultz summarized eloquently the importance of trust as he had experienced it across his long and distinguished career as a statesman: “Trust is the coin of the realm.” Schultz wrote. “When trust was in the room, whatever room that was — the family room, the schoolroom, the locker room, the office room, the government room or the military room — good things happened. When trust was not in the room, good things did not happen. Everything else is details.”

Hierarchies don’t work very well without trust, for instance. If you have to delegate tasks to subordinates whom you can’t trust, then you’ll always be checking up on them and less able to delegate as much as you might wish. To the extent that you have a great deal of trust with the other people in your hierarchy, however, these transaction costs can be greatly reduced. An organizational culture that provides for such trust within a hierarchy is essential to its effective and efficient functioning.

One might imagine markets without much trust: where you can never trust your counterparties to tell you the truth or fulfill their commitments. In such circumstances, actors must pay a lot more for some other coercive mechanism that guarantees conduct compliance, so that individual interests may be protected: Mafia-like enforcers, or complex and expensive contractual vehicles for instance. Otherwise, actors in such markets must charge more (or pay less) so that the greater likelihood of being cheated is “priced in” to the transaction.

The economics literature distinguishes between ‘transaction markets’ and ‘exchange markets.’ In a transaction market, where participants may only ever meet and transact once, trust is low. The classic ‘used car salesman’ conundrum results in these markets for “lemons.” But in an exchange market, where
participants expect to interact regularly and over time, a reputation for fair dealing is an important asset: if you know that cheating someone will damage your reputation so much so that no one in that market will ever want to do business with you again, there is far less incentive to cheat. The example of New York’s Jewish diamond merchants offers lessons in the value that can be achieved, and traded, where such reputation mechanisms are at work.¹²

While there is some evidence that democracies may foster trust,¹³ this is not guaranteed. And democracies cannot function without trust. As we have recently witnessed, when a large number of voters no longer trust that their electoral system is operating honestly and transparently, civil unrest may result. Moreover, when trust in government as a fair and impartial instrument of regulation and oversight is low, the economy stalls. “When the fairness of the rules grows questionable and the benefits of the system are distributed too unequally,” writes economist Luigi Zingales, “the consensus for free-market meritocracy can collapse.”¹⁴

Communities are the foundational type of Supermind. Indeed, humans had communities before they were humans. Communities were seen the hunter-gatherer bands of our hominin ancestors and they exist among our primate cousins today. All other types of human Supermind grew up in the context of these communities: social networks that provided a context within which mutual trust and behavioral norms could be established.

Because multiple, distinct, identifiable, and assessable communities are to be found at work within every human organization, it is important that leaders appreciate how those communities shape internal behaviors and organizational performance outcomes.

Countless misconduct scandals appear with regularity in almost every industry and geography, but this is perhaps most damaging when it occurs in the financial sector, which acts as the ‘circulatory system’ for any economy. When the health of that system is impaired, effects are felt broadly across society. Recognizing this, regulators have begun to emphasize the importance of networks, trust and norms – the ‘culture’ of a firm.

Traditional management science emphasizes the classical economic view of people operating as ‘rational actors.’ We also see a persistent emphasis on individual psychology as the basic unit of analysis when assessing one’s fitness for a particular organization. And, since the days of Frederick Winslow Taylor, management science has been enthralled by a metaphor that views the organization in ‘mechanistic’ terms, positing employees as mere cogs in the machine. These outdated views contribute to a persistence of poor risk governance.

PARADIGM SHIFT

Effective culture and conduct risk governance (and supervision) must start from a new set of basic assumptions about what shapes human behavior within organizations – predictably. And this in turn necessitates that we recognize and incorporate the lessons of our shared evolutionary history and inheritance. A new governance paradigm must therefore include three elements:
First, as behavioral economists have shown, humans are not rational actors – at least not always. Rather, we appear to be “predictably irrational,” acting on the basis of unconscious heuristics – habitual and contextually bound decision-making shortcuts that reflect our evolutionary predispositions, and which emphasize the maintenance of social ties through normative compliance.¹⁵

Second, countless studies have clearly demonstrated that behavior is driven more by the social influence of peers than by individual idiosyncratic psychological predisposition. We are social creatures, first and foremost. And third, Taylor’s mechanistic worldview must yield to ‘complexity theory.’ Like schools of fish, ant colonies, and flocks of starlings, human organizations are ‘complex adaptive systems’ made evolutionarily fit by emergent properties that benefit the group, but that are irreducible to its individual members.

Elevating these assumptions to supplant those traditionally emphasized by management theory, corporate culture is properly regarded as an emergent property, derivative of underlying group dynamics, arising from internal trust networks (‘communities’) that proliferate within firms, and which establish norms that shape decisions and behavior in ways that presumptions of rationality regularly fail to contemplate.

Group behavioral norms shape individual choice and action, within an organization, in an endless feedback loop that includes both ‘tone from the top’ as well as ‘echo from the bottom.’ Group norms dictate acceptable behavior and witnessed behavior reflects the behavioral norms to which group acceptance is firmly tied. Employees will thus do what they witness routinely: the “what is common is moral” heuristic.¹⁶

Kevin Stiroh, then head of Supervision for the New York Fed, remarked in a 2019 speech: “As we continue to see the impact of technology and big data in other parts of financial services, one interesting question is how innovation and enhanced technology will support the measurement and management of culture... For example, we might see firms routinely leverage broader data to make stronger predictions about potential misconduct risk, which could be useful to help focus scarce compliance resources.”¹⁷

Missing from the conduct risk governance and supervisory toolkit is a reliable and scalable means by which to identify and map out the Superminds at work in a firm, identifying and assessing them as they shift over time, so as to better anticipate how these internal networks of trust promote behavioral norms that may spread to permeate a firm. Much as epidemiological models permit us to track the spread of a viral pathogen through a population, and then to forecast how it will most likely continue to spread – via what conduits and over what hubs, etc. – such a capability would permit proactive corrective intervention and the precision targeting of risk management resources for greatest and most timely impact.

Managing through the Covid-crisis has placed a premium on organizational resiliency, which will remain a key priority for all firms as they work to restore organizational vitality as the crisis recedes. New ‘computational social science’ technologies offer much promise here. These tools allow us to map the Superminds at work within organizations by sifting predictively reliable signals from within readily available company data sets, yielding heretofore unavailable insights into the behavioral propensities within organizations.¹⁸

Such an ‘early warning system’ positions leaders to intervene, proactively, both with a view to encouraging desirable cultural and behavioral norms, and to anticipating and curbing the spread of behaviors inconsistent with an organization’s mission or values. The Covid-crisis has accelerated the demand for such capabilities, which stand to facilitate a paradigm shift in the conduct risk governance landscape that may help us to replenish our stocks of social capital.
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Deeper Dive
Fit for Purpose?

CASE STUDY: CREDIT SUISSE

As we go to print, Credit Suisse is been embroiled in a series of crises stemming from lapses in its financial risk governance practices. In the last year: it was caught up in alleged fraud at Chinese coffee house chain Luckin Coffee; exposed to the fraud-driven collapse of German payments company, Wirecard; indicted in Switzerland over alleged dealings with a Bulgarian cocaine smuggling operation; and it has faced enforcement action from the Swiss Financial Market Supervisory Authority (Finma) in connection with an expanded spying scandal that involved surveillance of its own employees, ordered by the firm’s COO. In March this year, the firm said its clients could lose up to $3 billion from frozen funds linked to collapsed specialist finance firm Greensill Capital. In April, it announced that it would suffer a $4.7 billion hit triggered by the meltdown of Archegos Capital Management.

On the surface, these seem to be financial risk related mishaps. But it has recently emerged that Credit Suisse ignored warnings before Greensill and Archegos imploded. In the case of Greensill,
senior risk executives – to include the bank’s chief risk and compliance officer, Lara Warner – overruled risk managers in approving further business with the already imperiled Greensill. In interviews with the Financial Times, six current and former Credit Suisse managers said the bank had hollowed out risk expertise to favor promoting sales. Dissenting voices were suppressed. “There was a dulling of the senses,” said a former executive. “There was systematic insensitivity at all levels,” said another. Warner was ousted late last month.

The reported suppression of dissenting voices at Credit Suisse illustrates the importance a ‘psychologically safe’ workplace culture, as Amy Edmondson styles it. And what is “a dulling of the senses” and “systematic insensitivity” if not textbook examples of Diane Vaughan’s “normalization of deviance?”

In December last year, CEO Thomas Gottstein promised to put legacy scandals behind him and to start 2021 with as clean a slate as possible. But Credit Suisse may be struggling with a problematic cultural legacy and it is not clear that the firm’s efforts to manage that challenge is “fit for purpose.” Like many firms, Credit Suisse appears to take a ‘detect and correct’ approach to its risk governance, at a time when regulators, shareholders and prosecutors are calling for a ‘predict and prevent’ approach that protects shareholder and broader stakeholder interests proactively.

As Gottstein contemplates next steps, he might benefit by viewing his task not as a methodological challenge (better processes and systems) but, rather, a conceptual challenge – one that requires new thinking about how risks may often flow from the relational dynamics among people. The crises in which Credit Suisse is embroiled appear to stem from non-financial risk challenges – challenges that stem from a culture which drove damaging decision making and conduct.

As this case illustrates, non-financial risk is financial risk.

**CASE STUDY: EY - GERMANY**

Germany’s Wirecard closely along with a related collapse in confidence suffered by the firm’s long-time auditor, EY. The now well-known fraud at Wirecard appears to have started over a decade ago and, while a full account of related events exceeds the scope of this report, certain elements of the story warrant our attention here. What interests us, in connection with the matters covered in this report, is why so few of those internal to Wirecard saw fit to report misgivings, and how its outside auditor failed, over several years, to uncover what in hindsight appears to have been a fairly obvious fraud, directed by the firm’s senior-most executives.

Reports are that an internal Wirecard whistleblower did in fact warn EY of the fraud, four years before the company’s failure. A subsequent investigation found that EY’s fraud team shared this information with audit colleagues on the Wirecard account, amidst...
an audit of the company's 2017 annual results, and repeatedly pointed out problems into March 2018.\textsuperscript{15} In June last year it emerged that EY had failed – inexplicably – to check on Wirecard bank statements for some three years.\textsuperscript{16} In November, German audit industry overseer ‘Apas’ reported EY to prosecutors, alleging that EY may have acted criminally in its work at Wirecard.\textsuperscript{17}

Earlier this month, the head of the EY fraud team who had sounded the alarm was called to testify in hearings before the German Parliament. That the red flags he and his team had waved before audit colleagues went somehow ignored is, he stated, “incomprehensible.”\textsuperscript{18}

But is it? Or were the cultures at both Wirecard and EY akin to what appears to be the case for at least some groups within Credit Suisse, where a lack of psychological safety led otherwise well-intentioned professionals to keep their heads down and their mouths shut amidst an obvious normalization of deviance? Such questions are being asked as the scandal has engulfed German politics. Bundestag MPs are asking why Germany’s key financial sector regulators were so slow to recognize the gravity of the situation at Wirecard. “No government agencies played any role in uncovering the crime — neither BaFin, nor the FIU, nor the public prosecutor,” one complained during hearings. “Wirecard is the latest in a whole series of financial scandals in Germany that BaFin failed to uncover,” said another.\textsuperscript{19}

Rather than scrutinize Wirecard, BaFin instead worked to thwart \textit{Financial Times} investigative journalists and issued a ban against traders short-selling Wirecard shares – despite having received warning from the German Bundesbank about taking such a step.\textsuperscript{20} BaFin President Hufeld has said that believed the FT journalists and short-sellers might be in league. Pointing to their “cultural background” Hufeld argued, “It cannot be ruled out that this is a matter of a network-like structure (‘insider ring’).”\textsuperscript{21}

It is consistent with the views expressed by contributors to this report that inside networks will likely have played some part in this drama. But perhaps not the same networks Hufeld had in mind.

Hufeld was forced to step down from his role at BaFin in January this year.\textsuperscript{22} The head of the Financial Reporting Enforcement Panel, Germany’s accounting watchdog, stepped down in February,\textsuperscript{23} as did the head of EY’s German business.\textsuperscript{24} The Wirecard/EY debacle, with its echoes of the fraud at Enron that caused the collapse of Arthur Andersen, has sounded a call to action for global regulators,\textsuperscript{25} even as German auditors are fighting to avoid tighter regulation.\textsuperscript{26} PwC pledged last summer to do more to try and detect fraud in the course of its audit work.\textsuperscript{27} The next month, in a letter to clients, the Chairman and CEO of EY Global, Carmine de Sibio, wrote that audits should “play more of a role in the future to detect material frauds.”\textsuperscript{28} But the audit firms are fighting a rearguard action. In April this year, the Bundestag announced an extension of its probe into EY’s audit work at Wirecard.\textsuperscript{29}

**RETURN ON RISK?**

Credit Suisse reportedly earned a total of $17.5 million in fees from its dealings with Archegos – a client that looks to have cost the firm $5 billion.\textsuperscript{30} EY reportedly earned approximately $10 million in fees through its audit work at Wirecard over a period of ten years.\textsuperscript{31} The ensuing damage to their reputation is immeasurable.

In both cases, compliance systems and audit processes uncovered the causal risks. Risk staff sounded warning bells at Credit Suisse. Evidence of
the fraud at Wirecard was apparently so obvious that it was spelled out in detail by investigative journalists over a period of years. Former FinCEN head and, at the time, Deutsche Börse Group compliance chief James Freis was brought in to Wirecard last summer to shore up faith in its compliance function. Freis spotted the fraud almost immediately and, after calling it to the attention of the firm’s supervisory board, Freis was elevated to replace the disgraced CEO Markus Braun, now in prison.

“The most notable lesson here on the topic of culture, Freis writes, “is the failure of individuals to speak up ... particularly as many likely knew enough to have formed dissenting views.”

The Basel Committee on Banking Supervision defines operational risk as that flowing from “inadequate or failed internal processes, people, and systems or from external events.” Credit Suisse, Wirecard and EY can point to robust risk management systems, processes and safeguards against external threats, none of which sufficed to overcome the internal risks that flowed from the behavior of their people, who were silenced by cultures that squelched psychological safety and allowed for a normalization of deviance to become deeply entrenched.

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Organizational culture theory proposes that behavior within an institution – for example collaboration, speaking-up, misconduct, or risk-taking – arises from the values prioritized by employees and managers. By developing shared norms around the practices that are encouraged (e.g., teamwork) and discouraged (e.g., risk-taking) within an institution, culture acts as a form of “social control” that defines what is important and how people should behave. Where values are positive and shared (e.g., on the importance of behaving ethically, or prioritizing customers), conduct and organizational outcomes tend to be enhanced.

In finance, academics and practitioners have found that conduct risk can be explained by whether employees and managers form shared values on the importance of managing risk effectively. Institutional norms – whether for integrity, open communication, risk management, reporting of mistakes, or performance target pressures – collectively shape organizational behavior that leads to the success or failure of conduct risk management efforts (e.g., breaching trading limits, mis-selling to customers, not reporting suspicious transfers).

Therefore, and emulating other high-risk domains (e.g., aviation, healthcare), culture measurement represents an avenue through which problems in conduct risk can be ascertained.

Measuring organizational culture

Approaches to measuring culture and conduct risk in finance typically rely on self-report methods: for example, surveys, interviews, focus groups, or ethnographies. Surveys measure organizational culture through having employees and managers respond to pre-defined questions that describe their culture on a given scale (e.g., on values relating to teamwork). Interviews, focus groups, and other qualitative approaches consider how employees and executives describe the culture (e.g., prevailing conduct norms) of their organization. Data is analyzed to reveal norms and practices relating to conduct risk, and to identify best practice and potential threats.

Although self-report and observational methods undoubtedly yield valuable data on organizational culture, they can be limited in their ability to identify problems in conduct risk. This is because the same cultural factors that lead to poor risk management (e.g., lack of integrity or transparency, silencing of concerns, normalization of unsafe practices) can skew measurements of culture. Safety research shows that culture surveys administered prior to organizational accidents often fail to pick-up on the problems leading to incidents, and a poor culture (e.g., blaming people for mistakes, scapegoating, silencing, high target pressure) can negatively impact upon the willingness of staff to report on risk.

In effect, and similar to research investigating the link between organizational culture and national culture, such findings reveal how culture
measurements can themselves be affected by the environment in which they are produced. In particular, seven key confounds emerge.

THE SEVEN CONFOUNDS OF CULTURE MEASUREMENT

1. **Access**: organizations with a lack of commitment to the values that underpin good conduct (e.g., transparency, integrity) may be less willing to support a culture survey, and resistant to findings that indicate cultural problems.\(^18\)

2. **Isolated groups**: where poor conduct is limited to a smaller organizational unit or set of individuals, these organizational members may not participate in surveys or interviews, and other organizational members might not be aware of poor practices and thus will be unable to report on them.\(^19\)

3. **Normalization of poor conduct**: where employees and managers have normalized and become used to poor conduct – for example excessive risk taking – they may not recognize and report on the problems within their institution.\(^20\) In effect, what is common can become moral, and self-report data may reflect this.

4. **Impression management**: where organizational norms encourage impression management and silence, employees may feel obligated to present themselves and their organization in the best possible light, and avoid raising issues around conduct risk that might lead to an investigation (e.g., of a unit or professional function) or adverse consequences.\(^21,2^2\)

5. **Blind spots**: employees may not be able to fully evaluate some cultural practices within an organization (e.g., listening and responding to concerns of customers), with alternative perspectives being required to identify threats to risk management (e.g., data from customers).\(^23\)

6. **Listening**: if employees do not believe they will be listened to, and that culture assessments are a performative exercise (itself indicative of a weak culture), they will not engage with the process.\(^24\)

7. **Detachment**: Culture assessments that focus on capturing the perspectives of senior managers may yield findings that do not represent the organization. For example, if senior managers spend limited time at the operational level, or if employees are reluctant to raise conduct issues due to steep authority gradients or the belief that management wishes to remain unaware of problems (termed the “Cassandra’s Regret” bias).\(^25,2^6\)

Unobtrusive approaches to measuring organizational culture

The above confounds can result in culture data that is partial or mis-leading, and one may therefore question whether traditional self-report approaches to assessing culture and risk management in financial organizations can be improved upon or replaced. The data they derive can be essential for evaluating a culture and capturing good practice. However, where a culture is poor, the effectiveness of self-report measures is reduced, and there is a need to identify data sources and measures that can enrich and reduce bias in culture assessments.

To address the paradox of self-reported culture data being a product of the culture itself, it has been suggested that an “unobtrusive” approach might be adopted\(^27,2^8\). This involves analyzing naturally occurring data within or around an organization in order to measure its “cultural footprint”. Self-report methodologies for measuring culture are very much rooted in 20th century approaches studying psychology: with surveys and self-report measures previously being the only reliable method for assessing values within an organization. Indeed,
one might argue that conceptualizations of culture – of shared norms amongst employees that vary in terms of intensity towards a given dimension (e.g., collaboration) – are an artefact of surveys, and do not capture the more behavioral or implicit aspects of culture.29

In the 21st century, the horizons of culture research have expanded, with the digital revolution leading to vast collections of unobtrusive data on organizations. For example: executive speeches, employee online reviews, emails, public resignation letters, job adverts, compliance data, board minutes, executive intelligence data, complaints from customers, online forums, websites, or organizational reports. These data have potential to provide insight on an organization’s culture, and being digital and accessible, they are dynamic, feasible to analyze (e.g., using natural language processing (NLP) or machine learning), suitable for benchmarking, and can be gathered retrospectively (allowing for longitudinal analyses).

Unobtrusive data can also overcome the limitations of self-report (e.g., impression management). Table 1. outlines a range of possible unobtrusive data sources and considers how they might be used to study organizational culture.

Example unobtrusive sources of data for studying organizational culture

<table>
<thead>
<tr>
<th>Data source</th>
<th>Description</th>
<th>Possible analyses</th>
<th>Considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual reports</td>
<td>A company’s report on its activities for the past year</td>
<td>Analysis of values/targets relating to sustainability</td>
<td>Reflects strategy amongst organizational leadership: but high in impression management</td>
</tr>
<tr>
<td>Complaints</td>
<td>Negative service-user feedback</td>
<td>Recurring/systemic problems in customer experience (e.g., service delivery) across an organizational function</td>
<td>Unfiltered and external observations of an organization’s culture: but without inside knowledge of organizational processes</td>
</tr>
<tr>
<td>Compliance data</td>
<td>Records of rule infractions</td>
<td>Groups commonly associated with rule violations</td>
<td>Hard data on risk management: but less reliable in a poor culture</td>
</tr>
<tr>
<td>Compliments</td>
<td>Positive service-user feedback</td>
<td>Organizational norms and behaviors valued most by customers</td>
<td>Unfiltered and external observations of culture: but without inside knowledge of organizational processes</td>
</tr>
<tr>
<td>Emails</td>
<td>Employee communications</td>
<td>Network analysis on collaboration between organizational units</td>
<td>Real-time behavioral data on employee activities: but minimal context for interpretation</td>
</tr>
<tr>
<td>Employee online reviews</td>
<td>Employee online comments or ratings of their organization</td>
<td>Employee experiences of misconduct, bullying, or extreme target pressure</td>
<td>External forums in which employees can vent about cultural problems: but skewed towards negative and manipulable</td>
</tr>
</tbody>
</table>
Unobtrusive data may be particularly useful for identifying cultural problems relating to risk conduct.\textsuperscript{30, 31} Internal company data (i.e., produced within a company), for example executive speeches, compliance data, employee emails, incentive systems, executive intelligence data, or organizational reports, can reveal management and executive thinking on risk conduct, and its instantiation into institutional processes. External data (i.e., produced outside of a company), for example employee online reviews, public resignations, or service user complaints, capture “culture spillovers” where problems in risk conduct lead to organizational stakeholders publicly voicing their concerns about the culture. In both cases, culture can be assessed through organizational practices that indicate values for risk conduct.

As illustrated in Table 1, each unobtrusive source can provide a distinct lens on culture and will therefore have limitations in terms of comprehensiveness and data veracity. However, in combination, unobtrusive digital data may provide a rich picture of organizational culture, capturing data on values and practices across a range of organizational groups and functions. Within the financial sector, research

\begin{table}[h]
\centering
\begin{tabular}{|l|l|l|l|}
\hline
Data source & Description & Possible analyses & Considerations \\
\hline
Executive analytics & Public data on organizational leadership & Diversity of senior leadership & Hard outcome data: but minimal context \\
\hline
Executive earnings calls & Executive responses to investor questions & Words indicating the salience of ethical issues to senior management & Extemporaneous: but still high in impression management \\
\hline
Incident reports & Staff reporting errors or system malfunctions (e.g., in financial trading) & Variations in organizational units of staff willingness to report making mistakes & Behavioral data on risk management: but less reliable in a poor culture \\
\hline
Job adverts & Adverts for roles within an organization & Values prioritized by the organization for potential employees & Captures values important to the organization: but high in impression management \\
\hline
Online forums & Employees or service-users discussing experiences of an organization or industry & Reports of problems within an organization to appropriately respond to failures or conduct issues & External forums in which employees and customers can vent about cultural problems difficult to raise internally: but skewed towards negative and manipulable \\
\hline
Policies/code of conduct & Policies and rules for setting organizational standards & Extent to which desired values are embedded into rules and incentive systems & Instantiation of values into corporate policy: but little insight on their actual application \\
\hline
\end{tabular}
\caption{Cont.}
\end{table}
at the Bank of England using unobtrusive indicators of culture drawn from such diverse data sources has been shown to predict bank risk.\textsuperscript{32}

This indicates that unobtrusive indicators of culture can provide a form of “smoke alarm” (e.g., for companies, regulators, investors) for detecting and even anticipating problems in risk conduct, and may be used to augment surveys and interviews. Nonetheless, the field is in its infancy, and researchers and practitioners must address a range of questions.

**FIVE QUESTIONS IN USING UNOBTRUSIVE INDICATORS OF CULTURE**

**Deriving indicators of culture:** what indicators of culture should we seek to derive from unobtrusive data sources? Research so far has tended to focus on language and behavioral measures. For textual data (e.g., employee feedback, executive speeches, emails), Natural Language Processing (‘NLP’) tools are used to focus on trends in language use that may be revealing of culture (e.g., words relating to target pressure). This is a reliable and powerful approach to studying culture as, when scaled over thousands or even millions of words, language can help to reveal underlying norms and assumptions within an organization. Behavioral data, for instance on incentives or compliance, is also analyzed to capture practices that in some way signal institutional or employee priorities (e.g., on ethics or performance). Data sources should be analyzed in terms of the practices and values they are likely to reveal, and this requires considerable interpretation on the part of researchers.

**Scoring indicators:** given that some unobtrusive indicators of culture may function in a counter-intuitive way, how should they be scored for reliability? For instance, references by executives to innovation in an annual report or speech may reflect aspirational values that belie a weakness, rather than being indicative of a truly innovative culture. Low reporting of risk incidents may indicate problems in reporting or effective risk management, rather than an absence of such incidents. And employee concerns around ethicality seen in online chat forums may be positive rather than negative (i.e., indicating promotion of higher moral standards). Factor analysis, associations with outcomes, and a combination of these different indicators can be used to determine how indicators should be scored. Furthermore, scoring will tend to be based on benchmarked data (i.e., comparisons of language within or between an organization) rather than predefined scales (e.g., the 1-5 Likert scale often used in questionnaires).

**Combining indicators:** is it possible to combine data sources (e.g., employee online reviews, customer complaints) that are heterogenous and revealing of different viewpoints (e.g., employees and customers)? Psychometric measurement often focuses on developing parsimonious and highly reliable measures that have concurrent validity: this is challenging to achieve for indicators of culture drawn from very different data sources. Yet, an aim of culture assessment in financial organizations is to detect potential areas for concern in risk conduct, and a broader – albeit more noisy – set of data sources for measuring culture may be more likely to achieve this.

**Conflicting data:** what happens if data sources do not reveal a coherent analysis of culture, or if they conflict with surveys (e.g., revealing different organizational norms)? Increasingly, it is recognized that culture is not uniformly experienced within an organization: many sub-cultures can emerge, and there can be different perceptions and misunderstandings around values and norms.\textsuperscript{33} Conflicting data on culture may reveal this, and provide important insight on contested values, or practices that are inconsistent with an organization’s aims.

**Ethics:** what are the ethical concerns around unobtrusively measuring culture: for example, in terms of collecting data without participant or organizational consent? Although research using unobtrusive data draws on publicly available data
or data in possession of a firm, it is essential that principles around anonymity and ensuring ethical use of data are upheld.

Conclusions

Organizational culture provides both a framework for explaining conduct risk in financial institutions and a way to assess and identify organizations where problems may be developing. Typically, culture assessments have relied on self-report data, such as surveys and interviews. However, the factors that lead to conduct risk (e.g., integrity, normalization of risk-taking, silencing, lack of listening) can also affect responses to measurements of culture. Paradoxically, as a culture worsens, the accuracy of indicators for measuring culture can become less reliable.

Unobtrusive indicators of culture are highly diverse and less influenced by an organization’s culture, meaning that they may be considered a more reliable form of “smoke alarm” for use in detecting conduct risk problems within financial institutions.

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Unlocking Diversity’s Promise: Psychological Safety, Trust and Inclusion

By AMY EDMONDSON

Diversity is valuable – but it is inclusion that really drives performance. Psychologically safe workplaces enable and harness the benefits of mutual trust among staff to create a meaningful sense of belonging, and this is the key to unlocking the benefits of diversity.

Investors, exchanges, regulators and policy-makers have pushed diversity to the top of the agenda for corporate board directors and executive leadership teams, and a spate of recent activism suggests an emerging consensus view: a company’s leadership should better reflect the societies that host them.

Recent census figures show that slightly more than half of the U.S. civilian labor force (51.8%) are female. African Americans make up over 13%, Hispanic and Latinos another 18.5%; and other studies suggest that nearly 5% of Americans identify as LGBTQ.

Yet corporate board rooms and C-suites remain overwhelmingly populated by white, straight, men. This seems set to change.

In a recent statement on its diversity priorities, Norges Bank – the world’s largest sovereign fund – called on companies to set a target of 30% for female board members. Noting that 17% of companies worldwide have none, the fund’s chief governance and compliance officer stated plainly: “What we want to see is better representation of women on the boards.” With stakes in 9200 companies, representing some 1.5% of all traded stocks worldwide, the “Oil Fund’s” views have obvious heft.

Norges is not alone.

NASDAQ CEO Adena Friedman made headlines late last year, when she announced intention to require that at least one woman and one person identifying as an underrepresented minority appear among the directors of companies listed on its exchange – the world’s second largest. The SEC has yet to sign off on this proposed policy shift, but Friedman’s priorities are likely to be consistent with those of the Biden administration. Her aims received lift with the passage of the Equality Act by US House of Representatives, and the UK government has also given recent voice to similar policy priorities.

Financial institutions would seem to agree with these policy prescriptions: State Street, for instance, recently announced that it will vote against directors when firms fail to disclose their gender, racial and ethnic make-up. Private equity leader, Carlyle, has established a credit line facility that is tied explicitly to board diversity goals. Early last year, Goldman Sachs announced it would no longer take public any company with a board made up exclusively of straight, white men, and the firm recently doubled down on prioritizing diversity when its asset management arm called upon companies to add more under-represented minorities to their boards. In January this
year, JP Morgan Chase, Bank of America, Citigroup, US Bancorp and Wells Fargo all committed publicly to diversifying their ranks.\textsuperscript{10}

While equality of opportunity and representation may be an unalloyed good, in and of itself, many nevertheless feel a need to justify their stance on diversity by emphasizing performance benefits.

For those prioritizing shareholder returns, for instance, the oft-stated rationale is that diversity leads to improved financial performance. “There are many studies that indicate that having a more diverse board ... improves the financial performance of a company,” Friedman noted when announcing NASDAQ’s new policy. So diversity is valuable, then, because it contributes to the bottom line.

Others, such as financial sector supervisors, may be less concerned with bottom-line, but many now contend that increased diversity is associated with reduced conduct risk as well.\textsuperscript{11} The UK Financial Conduct Authority (FCA), for instance, draws a clear link between diversity, firm culture, employee conduct, and consumer outcomes.\textsuperscript{12} So, diversity is to be valued for the risk reduction it engenders.

Central to these arguments are studies that purport to demonstrate a correlation between diversity and these superior financial results and risk related outcomes. Some studies find that firms with greater diversity (among teams, leaders and board members) tend to produce higher revenues, for instance.\textsuperscript{13} Other studies find that such firms outperform less diverse peers in terms of increased profitability,\textsuperscript{14} and that they do a better job of attracting and retaining more highly productive staff.\textsuperscript{15}

Perhaps. But I grow concerned when diversity is positioned as a means to an end, rather than being celebrated as an end in itself. If diversity is made subservient to profitability, then we are required to show that diversity does indeed generate higher returns. And the data here are, in fact, quite mixed. Indeed, some studies suggest that forced diversity results in a reduction in social solidarity, mutual trust, and shared purpose.\textsuperscript{16} This may be expected to negatively impact firm performance and, therefore, would stand as a strong argument against increased diversity.

This concern serves to highlight the critical importance of inclusion over merely statistical diversity.\textsuperscript{17} Where inclusion is low and diversity is high, firms may inadvertently foment a Balkanization among staff, with distinct sub-groups and sub-cultures working with poor cohesion and perhaps even at cross-purposes.\textsuperscript{18}

Consider, for instance, research into gender diversity conducted among hundreds of leading firms across 35 countries and 24 industries. “We found that gender diversity relates to more productive companies,” the authors concluded, “only in contexts where gender diversity is viewed as ‘normatively’ accepted. By normative acceptance, we mean a widespread cultural belief that gender diversity is important.”\textsuperscript{19} Although at first glance circular, these results in fact suggest that diversity only drives performance in cultural contexts that allow firms to use the insights women and minority groups may bring to the table. Once again, inclusion is the key, and that is not guaranteed by diversity alone.

\textit{Diversity is valuable – but it is inclusion that really drives performance. Psychologically safe workplaces enable and harness the benefits of mutual trust among staff to create a meaningful sense of belonging, and this is the key to unlocking the benefits of diversity}
Diversity of thought is often argued to be a key benefit of any diversity initiative. But while promoting a more diverse “internal marketplace for ideas” may ensure that a wider range of alternatives will be put forward within a collaborative group, this will not ensure that the group will adopt the superior ideas. Nor is it immediately clear why a wider range of ideas, promulgated and considered among more diverse teams, should be expected to reduce conduct risk. Something essential is missing...

I have spent over 20 years studying workplaces across the healthcare, tech, pharma, consumer products, and find consistently that psychological safety plays a central role – and often the central role – in the success of organizations and teams, wherever people with diverse skills and backgrounds must work together effectively to accomplish challenging goals.

The desire to belong is perhaps the greatest driver of behavioral choice. The subtle fear of exclusion due to a failure to fit in to a dominant culture, or from saying the wrong thing, inhibits the expression of dissenting views or novel ideas. Simply hiring for a diverse workforce does not guarantee that everyone in a firm will feel a sense of belonging. It must be fostered in order to create real inclusiveness, and this flows from psychological safety and the trust dynamics among employees and teams.

Defined as an environment in which people believe that they can speak up candidly – whether with ideas, questions, concerns, or to admit mistakes – psychological safety is vital to realizing the benefits of diversity, because it helps to make inclusion a reality. And the higher the uncertainty and learning required in a given set of tasks, research shows, the more critical is psychological safety to the achievement of those undertakings.

It is thus critical in the banking and financial sector, where we have clear data on the consequences of its absence. Over the last five years, the UK’s Banking Standards Board (the ‘BSB’ herein, but recently renamed the Financial Services Culture Board) has conducted an annual survey of the country’s bankers. Survey respondents consistently complain of poor psychological safety. This results in a broad unwillingness to ‘speak-up’ when they witness misconduct. As the BSB rightly observes, “speaking up, diversity and inclusion are inextricably linked.”

The wisdom of crowds works only when the crowd contains a diversity of thought and each individual feels safe to voice their thoughts. In a firm where different views are welcomed, respected and encouraged, such views will be offered, and the organisation as a whole will be better placed to learn more quickly, catch problems earlier and enhance both its competitiveness and its appeal as an employer.

Where bank employees do elect to speak up, the BSB finds that in 80% of such cases these employees elected to approach a direct line manager. “This aligns with previous research that emphasises the importance of managers both as sources of behavioural cues and as important engineers of a culture of psychological safety,” the BSB concludes.

In a recent speech, newly-installed CEO Nikhil Rathi expanded upon the FCA’s related views:

“...we care because diversity reduces conduct risk and those firms that fail to reflect society run the risk of poorly serving diverse communities. And, at that point, diversity and inclusion become regulatory issues. This is much broader than representation. It is about a firm’s culture. Not just in relation to diversity, but inclusion, too. Do people feel comfortable in the work environment such that they can demonstrate, share and bring to bear their diversity of experience and background?”

Building a fearless, inclusive organization that realizes the benefits of diversity through greater inclusion and belonging is the most important goal for any
leader today, whether in the public or private sector. Those who care about diversity must also care about psychological safety, just as those who care about psychological safety must also care about diversity, inclusion, belonging and trust among staff.

A firm’s culture must engender belonging and inclusiveness if different views are to be expressed and heard. Key to this is creating psychologically safe and high trust work environments. Leaders who appreciate this, therefore, will not hire for diversity alone. Rather, they will attend to psychological safety throughout their organizations: measuring it, managing it, and looking for it among all employees.

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Deeper Dive
Governance: putting the G in ESG

We noted in last year’s report that a focus on the management and supervision of culture and conduct risk issues had begun to overlap with an increased focus on environmental, social and governance (ESG) considerations among investors. This stands to reason: many of the factors regarding corporate culture and ESG performance that matter to investors are similar, if not the same, as those in which regulators take interest when considering a firm’s non-financial risk management and operational resilience.

There is a strong case to be made that governance interests will receive more attention as we move past the COVID-crisis. “Whilst the focus on sustainability and ESG factors is good, we think that in addition it would be worth considering whether more traditional elements of corporate governance deserve attention,” PwC opined in an October 2020 letter to the European Commissioner for Justice. “In particular, the importance of whether corporate transparency and corporate governance in relation to business continuity and the sustainability of the business model could be enhanced.”

Governance concerns outstrip environmental and social factors for asset managers, Russell Investments reports in its ‘2020 annual ESG survey: turning up the volume’, which canvassed 400 asset managers globally. Of those surveyed, 82% said governance led their ESG-related decisions in 2020, while 13% of respondents said environmental and 5% said social.

“The pandemic has taught us that if businesses are to defend against future shocks, protect workers and ultimately support long-term growth, the social element within ESG should be considered just as critical as environmental and governance factors,” said Naim Abou-Jaoude, CEO of Candriam Investors Group and chairman of New York Life Investment Management International.

A BlackRock study found the firms with a better record on social issues have proven more resilient over the course of the pandemic. But the relationship between governance failures and harmful social outcomes is robust.

While there may be differences in prioritization or interpretation of specific ESG measures, on broader levels a consensus is emerging. “ESG is often a good proxy for quality of management,” said Brunno Maradei, Global Head of Responsible Investment at

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Which ESG factor impacts most to your investment decision?

<table>
<thead>
<tr>
<th>Year</th>
<th>Environmental</th>
<th>Governance</th>
<th>Social</th>
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<tbody>
<tr>
<td>2020</td>
<td>13%</td>
<td>82%</td>
<td>5%</td>
</tr>
<tr>
<td>2019</td>
<td>9%</td>
<td>88%</td>
<td>5%</td>
</tr>
<tr>
<td>2018</td>
<td>5%</td>
<td>91%</td>
<td>4%</td>
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</tbody>
</table>

Source: Russell Investments 2020 Annual ESG Manager Survey
At the same time, ESG risks top the list of near-term concerns for executives in the banking and finance sector.6 “The ESG boom is now being driven as much by risk management as activism: Covid-19 has shown company executives and financiers around the world the perils of ignoring so-called ‘externalities’,” the Financial Times ‘Moral Money’ column offers.7

Such sentiment aligns closely with evolving regulatory priorities. “If the last decade of bank supervision was about designing rules that lead to more resilient bank balance sheets, the next will be about designing supervisory tools and strategies that lead to more resilient bank cultures,” Carolyn Rogers, Secretary General of the Basel Committee on Banking Supervision, observes in her closing comments to this year’s report. P. 285 “And the goal in the decade ahead must be for banks to improve their risk culture and operational resilience by at least the same margin as they have improved their financial resilience in the decade past.”

A STEADY DRUMBEAT

At Davos earlier this year, more than 60 global businesses committed to the core Stakeholder Capitalism Metrics released by the World Economic Forum’s International Business Council (IBC).8 This statement was the culmination of work that began in the summer of 2019, when the IBC initiated a discussion regarding ESG concerns and aspirations that are central to business risk and performance. IBC members were concerned for the challenges that corporations face in demonstrating long-term value creation for all stakeholders on an internationally consistent basis across industries. Under the chairmanship of Bank of America CEO Brian Moynihan, the IBC launched a collective effort to establish a core set of ESG metrics and related disclosure requirements that could be reflected in mainstream annual reports on a consistent basis across all industry sectors and countries.9

Some progress in this direction was made before plans to reset the basis of capitalism ran headlong into the challenges of addressing the COVID pandemic. Progress was stalled.10 But now, as we the world begins to emerge from the pandemic’s lockdown impacts, sustainable capitalism interests seem set to surge11 and a prioritization of ESG interests looks to be part of the post-pandemic ‘new normal’.12

In part, this is driven by investor demand. Russell Reynolds Associates interviewed over 40 global institutional and activist investors, pension fund managers, proxy advisors and other corporate governance professionals to identify the corporate governance trends that will impact boards and directors in 2021. “The largest institutional investors continue to increase their expectations around board oversight of human capital management (HCM) and corporate culture,” it finds. “As part of the economic fallout from the pandemic and the social justice movements in many regions, demand for disclosure of more HCM data (e.g., gender pay gap, safety incidents, employee turnover) has skyrocketed.”13 In its 2021 report on emerging governance issues for boards, under the rubric, “Mission Critical’ Risks and the Corporate ‘Mission’ Converge,” the National Association of Corporate Directors observes that “companies are confronting a panoply of employee and human-capital management issues that are critical to long-term value creation at a time when investors and others are seeking commitments from corporations to align their governance principles with stakeholder capitalism.”14
The forced departure of Rio Tinto’s CEO in September last year, after the Juukan Gorge fiasco discussed elsewhere herein [p. 215], has resonated across boardrooms worldwide. “Reputation is now the thin red line between license to operate and failure,” said Edentree Investment Management’s Head of Responsible Investment Policy & Research, Neville White.15 “There is no doubt that increasing societal expectations and regulatory pressure place greater scrutiny on how investors are effective stewards of the assets entrusted to their care,” argued the UK’s Financial Reporting Council in October.16 In October, the head of Norway’s $1 trillion Oil Fund, Norges Bank Investment Management – the world’s largest sovereign wealth fund – told the Financial Times that he aims to “use risk in a more clever way” – increasing divestments for ESG reasons.17

IF YOU CAN’T MEASURE IT, YOU CAN’T MANAGE IT

With $2.6 trillion in client assets in its wealth management business, UBS has begun to recommend ESG-driven investment strategies to all clients. “The evidence is there to show this is a credible way to invest ... [and] a credible way to outperform,” said Tom Naratil co-president of UBS Global Wealth Management and president of UBS Americas.18 This adds to the already loud call for consistent and reliable ESG metrics and reporting standards. Efforts to define and measure ESG related factors now abound. In addition to the IBC effort referenced above, which issued initial results last September,19 the past year has witnessed a flurry of initiatives to define the ESG landscape usefully. Last July, market data firm Refinitive announced the launch of the world’s first “sustainable-finance league table.”20 A month later, Bloomberg announced its own proprietary ESG scores.21 Others are following suit.

And yet at the same time, asset managers worry that a lack of consistent, industry wide ESG ratings leaves them unable to “effectively compare investments which are marketed as sustainable,” says Steven Maijoor, chair of the European Securities and Markets Authority (ESMA).22 The numerous and often divergent standards-providers that have quietly evolved over the past decades now face pressure from industry giants like Blackrock to consolidate around a common framework.23 Even as Bloomberg promotes its proprietary ESG scores, it is reaching out encourage consolidation around the underlying standards which drive them.24

The last year has seen a flurry of activity among ESG standards setting bodies designed to demands for simplification and consolidation of the cacophonous ESG standards landscape.

In July, the Sustainability Accounting Standards Board (SASB) and the Global Reporting Initiative (GRI) announced an initiative aimed at creating basic ESG reporting standards and clarifying the methodology used to grade companies’ ESG reporting.25 Then in September, five framework and standard-setting bodies of international significance came together to publish a shared vision for more comprehensive corporate ESG reporting and issued a joint statement of intent to work together to drive towards this. With SASB and GRI, the Climate Disclosure Standards Board (CDSB), the International Integrated Reporting Council (IIRC), and an environmental impact-oriented NGO (CDP), committed to collaboration and to engaging with other relevant global actors, including the International Organization of Securities Commissions (IOSCO), the European Commission, and the World Economic Forum’s International Business Council, and the International Financial Reporting Standards Foundation (IFRS).26
Consolidation continued as the year progressed. In November, SASB and the IIRC announced their intent to merge and to work towards further simplifying the corporate reporting system.\(^{27}\) As the year drew to a close, SASB head Janine Guillot suggested that we might see full convergence of ESG standards within the next 12 to 24 months.\(^{28}\) In March this year, the IFRS Foundation announced the formation of a Working Group to help accelerate standards convergence. IOSCO established its own Working Group to support the IFRS Sustainability Project, naming the US Securities and Exchange Commission (SEC) and the Monetary Authority of Singapore (MAS) as co-leads of a new Technical Expert Group (TEG).\(^{29}\)

**SHOW ME WHAT YOU’VE GOT**

“It is important to distinguish between ‘values-driven investing’, strategies aligned with an investor’s own environmental, social and governance preferences, which prioritize impact over returns, and ‘value-driven’ investing that incorporates material ESG factors alongside other traditional financial metrics while still seeking to maximise returns,” wrote Cyrus Taraporevala, president and CEO of State Street Global Advisors in August last year.\(^{30}\)

Whether out of interest in value or values, demand from investors has put firms under increased pressure to expand their ESG-related disclosures. “Positive action and transparency on ESG matters can help companies protect their valuations as more
global regulators and governments mandate ESG disclosures,” argued George Serafeim in a late 2020 *Harvard Business Review* article. But such transparency will not be achieved, he adds, by relying on “words you see on a wall when you enter company headquarters, mission statements posted on websites, or grandiose speeches by CEOs in town halls.” In fact, Serafeim notes, “Research has shown those to be ‘cheap talk’ that is unrelated to real outcomes in the organization.”

Regulators have also urged caution at the current state of affairs in ESG disclosures. Disclosures by public companies of such nonfinancial information aren’t always “clear or useful,” according to a July 2020 report released by the U.S. Government Accountability Office (GAO). Institutional investors interviewed by the GAO said they need more reliable information on ESG matters so as to develop a better understanding of the risks that could affect the financial performance of companies they own over time. Despite the present lack of clarity, investors are nevertheless forging ahead and adopting a variety of investment strategies that incorporate evolving ESG disclosures to varying degrees.

Companies will be expected to share much more non-financial data going forward, even while there remains uncertainty as to what form such disclosures should take. Note, for instance, that the Board of Governors of the Investment Company Institute (ICI) unanimously approved a statement encouraging U.S. public companies to provide enhanced reporting on ESG factors. According to a survey of 600 investors in North America, Europe and Japan, by the end of March this year, 94% of investors will have engaged with boards on matters such as workforce diversity and corporate culture.

As the Biden administration takes shape, expectations are that companies will face pressure to disclose greater ESG data and to produce more fulsome sustainability metrics. “Our regulations have not kept up with this new landscape of institutional investor-driven corporate governance,” the acting chair of the SEC argued in a February speech this year. Such demands, however, highlight the challenges of establishing adequate and broadly accepted ESG metrics. “In response to investor demand, investment advisers and funds have expanded their various approaches to ESG investing and increased the number of product offerings across multiple asset classes,” the SEC Division of Examinations wrote in a Risk Alert last month. “This rapid growth in demand, increasing number of ESG products and services, and lack of standardized and precise ESG definitions present certain risks.”

**WHAT’S NEXT?**

Most investors now believe that ESG-minded capital deployment generates positive returns. They point to studies which find a positive correlation between ESG and corporate success. “Companies’ sustainability initiatives appear to drive better financial performance due to factors such as improved risk management and more innovation,” finds one meta-study summarizing the results of over a thousand peer reviewed papers and another two dozen meta-studies, published in the last five years, which took into account the findings from another 1,400 underlying studies.

Yet a recent study from a number of prominent law schools and the European Corporate Governance Institute, points to “infirmities” in standard corporate governance data sets, leading to “an error rate exceeding eighty percent in the G-Index, the most widely used proxy for ‘good governance’ in law and finance.” Debate will continue but there can be no question that ESG interests – and reliable ESG metrics – will feature prominently among investors, boards, regulators, policymakers and legislators worldwide in the near-term.

And given the priority that investors place on governance, it is reasonable to expect that the G in ESG will receive more attention going forward. Where governance matters overlap with expectations
regarding firm purpose, culture, conduct risk and other material non-financial risk issues, the growing convergence between these two trends may well accelerate.

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2021 Compendium of Regulatory Priorities Aimed at Culture and Conduct Challenges in the Financial Sector

This section comprises the main body of our annual report—the “Compendium” proper. It is broken out by global regions and specific national jurisdictions in each. Where practicable, we have broken the information out further to highlight specific regulatory or supervisory agencies, standard-setting bodies, and other industry organizations of relevance.

We highlight here the activities and priorities that were in evidence over the last year, both with regard to the supervision of culture and conduct risk concerns and in terms of expectations for the governance thereof within firms. Some markets have experienced more significant public activity, often driven by scandal and public reaction to such. Others have featured less public activity, which may or may not mean that they are actually devoting less attention to issues of culture and conduct, as regulators often engage with firms outside public purview.

We are pleased, therefore, that our efforts to curate and collate relevant information have been complemented by the many contributions that we have received from across most major jurisdictions. You will see that input incorporated throughout this report, significantly enriching it.

Please note that the following summary seeks not to make qualitative judgements but, rather, simply to provide our readers with some organized information concerning the global culture and conduct risk supervisory agenda, identifying trends and open questions.
Every year, in the course of writing this report, we pull out a list of ten key takeaways which represent the topics that received the greatest attention in the past year or to highlight new trends and developments of particular note. This list is never the same year to year. With that being said, it is perhaps useful to take note of the takeaways which remain on the list year-on-year, those new to the list, and those that dropped off.

Among the key takeaways of our 2020 report was the importance of social capital. We wrote, “The COVID-19 crisis demands that we rebuild depleted stores of ‘social capital’ and work together to craft mutually beneficial solutions,” adding that, going forward, “there will be very low tolerance of firms that engage in misconduct and cause social harm.”

This has become even more clear in the last 12 months. In remarks provided for inclusion in this report, Monetary Authority of Singapore Managing Director Ravi Menon explained that remote and hybrid working arrangements can affect relationships among employees, “Financial institutions must not ignore how changes to work processes, greater digitalisation, and less frequent face-to-face interactions might affect trust, identity, resilience, connectedness, and risk governance – both positively and negatively.”

ESG imperatives were also a key takeaway from our report last year and remain a key theme this year. The common consensus appears to be that, while ESG reporting is beneficial for investors, we need consistent reporting standards and disclosure requirements to allow for comparison between companies.

A major theme in this year’s report is a rash of corporate governance, audit, and regulatory failures. In nearly every major financial market, auditors, regulators, and firms have been held to account for their missteps. While the clearest example of these failures in the past year is perhaps the Wirecard scandal, there have been others. Ireland’s largest stockbroker, J&E Davy, was forced to shutter its bond desk in March 2021, when its mandate as a primary dealer of government bonds was revoked in the wake of a major misconduct scandal.

Another key takeaway from this report is the focus on outcomes instead of intent. Firms must prove that their efforts to improve culture are working to good effect, and that firms look to develop leading indicators of risk before culture and conduct lapses cause consumer harm. In an example of this, the Monetary Authority of Singapore released a paper in 2020 which outlined nine outcomes toward which institutions should strive in improving their culture and conduct practices, rather than specifying exact actions which must be taken.

Personal accountability of executives has also been a major theme for the previous two years. In the past, sanctions for misconduct have largely been levied at companies and particularly egregious ‘bad actors.’ However, in recent years, executives have been held accountable for risk governance failures that occur on their watch, encouraging them to take ownership of their company’s culture and to develop an ability to evidence how it drives good stakeholder outcomes. For some regulators, such as those in the United States, this occurs with no formal accountability regimes. After the fake accounts scandal at Wells Fargo, multiple executives have faced regulatory sanctions for failing to ensure compliance and good customer outcomes in their organization. As recently as April 2021, the Office of the Comptroller of the Currency sought $11 million from Wells Fargo executives in relation to the scandal.

However, other regulators, such as the Australian Prudential Regulation Authority (APRA), operate with a formal regime to hold executives accountable. APRA’s regime is called the Banking Executive...
In Focus
Organizational culture: One central bank lawyer’s perspective

by MICHAEL HELD *

It is an honor to join the regulators, academics, and market participants contributing to this edition of Starling’s Compendium. My colleagues and I at the New York Fed have learned much from our conversations with many of these contributors, and I look forward to reading this year’s essays.

About seven years ago, the New York Fed decided to use its position, influence, and credibility to “shine a spotlight” on the issue of culture. We wanted to persuade the financial services industry to pay greater attention to the group norms that affect individual behavior and to use all available tools to strengthen norms that contribute to public confidence in finance.

The Global Financial Crisis and a subsequent litany of scandals prompted our action. Although the Dodd-Frank Act and its implementing regulations did much to improve the resilience of banks and the stability of the financial system, misconduct persisted. And, in several notable examples, bankers collaborated across institutions to accomplish their goals—strongly suggesting that behavioral problems were shared across the industry, or at least across large financial institutions.

In my view, and in the view of many of my colleagues, regulation and enforcement were a necessary response to the Crisis and to subsequent misconduct. We wondered, though, whether either was completely effective at addressing the root causes of misconduct. We doubted the industry and the public could rely on laws, enforcement actions, and lawsuits alone to improve the trustworthiness of financial services.

Although we did not know for certain what the root causes of misconduct were, we had credible suspicions—many of which were shared by others in central banks, government, academia and even the private sector—that organizational culture played a material role.

For example, an organization sends powerful messages when it promotes and fires employees. It is only natural that other employees will try to replicate behaviors leading to the former, and try to avoid behaviors leading to the latter (assuming they want to keep their jobs and do well at them). Compensation incentives also influence conduct by pricing certain outcomes above others. Recruiting and training offer opportunities to communicate senior leadership expectations and to reinforce the importance of seeing the ethical dimensions of business decisions. Diversity and inclusion also play a role—a big role—especially if we want to avoid groupthink and encourage employees to speak up when they see something wrong. Finally, but perhaps most elusively, the way employees treat one another in everyday workplace settings matters. A lot.

*The views I express are my own, not necessarily those of the Federal Reserve Bank of New York or the Federal Reserve System.
I know. “Duh.”

That was the reaction we received from many organizational psychologists and leaders in other industries for whom culture was a widely-accepted feature of corporate governance and a key responsibility of a firm’s management.

At the time, though, this was not an obvious inquiry when it came to financial services—at least, not to many in the official sector. In the wake of the Global Financial Crisis, the focus of the official sector was, as I mentioned, the resilience of large firms (especially their management of capital and liquidity) and the stability of the financial system. The principal methods for accomplishing these goals was laws and regulations.

But, if you consider the examples I just mentioned, it becomes clear why laws and regulations are insufficient to address the root causes of misconduct. Laws might provide the outer guardrails for what is ok and not ok. They can make certain kinds of transactions illegal—wash sales, or trades that artificially manipulate a fair market price. Within those boundaries, however, regulated firms and individuals make judgements about what is right and not right.

Take, for example, an innovative trading strategy that exploits a regulatory loophole in a consumer market to make a profit through economically unrealistic bids in a related wholesale market. Is that just a clever trade? What if the result of the trade is significantly higher consumer prices? Does that mean that regulations weren’t written narrowly enough? Or are lawmakers and regulators entitled to assume a certain level of economic reality or ethics when writing laws? Examples of this type of “legal but shady” transaction abound, and illustrate the problem of writing financial laws and regulations with precision.

Or take compensation—a feature of European banking regulation, but not a significant component of U.S. law. It’s one thing to impose caps on bonuses, or to mandate deferrals across several years. It’s another to decide, within the legal limits, the right level of compensation to help achieve desired outcomes. Each firm needs to decide for itself how it wants to operate, what kind of culture will achieve its goals, and what kind of incentives will reinforce that culture. I don’t think laws and regulation alone can get the job done.

Starting in 2014, the New York Fed convened an annual conference of industry leaders, policymakers, law enforcement and regulators, academics, journalists, and ethicists to discuss cultural change within the industry. For those interested in learning more, my colleague, James Hennessy, described the history of our culture work, in an essay that featured in Starling’s 2020 Compendium.

In addition, both before and since the pandemic, we’ve held more targeted conversations with different groups that play a role in a bank’s culture—most recently through a public web series that explore specific issues in organizational culture. For example, in early March 2021 we hosted a discussion about the role that diversity, equity, and inclusion initiatives play in shaping group norms. In December 2020, we examined trust and decision-making from a variety of perspectives, including neuroscience, behavioral science, and technology. In October 2020, we showcased two projects that the New York Fed has sponsored: the FX Global Code, which aims to raise standards in the international foreign exchange market, and the Education and Industry Forum’s case studies, which present ethical dilemmas faced by junior employees in financial firms. (If the example above about the ethics of coordinated trading in two markets intrigued you, there’s a case study about that.)

My colleagues and I have also paid particular attention to the role of lawyers in shaping a financial institution’s culture. This topic featured in our
very first conference on culture, which offered the viewpoints of senior state and federal prosecutors, and was the focus of a 2016 meeting that the New York Fed hosted with the Federal Bar Council, a local professional group for lawyers and judges. Since then, I have made the topic a focus of my public speaking and writing.10

The role of lawyers interests me not only out of necessity—I’m the chief lawyer of a public institution—but also because it benefits from cross-industry perspectives. Indeed, one of the best authorities I know of on the role of lawyers is Ben Heineman, the former General Counsel of GE. Although briefly a financial services company, GE operates principally in the manufacturing and technology sectors. But reading any of Heineman’s books and articles, it is apparent how transferrable his lessons are to lawyers advising financial institutions.

Heineman’s thesis is that the lawyer plays a dual and sometimes conflicting role: she is both a partner and a guardian.11 Lawyers are partners in trying to achieve the goals of the organization together with the business or operational departments. They are also guardians of the firm’s reputation, objectives, and integrity—which, at times, means saying no to business partners. The genius of Heineman’s argument is that he finds within the tensions of the dual-hatted model an opportunity for the two concepts to strengthen each other.

In my experience, in-house lawyers offer the greatest value to their clients when they embrace the partner-guardian model. Finding the right balance is, of course, the art of our profession. Judge Jed Rakoff of the United States District Court for the Southern District of New York has provided an instructive anecdote from his early career. Writing in the Seattle Law Review, he recalled a time when he was an associate in a law firm that served, in effect, as in-house counsel for a corporation.12 (This was a time before the rise of corporate legal departments, when law firms frequently served the role that in-house counsel play today.) An ambitious senior executive at the client corporation “had come up with a clever new business idea that would materially enhance the company’s profitability (and likely would also increase his chances of becoming the next CEO).”13 The current CEO asked the vice president to seek advice from Judge Rakoff’s firm, a task that ultimately fell to Judge Rakoff (then a junior associate), a senior associate, and Oscar Ruebhausen, a respected partner. Here’s what happened next:

The senior associate concluded that, while the proposal was “technically” legal, it was directly contrary to the spirit and purpose of various relevant SEC regulations. He wrote a searing memo to Ruebhausen, stating that he considered the senior executive’s proposal “unethical” and “outrageous.” Oscar then asked the senior executive to come meet in his office and he also invited the senior associate and me to attend—I think as an object lesson as to how these situations should be handled. When the senior executive arrived, [the partner] congratulated him on the cleverness of his idea, and told him flat out that it did not technically violate the law and that the firm could issue an opinion stating so. But he then proceeded to describe how the proposal might be “somewhat risky,” because it might offend the SEC, with which the company had to remain on good terms in the long run. Moreover, Ruebhausen said, even though the proposal was technically legal, it was “close enough to the edge” that the class action bar might challenge it, and, he added, “You know what they are like.” Ruebhausen then proceeded to outline some changes to the proposal that, while somewhat reducing its profit potential, would make it much less risky. The executive immediately accepted the proposed changes, and, it was my impression, left the meeting a happy man, knowing he would now get credit for a still-profitable new proposal that had “Oscar’s blessing.”14
Judge Rakoff astutely observes that “even though Ruebhausen never mentioned ethical concerns in his meeting with the senior executive, we had no doubt that it was those ethical concerns that animated Ruebhausen’s professional advice.”

This story stands out in my mind, and I recommend it to my colleagues to illustrate Heineman’s point that being a partner and a guardian does not pose insurmountable conflict. Done properly and skillfully—and that is key—one role enhances the other. A lawyer becomes a trusted advisor because she is also perceived as a guardian of the organization. Her “blessing” carries that much more weight and influence.

Judge Rakoff’s observation about conveying ethical advice without using the language of ethics is particularly instructive. I’ve found that once lawyers start talking about ethics per se, we lose our audience. After all, what do lawyers know about ethics? We’re not hired to be philosophers. We’re hired principally because of our knowledge of the law. Our primary functions in an organization are to identify legal risks and advise on how to minimize them (if possible).

“Principal” and “primary,” however, do not mean exclusive. Almost every lawyer has had a difficult conversation, in which a client (or, for an in-house attorney, a client representative) has asked us for a narrow, legal view. “How close to the legal line can I get?” Or maybe the message is more explicit: “Just tell me if this is technically legal or illegal, not what I should do.”

Questions and demands like these assume that attorneys serve as purely “transactional engineers.” Although the American Bar Association advises against an attorney becoming a “moral advisor,” it has also cautioned that “[p]urely technical legal advice . . . can sometimes be inadequate.” This is especially true when “a client inexperienced in legal matters” requests purely technical advice. In that circumstance, “[a] lawyer’s responsibility as advisor may include indicating that more may be involved than strictly legal considerations.”

In my experience, a request for purely technical advice from lawyers is a frequent attribute of decisions that later attract scrutiny, regulatory or otherwise. This type of request also tends to arise where the interests of one desk or line of business may not wholly align with the broader, long-term interests of the organization—which is the in-house lawyer’s client. This was the essence of the dilemma in Judge Rakoff’s example.

Distinguishing legal from illegal conduct is one aspect of a lawyer’s job, but it is not the limit of a lawyer’s responsibility. We would be neither an effective partner nor a trusted guardian if it were. That said, our expertise—the reason we’re part of a conversation in the first place—is our knowledge of the law. The advice we give must remain grounded on legal considerations. This is reflected in the American Bar Association’s Model Rule: “In rendering advice, a lawyer may refer not only to law but to considerations such as moral, economic, social and political factors, that may be relevant to the client’s situation.” In my view, the two key words of that rule are “not only.” In Judge Rakoff’s example, Oscar Ruebhausen brilliantly anchors his advice in the law, and succeeds in addressing ethical issues at the same time.

One might argue that avoiding the ethical issues of business decisions head-on—that is, calling an ethical dilemma an “ethical dilemma”—is dangerous. Research in organizational behavior has shown that “morally-oriented conversations” can yield greater
consideration of the “ethical dimensions” of decisions and “enhance moral intensity . . . thereby[ ] put[ting] ethical considerations on firmer footing within group decision-making processes.” Fair enough. In my experience, the opposite is also true. If avoided persistently, the ethical dimensions of problems become less recognizable. When a truly serious ethical dilemma arises, employees will have little preparation for identifying it, much less resolving it. That concern motivated the New York Fed to launch the Education and Industry Forum’s case study project. Ethics is a skill and should be a habit. Like playing the piano or hitting a curveball, it requires sustained practice to maintain any facility and acquire some degree of mastery. My point is that lawyers should help spot and resolve ethical dilemmas, but will be more successful if they offer ethical advice grounded in their expertise.

Another risk from attorneys advising on non-legal matters is that an attorney’s personal moral beliefs could impede corporate objectives. When it comes to ethical dilemmas, the involvement of an attorney’s personal beliefs is hard to avoid. What’s more, we want attorneys to bring their own experience and common sense to bear on legal and business dilemmas. It is unrealistic to separate that experience and judgment from an attorney’s moral outlook.

In my experience, bringing personal moral views to bear on business dilemmas—whether legal or ethical in nature—does not have to be problematic if done well. And by that I mean, it is important that the lawyer be clear when her advice is legal in nature and when it is not. We as lawyers may have a monopoly on legal advice, but we do not have a monopoly on ethical advice. It would be dangerous and counterproductive if the lawyer’s monopoly on legal advice ended up shutting down other viewpoints on ethical quandaries—particularly where a diversity of viewpoints and backgrounds can lead to better and more informed decision-making.

I also think any downside risk can be managed effectively if an attorney’s ethical advice is grounded principally in the client’s code of conduct—a feature of almost every large organization. Reference to a code of conduct has a number of salutary features. For one thing, referring to a code of conduct when providing non-legal advice allows an attorney to stay within a legal framework. After all, the code of conduct is an internal rule and has implications under many public laws. For another, referring to the code of conduct reinforces its salience in day-to-day decisions, helping the document to obtain greater traction within the organization. This may help curb the perception of some (perhaps justified) that codes of conduct are “little more than worthy statements with little or no impact on behavior”. It has been observed, for example, that the Goldman Sachs code of business conduct and ethics in 2009 stated that “integrity and honesty” were “at the heart of our business,” but that “from time to time, the firm may waive certain provisions of this Code.”

A code of conduct, of course, does not provide an answer for every ethical dilemma. A code may, for example, mandate that employees act with integrity at all times. But what does that really mean in an actual, real-life situation? The attorney can be a partner with the business line and others in reaching a decision. The attorney must also be a guardian of the firm’s integrity by raising the question if no one else has—ideally with the finesse and effectiveness that Judge Rakoff observed from Oscar Ruebhausen.

The Compendium is likely to find many attorneys among its readership, given its focus on culture and regulation. I hope my observations invite attorneys into a dialogue about culture and the role they play in shaping it.

*Michael Held is EVP of Legal Group for the NY Federal Reserve Bank*
Accountability Regime (BEAR) and has been found to be effective at creating ownership of conduct concerns among management at banks.\textsuperscript{135} \textsuperscript{p. 182}

The failures in traditional control functions discussed above have led to calls for new ways to detect and prevent misconduct. A key part of this effort will be the development of \textbf{forward-looking metrics}. For instance, the International Association of Insurance Supervisors announced that it plans to issue an application paper on the use of key indicators to assess conduct-related outcomes in the next year,\textsuperscript{136} paving the way for insurers globally to implement methods to assess their culture and conduct efforts beside traditional lagging indicators.
In recent years, we have discussed how financial sector regulators are looking to behavioral science to develop a greater understanding of how culture drives conduct in firms. This remained in evidence over the past 12 months. The UK’s Financial Conduct Authority (FCA), for example, uses its “5 Conduct Questions” – soon to be 6 – in order to assess organizational dynamics and how management directives, on topics of culture, conduct, psychological safety, and more, translate down to the every-day experience of employees.\footnote{p. 117}

The FCA’s focus on psychological safety is not unique. We have seen a marked increase in focus on this in previous years, as regulators seek to ensure that firms empower their employees to speak up when they witness or believe something to be amiss. The Hong Kong Monetary Authority noted that many of the banks under its supervision had a lot of work yet to do in cultivating an environment where employees felt free to speak up without fear of consequences in its review of bank culture self-assessments in 2020.\footnote{p. 166} This has become especially important as the many regulators acknowledged the adverse effect that remote working arrangements could have on employees’ sense of psychological safety and their mental state more generally.

Remote working arrangements have dramatically altered employees’ relationships with work. In particular, many employees in all industries are facing record rates of burnout as a result of the degradation of their work-life balance. As discussed in the introduction to this report, many have found it difficult to separate their work from their personal life, both in terms of their physical space and available time.

This struggle has gained the attention of regulators. The United Kingdom’s Financial Conduct Authority (FCA) called for financial firms to ensure their employees felt free to speak up about issues as the rates of “lockdown fatigue” skyrocketed.\footnote{p. 117} Many firms and regulators have taken to exploring new technologies to deal with the altered risk profile, both operational and financial, created by the coronavirus pandemic.

As remarked upon in our past reports, the regtech and suptech space continued to generate interest among regulators, central bankers and standard setters in the course of the last 12 months. In our 2020 report, we found a key takeaway to be regulatory activity to promote the use of these emerging technologies, and that is still very much in evidence throughout this report.

Many regulators have devoted resources to developing new technologies for bank supervision, while also encouraging innovation in and adoption of regulatory technology among financial services firms. In 2020, the Australian Government’s Productivity Commission, an advisory body under Australia’s Treasury that provides independent analysis and advice to governments, released a report analyzing the benefits of regtech and made recommendations for regulators and supervisors to support innovation in the regtech space.\footnote{p. 182}

Among the key takeaways from 2020, there were several which are not present at all on this year’s list: CEO turnover, cross-border collaboration, and culture supervision. This is not to say that efforts are not being made in these directions, or even to say that they have decreased. For example, over the last few years, culture supervision has become an established priority for most financial regulators. As culture supervision has become part of what it means to supervise financial institutions, it need not be called out as a key takeaway of this report.

The main body of our annual Compendium begins with the United States, where we have seen all the foregoing key themes at work, making the market a good starting point for this global tour of happenings relevant to culture and conduct in the financial sector.
Culture and Conduct Risk Regulatory Landscape

SUMMARY

For the second year, Starling offers its Culture and Conduct Risk Regulatory Landscape chart. The Landscape provides a means to compare the various strategies and approaches the global regulatory community has taken with respect to the supervision of Culture and Conduct Risk.

The X-axis describes the relative strategies regulators have taken to the regulation of Culture and Conduct risks and whether those strategies tend more towards a Rules-based vs a Principles-based approach.

The Y-axis reflects the relative prioritization of programs and activities targeting culture and conduct risk vs other supervisory priorities. This does not necessarily reflect total resource commitments. Rather, this measure captures each regulator’s relative mix and range of activities and programs that are designed to support a Culture and Conduct agenda.

In producing this chart, we relied on responses to our annual Survey which we complemented with regulatory announcements, speeches, and other public information. As such, this analysis does not reflect any guidance regulators may have issued privately.

Our goal is not to make value judgements as to which approach is most effective. There are numerous factors that influence regulatory approaches which go beyond the scope of this exercise. Rather, our intent is to represent how various regulatory and supervisory bodies have positioned themselves publicly in an effort to identify forward-oriented trends. It is appropriate to assume that current events and politics will drive changes to the regulatory stances reflected herein.

As the industry evolves, as regulators roll out new initiatives, and as new information becomes available to us, we will of course incorporate those developments into future updates to this chart. Readers may have suggestions as to how we might improve on this current work and, if so, we encourage you to be in touch. Please write us at compendium@starlingtrust.com.

A summary of Abbreviations and our Methodology is available in the Appendix.

United States 🇺🇸

INDUSTRY AND REGULATORY BACKGROUND

Wall Street banks and institutional investors have been the subject of widespread ire since the financial crisis. One needn’t look any further than the Occupy Wall Street protests from the early 2010s to see the anger that ordinary people harbor towards financial industry participants whom they believe to be exploiting main street.141

Such sentiments may have contributed to the coordinated behavior among millions of retail investors who banded together earlier this year in order to ‘squeeze’ hedge funds in their short positions in video game retailer GameStop. Many of these investors appeared willing to risk losing money
if it allowed them to ‘punish’ wealthy hedge fund managers who had amassed more than their fair share of riches.\textsuperscript{142}

“They have had this game rigged for over a 100 years,” one posted to Reddit. “Pay back is a b----. You think we all forgot what these a------ elitists did during 2008 and the sweet bailouts they got while the rest of us suffered?” wrote another.

**PANDEMIC RELIEF RESPONSIBILITY**

With the onset of the COVID-19 pandemic, and the economic dislocation it engendered, the US government entrusted large banks with the distribution of economic relief monies to millions of households and small businesses.\textsuperscript{143} As the government now engages in a post-action audit of related activities, it has discovered instances of bank employees taking advantage of these programs.
JPMorgan Chase, the largest lender under the Paycheck Protection Program (PPP), reported that its own employees had applied for and received Economic Injury Disaster Loan loans intended for small businesses. In October, Wells Fargo fired more than 100 employees for misrepresenting themselves in applying for COVID relief funds. In September 2020, the Justice Department announced charges against 57 people for fraudulently applying for more than $175 million in small business loans.

The Small Business Administration has found that tens of thousands of companies received loans well in excess of the amounts for which they had qualified under the PPP, or loans for which they were ineligible entirely. For example, more than $1 billion was given to companies that received multiple loans from the program, which was prohibited.

These misappropriated funds might have gone to saving more small businesses, and it is to be expected that Congress, SBA and prosecutors will take action where their audit activities discover more wrongdoing, and particularly where this involves the banks upon which we rely to act as trusted intermediaries.

Given the sheer number and impact of the unpredictable events that occurred in 2020, some have claimed that risk management has never been more important. This is both applicable for large systemic risks and conduct risk, as the Coronavirus pandemic is believed to have increased conduct and compliance risk for many companies.

In many jurisdictions, regulators and institutions have struggled to contend with employees using private and/or encrypted communications channels to discuss work related information.

In September 2020, the Securities & Exchange Commission (SEC) reached a settlement with a broker-dealer for failing to maintain business-related text messages. Senior managers at this firm were aware that employees were using text messages to discuss business, and were even doing so themselves, but were not able to produce the relevant messages when such were requested by the SEC. In October, two Morgan Stanley traders were fired after using WhatsApp to communicate offline about work related matters.

Non-financial risks have been at the fore in the last year. In the 12th edition of its Global Risk Management Survey, Deloitte writes, “In 2020, risk management at financial institutions faced challenges of a scale and scope not seen in living memory as the world responded to a global health crisis caused by COVID-19.” The survey results show that only 65 percent of institutions believe they are very or extremely effective at managing nonfinancial risk, which is much lower than for managing financial risk.

In 2020 the Federal Reserve Board, Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC) issued joint guidance in a paper entitled, “Sound Practices to Strengthen Operational Resilience,” detailing
the importance of governance and operational risk management to operational resilience and business continuity.\textsuperscript{156}

The three regulators place responsibility for this with the board, as well as senior management, emphasizing that a firm’s board of directors “oversees the firm’s management of operational risk in its business line operations, its independent operational risk management function, and its independent internal (or external) audit function.”\textsuperscript{157}

**ESG INCREASING IN PROMINENCE**

A focus on ESG investing has grown significantly in recent years, a trend likely to continue.\textsuperscript{158} This focus is not expressed solely in terms of ethics and or social mores. Rather, emphasis tends to focus on mounting evidence suggesting that ESG factors are linked to long-term corporate performance.\textsuperscript{159} With this in view, among others, Blackrock has pushed for development of a single, global reporting framework for ESG data.\textsuperscript{160}

According to Sustainability Accounting Standards Board CEO Janine Guillot, ESG standards are likely to converge in the next 12 to 24 months.\textsuperscript{161} Given Biden’s nomination of Blackrock’s former Head of Sustainable Investing, Brian Deese, as Director of the National Economic Council, ESG seems to be a top priority for the new administration.\textsuperscript{162}

The SEC announced a new corporate governance rule in October 2020 requiring that companies disclose how many employees they have and any human capital measures material to understanding the business. These requirements show the SEC’s emphasis on human capital. However, some have criticized these rules, stating that they do not go far enough, and that the SEC must be diligent in ensuring that accurate and material information is being presented to investors.\textsuperscript{163}

Under Gary Gensler, it is expected that the SEC will develop a new approach to monitoring and reporting on ESG issues.\textsuperscript{164} The new administration has already begun to emphasize disclosure standards in this regard, especially given the \textit{de}-emphasis of such matters that it sees as having characterized the last administration. In this direction, the SEC has created a new role to guide these efforts, appointing Satyam Khanna to be Senior Policy Advisor for Climate and ESG.\textsuperscript{165}

The Federal Reserve Board also seems to be placing more emphasis on ESG and climate related issues. It announced in January 2021 that Kevin Stiroh, then head of the Supervision Group at the NY Fed, would join the Board of Governors as senior advisor to Mike Gibson, head of the Fed’s Supervision and Regulation Division, and lead its Supervision Climate Committee.\textsuperscript{166}

In March 2021, the SEC announced that it would form an enforcement task force focused on ESG. This task force will look for gaps and misstatements in ESG disclosures, as well as investigating disclosure and misconduct issues relating to investors’ ESG strategies.\textsuperscript{167}

**IS DIVERSITY ENOUGH?**

In an interview, Jane Fraser, the newly appointed CEO of Citi and the first woman to lead a major Wall Street bank, said, “It’s getting outdated to think about a corporation’s obligation to society separately from its duty to its shareholders. It’s not an either-or.”\textsuperscript{168} Investors seem to agree. There has been a large push from retail and institutional investors alike for banks and large corporations to live up to their commitments to all stakeholders.\textsuperscript{169}

Jane Fraser’s appointment as the CEO of Citi marks a big change in an industry dominated by men.\textsuperscript{170} In a 2019 study, McKinsey found that, while women made almost half of entry-level positions in financial services, they only held about 20 percent of C-suite
level positions. While the change is occurring slowly, many foundational institutions are taking steps to make the industry a more equal place. In September 2020, for example, Goldman Sachs named Stephanie Cohen co-head of its consumer and wealth management business.

In December 2020, Nasdaq filed a proposal with the SEC that would require listed companies to have at least one woman on their boards, in addition to at least one director who representing a racial minority or who self-identifies as lesbian, gay, transgender, or queer. In the review which precipitated this change, Nasdaq found that 80-90% of companies listed on its exchange had at least one female director, but that only about 25% would satisfy the second requirement.

There is also tremendous pressure from regulators and legislators. In August 2020, Senate democrats introduced a bill, written by Senators Elizabeth Warren, Kirsten Gillibrand, and Maxine Waters, which would require the Federal Reserve to take action “to minimize and eliminate racial disparities in employment, wages, wealth, and access to affordable credit.”

These changes come as an increasing amount of research is being conducted on the benefits of diversity and, conversely, the operational issues that may arise where adequate diversity is not seen. Some such research, for instance, has shown that the presence of more women on a corporate board is correlated with fewer misconduct fines at such firms, equating to an average savings of almost $7.5 million a year.

However, the jury is still out on what drives these performance outcomes. Amy Edmondson, Novartis Professor of Leadership and Management at Harvard Business School, has argued that diversity, coupled with conscious efforts to develop inclusion and belonging, is essential to developing psychological safety in the workplace. Edmondson argues that firms successful in cultivating a sense of belonging, psychological safety and trust among teams are likely to see a decrease in operational risks and improvement in collaboration and innovation.

**BANKS UNDER PRESSURE**

The past year has witnessed aggressive regulatory action to punish misconduct and failed risk management across the financial industry. Fines against U.S. banks accounted for 73% of the global penalties in 2020, or about $11.1 billion. Over the past 20 years, the six largest US banks have paid out nearly $200 billion in fines and penalties globally. This, despite investment in financial crime compliance measures which totaled $35.2 billion for U.S. firms in 2020 alone.

For instance, Goldman Sachs reached a deal with the Justice Department to pay $2.9 billion for its role in the 1MDB fraud in Malaysia. This money will go to the SEC, Justice Department, Federal Reserve, and other regulators in the UK, Hong Kong, Singapore, and Malaysia. Along with the $350 million penalty levied by Hong Kong’s Securities and Futures Commission and the $3.9 billion settlement reached in Malaysia, Goldman has been ordered to pay more than $5 billion in total penalties in relation to the 1MDB scheme.

Separate from the monetary sanctions, prosecutors have charged two Goldman bankers for their involvement. While there are many more examples of this in the past year, this singular event sends a powerful message: the incentives have never been higher for global banks to sniff out and put an end to misconduct in their firms. The multinational investment bank has pledged to overhaul its compliance and oversight functions.

In September 2020, the Treasury Department fined Deutsche Bank $583 thousand for violating US sanctions. However, the Treasury’s Office of Foreign Assets Control noted that the Bank’s efforts...
In compliance and cooperation were why the fine was so far away from the maximum of $75 million it could have faced.\textsuperscript{186}

In contrast, the OCC fined JP Morgan Chase $250 million for deficiencies in internal controls and audit practices in November 2020. According to the OCC, the bank had “a weak management and control framework for its fiduciary activities and had an insufficient audit program for, and inadequate internal controls over, those activities.” This fine came about two months after the firm was fined $920 million for commodity price manipulation, which is discussed in more detail in the Commodity Futures Trading Commission subsection herein.\textsuperscript{187}

This U.S. OCC levied a $400 million fine at Citibank, which was made to agree to a Consent Order.\textsuperscript{188} The Order lays out detailed steps that Citibank must take in order to demonstrate more robust and effective compliance risk management capabilities.\textsuperscript{189} These steps include establishing a clear relationship between the first and second lines of defense, and policies, processes, and control systems within the two lines to ensure each is fulfilling its duties. They also suggested a more dynamic and independent approach to compliance risk management.

Simultaneously, the Federal Reserve also issued a Consent Order to Citibank which, among many other requirements, stated that the firm’s General Counsel should have oversight over the compliance function.\textsuperscript{190} Some have said that this Order seems to contradict the OCC’s own policy approach, as the order for a robust and independent compliance function implies that it should not fall under another department.\textsuperscript{191}

Demonstrating that operational and conduct risk has very real financial performance impacts, Citigroup announced that it had inadvertently paid out $900 million to a group of lenders. To date, the bank has only been able to recover about $400 million due to ongoing disputes with certain members of the lending group.\textsuperscript{192} In a similar example, human error caused an automated maintenance process to take down the Fed’s electronic payments network in February 2021.\textsuperscript{193}

Following an examination of Credit Suisse’s AML program in the United States, The Fed ordered the bank to undertake a full review of all business lines with a view to improving customer due diligence and suspicious transaction monitoring, among other things. The bank agreed to submit a plan to improve compliance with the Bank Secrecy Act and Anti-Money Laundering regulations within 90 days of the order.\textsuperscript{194}

In 2018 the Fed took the unprecedented step of limiting Wells Fargo’s growth through an ‘asset cap’ that was to remain in place until the Fed finds that Wells has made adequate progress towards improved risk management.\textsuperscript{195} The action, which followed on the heels of the false accounts scandal at Wells, was estimated to cost the firm as much as $4 billion in profits by summer 2020, making it one of the costliest enforcement actions taken against a bank ever.\textsuperscript{196} The difficult financial position created by the asset cap led to an especially tough 2020 for the firm and a 12% pay cut for Wells Fargo CEO Charles Scharf.\textsuperscript{197}

As many came to believe that Wells was nearing a close to the asset cap, the company’s stock saw a surge in trading in the latter part of 2020.\textsuperscript{198} And, indeed, in February 2021 the Fed signed off on Wells Fargo’s proposed risk overhaul plan.\textsuperscript{199}

Wells is not yet out of the woods, however, as this overhaul plan must now win sign-off from an independent reviewer before being revisited by the Fed for final say. It is also perhaps notable that affixing the asset cap at Wells was one of the last acts taken by then Janet Yellen, before she stepped down as Fed Chair. Yellen has since been confirmed as Secretary of the U.S. Treasury in the new Biden Administration.
Reflecting trends in other major financial markets, regulators in the US are increasingly making use of tools that allow them to single out responsible executives and to hold them accountable for the compliance failings of their organizations.

In the wake of the false accounts scandal and other troubles revealed at Wells Fargo in 2016, for instance, the OCC charged eight former Wells Fargo executives a cumulative $59 million in personal fines, while former CEO John Stumpf was banned from the industry for life.200

In November 2020, the SEC filed charges against Stumpf and former head of Wells Fargo’s Community Bank, Carrie L. Tolstedt, alleging that they had misled investors about the bank’s performance. Stumpf settled the charges for $2.5 million.201

In January 2021, the OCC fined former Wells Fargo General Counsel James Strother for his role in the systemic misconduct in Wells Fargo’s sales practice.202 These charges indicate a trend towards personal liability actions among the regulators. Then, in April 2021, the OCC announced that it would seek an additional $11 million from three Wells Fargo executives.203

Bank Boards and C-Suites appear to be following suit: on the heels of the 1MDB settlement, Goldman announced a $174 million round of clawbacks from top executives.204 Similarly, following the announcement of the OCC and Fed Consent Orders, Citi announced it will reduce bonuses for the executive management team and for CEO Michael Corbat.205 The bank also announced that its President, Jane Fraser, would be taking over for Michael Corbat as CEO in early 2021, several months earlier than industry watchers had expected.206 Fraser announced that Citigroup was forming a global operating team to hold executives accountable, to help address the concerns raised in the Fed and OCC’s consent orders.207

Following the collapse of US-based family office Archegos Capital in March 2021, Credit Suisse faced losses of $4.7 billion while still reeling from its Greensill scandal, discussed in the Germany section herein.208 In the wake of these crises, Credit Suisse’s Chief Risk and Compliance Officer, the Head of its Investment Bank,209 and the two heads of its Prime Brokerages210 left the bank.

CORRECTIVE MEASURES

The Financial Services Forum (FSF), whose members include the CEOs of the eight largest financial institutions in the United States, argues that the financial services industry has taken great strides in improving its resilience. Not only are they more stable financially, the FSF writes, but they have also invested heavily in governance, risk and compliance management.211

We have yet to learn if such investment will be viewed as adequate by the incoming Biden administration, but the wave of deals between firms and prosecutors in the final months of the Trump administration suggests that bank executives may expect more prosecutorial and enforcement action going forward.212 Banks are said to be bracing for tougher rules and stricter supervision when it comes to consumer protection.213 And white-collar lawyers reportedly expect to see a large influx of business in the next four years.214

Late last year, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) - a joint initiative to combat corporate fraud, misconduct and other forms of compliance failures - issued voluntary guidance to companies with a view to helping them to better coordinate their risk management, compliance, and ethics functions and to ensure they are not duplicating efforts. Where these critical corporate functions are siloed, operational risks could become compliance risks without the proper staff being made aware. COSO’s guidance also suggests that compliance and legal
departments should be kept separate, as COSO sees their responsibilities as being substantially different, perhaps at times, conflicting.²¹⁵

In March 2021, Democratic senators called for tougher capital requirements on US banks as regulators considered extending looser requirements which were put in place at the beginning of the pandemic. Senators Elizabeth Warren and Sherrod Brown wrote, “You and your predecessors at your independent regulatory agencies succumbed to political pressure to weaken these key reforms, creating new risks for the economy and the financial system.”²¹⁶

Warren, who was recently appointed chairwoman of the Banking Subcommittee on Economic Policy and the Finance Subcommittee on Fiscal Responsibility and Economic Growth, has made it clear she intends to hold banks and bank executives accountable in her tenure:

As the chair of two subcommittees tasked with overseeing America’s economy, I’ll continue to push for racial and economic justice and lasting economic security for families. I’ll also use these committees to hold big corporations and their executives accountable and to strengthen our banking, securities, and tax laws – and make sure they are enforced.²¹⁷

Regulators seem to be heeding these warnings. The CFPB announced in March that it would retract the measures it put in place to grant financial relief to financial institutions to allow them to deal with the coronavirus pandemic.²¹⁸

**FOCUS ON REGTECH**

The use of new RegTech and SupTech tools to improve regulatory compliance and supervision has won attention from U.S. regulators, and the technology space is gaining closer scrutiny among firms looking for ways to decrease their governance, risk and compliance costs, without decreasing the effectiveness of those functions.²¹⁹ Many firms have begun to use artificial intelligence and machine learning to generate insights from the vast amounts of data they possess, huge volumes of data for business and risk management purposes.²²⁰

In the 2021 version of its annual Fintech, Regtech, and the Role of Compliance report, Thomson Reuters Regulatory Intelligence (TRRI) reported on the results of its fifth annual survey on these topics. It shows 32 percent of firms expecting to see an increase in their regtech budgets over the next 12 months. The report also notes that 96 percent of the G-SIFIs have established budgets for regtech solutions, while only 63 percent of all firms do.²²¹

An example from the past year illustrates how these new technologies are already impacting supervisory capabilities. In 2008, the CFTC began an investigation into traders at JP Morgan for price-manipulation in silver markets. After spending 7,000 hours investigating over 5 years, the agency was not able to present conclusive evidence that price manipulation had occurred.²²² Despite changes introduced by the Dodd-Frank regulatory overhaul that made such investigations easier, the CFTC was ultimately unable to make its case.

But in September 2020, the CFTC announced a $920 million fine against the bank for price manipulation and spoofing across multiple precious metals markets covering an even longer period of time – from 2008 to 2016. The Commission was able to make its case through the use of data analysis tools to which it did not have access in the course of the original investigation.
Using data provided by the CME Group, a Chicago-based exchange operator, as well as new methods of storing and analyzing trading data in the cloud, the CFTC was able to identify patterns of manipulation in trades that it had missed in its earlier investigative undertakings.\(^{223}\) Former CFTC Enforcement Director James Macdonald explained, “We could not have brought the JPMorgan case without the data analytics program we have now.”\(^{224}\)

In March 2021, five US regulatory agencies announced a request for information on the use of AI by financial institutions, focusing on the use cases, governance and risk management controls, and challenges associated with its adoption.\(^{225}\)

**REGULATOR ACCOUNTABILITY**

Following a trend seen in nearly every other major financial market globally, financial regulators in the United States have been held to account for their own perceived missteps in 2020. For example, in September 2020, the U.S. Treasury’s Office of the Inspector General (OIG) released a report entitled, “Prior to 2015, OCC Missed Opportunities to Analyze and Address Inappropriate Sales Practices at Wells Fargo Bank.”\(^{226}\)

The first finding of the OIG’s audit was that the OCC’s examiners missed opportunities to address the compliance issues in Wells Fargo. While the examiners did assess Wells Fargo’s governance and risk management practices related to compliance and operational risk, they did not assess its oversight of sales practices until 2015. The second OIG finding was that the OCC lacked an enterprise-wide process for tracking whistleblower reports adequately, from initiation to resolution.\(^{227}\) In a response to a draft of the OIG’s report, OCC management agreed with the findings and stated that they are consistent with the results of the OCC’s own 2017 lessons learned report.\(^{228}\)

Another example of U.S. regulators being held to account, the Government Accountability Office (GAO) called upon the Federal Deposit Insurance Corporation (FDIC) to do more to ensure that its examiners are not going easy on banks in order to increase their own chances of winning a high-paying job from those firms in the future. Such perceived ‘regulatory capture’ was found to be a key weakness in bank supervision prior to the financial crisis.\(^{229}\)

**US TREASURY**

Included in the 2021 National Defense Authorization Act was an expansion of U.S. anti-money laundering and combatting the financing of terrorism rules. (AML/CFT) One significant change is that all US corporations will have to identify their beneficial owners so they may be registered with the Treasury Department’s Financial Crimes Enforcement Network (FinCEN). This aims to reduce the ability of criminals to launder illicitly obtained funds through shell companies.\(^{230}\)

Under the new AML/CFT rules, FinCEN is now permitted to share information reported in suspicious activity reports (SARs) to regulatory agencies in other jurisdictions, for instance, and the Treasury is also now required to establish AML priorities so as to better direct and increase the scale and scope of FinCEN’s monitoring activities.\(^{231}\)

The Treasury launched a new Bank Secrecy Act Whistleblower Program, in January 2021, as authorized by the National Defense Authorization Act.\(^{232}\) The program is to be administered by FinCEN and will resemble those set up by other agencies. The whistleblower program will allow the Treasury and DOJ to pay a ‘bounty’ award of up to 30% when a whistleblower provides original information which leads to enforcement actions and sanctions of more than $1 million.\(^{233}\)
In March 2021, Treasury Secretary Yellen reconvened the Financial Stability Oversight Council to address the vulnerabilities created by the pandemic and its associated economic effects. While some critics see the committee as political, others believe it is a necessary tool for monitoring market risks.234

**BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

In a speech at an AI Academic Symposium, Governor Lael Brainard spoke about the use of AI to ensure equitable outcomes and improve supervisory clarity. Brainard said:

Recognizing that AI presents promise and pitfalls, as a banking regulator, the Federal Reserve is committed to supporting banks’ efforts to develop and use AI responsibly to promote a safe, fair, and transparent financial services marketplace. As regulators, we are also exploring and understanding the use of AI and machine learning for supervisory purposes, and therefore, we too need to understand the different forms of explainability tools that are available and their implications.235

Brainard also said that several agencies are considering a formal request for feedback on the adoption of artificial intelligence in financial services. To ensure that the models are decreasing discrimination, and not expanding upon historical discrimination because of poor model training, there must be a push toward greater transparency around the inner workings of the AI models used to analyze customer data and detect fraud, Brainard said.236

At a December 2020 community bankers summit, Governor Michelle Brown spoke about how the increased adoption of fintech in community banks and discussed potential impact for risk management. To facilitate innovation, and decrease the banks’ supervisory burden, the Federal Reserve Board will issue a guide to detail the Board’s expectations. To share information on risk-management processes and controls with crucial service providers, the Board will send reports to all client banks as a part of its service provider supervision program. The Board also plans to partner with the OCC and FDIC to align their guidance on these topics.237

In March 2021, the Federal Reserve Board adopted a rule which would formalize the use of supervisory guidance for regulated institutions.238 Five US regulatory agencies proposed this rule in October 2020. Supervisory guidance, in contrast to regulation, is non-binding and does not have the force and effect of law, but allows regulators to communicate what they see as best practices. However, it does allow agencies to more clearly communicate priorities, expectations, and best practices.239

**FEDERAL RESERVE BANK OF NEW YORK**

In a January 2020 speech entitled, “Getting to the Core of Culture,” The Federal Reserve Bank of New York President and CEO John C. Williams argued that culture is the root of misconduct in financial institutions:

> [I]llicit and unethical behavior is rarely the result of an isolated “bad apple.” It’s more often the symptom of a rotten culture. And rotten cultures don’t appear overnight—nor for that matter do positive, inclusive ones, where people feel empowered and accountable to upholding the values of the organization.240

The Federal Reserve Bank of New York has been a leader in recognizing culture as a driver of conduct within financial institutions. New York Fed Senior Vice President James Hennessy has been the head of the institution’s Governance and Culture Reform initiative since it began in 2014. (We are grateful to Hennessy for detailing the history of that work in an In Focus insert he contributed to our 2020 Compendium).
In order to continue this work in the remote environment mandated by the coronavirus pandemic, the NY Fed hosted a series of webinars “highlighting current work and scholarship in this area.” The first event in this series featured a set of case studies with the goal of promoting ethical norms to current or future employees in the financial services industry. For example, one of these case studies touches on the issue of employees and clients using unmonitored applications, such as WhatsApp, to discuss work-related matters.

Another webinar, hosted in March 2021, focused on how diversity, equity, and inclusion are central to driving culture change in financial institutions.

In a keynote address for the 6th Annual Culture and Conduct Forum for the Financial Services Industry, Hennessy spoke on the importance of psychological safety and workplace culture, especially in the workplace environment and in the context of the changed circumstances ushered in by the COVID-19 pandemic. As defined by Harvard professor Amy Edmondson, the concept of psychological safety relates to, “an absence of interpersonal fear” that, in turn, permits people to speak up with work-relevant content. Hennessy suggested that, in the course of its own experience navigating the difficulties of the coronavirus pandemic, the NY Fed’s efforts to encourage psychological safety helped to enable their teams to remain connected and to engage with candor.

In remarks at a Risk USA Conference, NY Fed Executive Vice President Kevin Stiroh discussed the importance of “cultural capital,” – equating it to human, financial and other forms of capital critical to a firm’s success. Those failing to invest in their cultural capital, Stiroh argued, are likely to experience greater risk of misconduct and will likely achieve sub-optimal business outcomes. Particularly in the course of a crisis such as the present pandemic, this cultural capital becomes an essential part of business continuity and performance, Stiroh added.

In a December 2020 Staff Report, NY Fed Executive Vice President and Director of Research and Statistics Group Beverly Hirtle, offered an analysis of the economics of banking supervision, as distinct from banking regulation. In her study of the relevant economics literature, Hirtle finds that supervision can decrease risk without reducing an organizations’ profitability. “The channels through which supervision achieves these results have yet to be fully explored,” Hirtle concludes, but the direction of her paper suggests that supervision may be preferable to regulation as an economically efficient means of achieving risk control in the industry.

In 2020, the OCC was clear in observing the increased operational and compliance risks associated with the accelerating digitalization of financial services and the work from home environment prompted by the Covid-crisis. In its Semiannual Risk Perspective for Spring 2020, operational and compliance risks resulting from the workarounds implemented in order to deal with the pandemic were noted as key risks. And in its Fall 2020 Risk Perspective, the OCC explicitly outlined the new work environment as a driver of operational and compliance risk. In the report, the OCC also states that it communicates concerns to banks as Matters Requiring Attention (MRA), and that the largest proportion of those open concerns relate to operational risk.

The OCC updated its Director’s Toolkit in 2020 to guide the entities it regulates on risk management, among other things. In the Director’s Reference Guide to Board Reports and Information, the OCC makes recommendations for how these entities can analyze their risk management practices and identify red flags where these systems may be performing suboptimally. It also includes elements of the “Corporate and Risk Governance” of the Comptroller’s Office of the Comptroller of the Currency.
Handbook issued in 2019, which, among other things, makes recommendations on how boards and senior management should work to establish a sound corporate culture.256

In testimony to the House of Representatives Committee on Financial Services, Acting Comptroller of the Currency Brian Brooks wrote, “if an individual bank employee operates in such a way that jeopardizes the safety and soundness of the institution or causes consumer harm, the OCC will hold those individuals accountable.”257

In this testimony, Brooks also noted his support of the working being done by the OCC’s Office of Innovation, “in developing capabilities to evaluate emerging technologies and developments to reduce regulatory uncertainty,” and to “promote responsible innovation...” This drive to facilitate regtech innovation is not new for the OCC.258

The OCC promoted two bank examiners to Deputy Comptroller for Large Bank Supervision in February 2020. With the number of deputies in the large bank supervision department now returned to four, the OCC felt it would be more effective at achieving its supervisory objectives.259

In May 2021, the Wall Street Journal reported that Treasury Secretary Yellen planned to appoint Michael Hsu, associate director of the Fed’s bank supervision and regulation division, as first Deputy Comptroller at the OCC. This would make Hsu the acting Comptroller until a permanent Comptroller is confirmed by the Senate.260

With the recent reversal in political fortunes, firms have grown concerned that they will face an emboldened CFPB under the incoming Biden administration.262

Such concerns were deepened when President Biden nominated Ruhit Chopra to head the agency. Chopra is known to be an ally of Senator Elizabeth Warren, who has consistently taken an aggressive stance towards Wall Street.263 Bank executives recall that, in 2015, the CFPB ordered Citibank to pay $700 million in customer relief after finding that the bank had engaged in deceptive marketing, billing, and administration.264

In the CFPB’s 2020 Supervision and Examination Manual, the watchdog spelled out what it looks for in assessing the effectiveness of a firm’s compliance management system. It states, “an institution must develop and maintain a sound compliance management system (CMS) that is integrated into the overall framework for product design, delivery, and administration across their entire product and service lifecycle.” This is interpreted to imply that compliance must be embedded across all front office business operations.265

FEDERAL DEPOSIT INSURANCE CORPORATION

In remarks at a conference hosted by the Federal Reserve Board, FDIC Chairman Jelena McWilliams discussed the agency’s efforts to modernize bank supervision. Digital bank examinations became essential during the coronavirus pandemic, and are among the many innovations the remote work environment spurred that are likely to remain in place after the crisis is past. In 2019, the FDIC established a Subcommittee on Supervision Modernization. The subcommittee, which comprises former regulators and industry experts, discussed methods to improve supervision without putting an excessive burden on the supervised entities.266

CONSUMER FINANCIAL PROTECTION BUREAU

CFPB enforcement actions decreased significantly in recent years, following the change from a Democrat to a Republican administration.261
Interview
On Tech
Transformation of Bank Supervision

With BRIAN P. BROOKS

Q: Brian, you have suggested that banking is at an inflection point, driven by unbundling and decentralization. How are these forces changing the industry, and what are the regulatory and supervisory considerations?

A: The market delivers what consumers demand and technology enables. Many customers have determined they want the bespoke experience of tailored apps and boutique service providers instead of financial supermarkets. That is driving some servicers out of one-stop shops and onto specialty fintech platforms. At the same time, technology is enabling a decentralization of services in the same way that the publishing process became universally accessible after the expansion of the Internet. I described the forces at length in a recent issue of International Banker.¹

These are tectonic forces, which really can’t be resisted, but they can be framed and managed. Industry participants and regulators need to shift their perspectives to understand how risks change when moving from relatively few monolithic service providers to very many providers satisfying particular needs and functions within the markets. There is great strength in greater consumer choice, diversity and lack of concentration, but we need to understand the interconnectedness and discreet risks in this new operating environment. OCC examiners are well-prepared to regulate and supervise emerging risks wherever they are located in the national banking sector.

Q: The Financial Stability Board recently issued a report on the increased use of SupTech and RegTech by regulators and supervised entities, respectively. Perhaps reflective of that trend, the OCC joined the Global Financial Innovation Network (GFIN) late last year. What are your priorities regarding the promotion of innovation in RegTech?

A: RegTech holds great promise for supplementing the training, judgment, and expertise of bank examiners and supervisors. The best RegTech eliminates burden of data entry and retrieval, minimizes risk of human error, and helps identify patterns and indicators that may go undetected by the human eye. At the OCC, we are undergoing just such a transformation as we modernize and integrate the toolset we use to manage and administer our bank supervision process. Rather than replace human beings, we want tools that make examiners super capable, because we still have not found a greater substitute for the curious, skeptical human mind.

Q: Some argue that our collective approach to non-financial risk management (e.g., BSA/AML) remains cumbersome, expensive and focused on systems of record rather than tools for proactive risk mitigation. How do you see the compliance burden changing as technology creates new capabilities?

A: There’s no doubt about it. Compliance burdens, particularly those involving BSA/AML, are burdensome and costly. More importantly, I’m not convinced they are as effective as they need to be to prevent the kind of misdeeds or illicit activity that they were intended to catch. Some of that can be addressed through better policy and greater coordination, and some of that can be fixed by allowing banks greater flexibility to share data and information and to explore new technologies that
alleviates burdens while giving the good guys what they need to catch the bad guys. Today, we have a high-definition view of what happens within a financial institution, but we need greater technology to assess what is occurring in the gaps and exchanges in between. Emerging technologies hold great promise to shine a light on these shadows.

**Q:** Many regulators in other jurisdictions have established ‘accountability regimes’ that hold individuals personally liable for risk management failures that occur on their watch. While the US has not adopted a similar new regime, the OCC has nevertheless been very visible in holding individuals to account. Can you comment on this?

**A:** In some sense, the OCC is the ‘accountability regime’ you are looking for. The U.S. banking system includes financial, regulatory, and even criminal accountability for individuals who fail to fulfill their obligations, act irresponsibly, or break the law. At the OCC, we don’t have criminal prosecutorial authority, but our authority to take actions against institutions and individuals is robust, and we use it when appropriate. Individual accountability is an important piece in ensuring an orderly market and, in our case, making sure the federal banking system behaves in a safe, sound, and fair manner.

**Q:** The OCC has long been an advocate of ‘Responsible Innovation.’ What role can bank regulators play—the OCC in particular—in promoting innovation in non-financial risk management, while guarding against the potential downside risks that such innovation may entail?

**A:** The Federal Banking System holds more than $14 trillion in assets and has more than $60 trillion under its fiduciary and custody control. With all that money, you would think that the most of risks facing the banking system would be financial. But, as our most recent *Semiannual Risk Perspective* points out, three of the four top risks facing banks are not financial at all, they involve strategic, operational, and compliance risks. These are the risks that tend to challenge bankers and require a great deal of examiner attention. We dedicate a significant amount of human resources and have an entire function within our organization identifying, assessing, and sharing our perspectives on these risks with the industry so they can sharpen their risk management and operate more soundly.

One area where we have been very active in encouraging innovation in non-financial risk management involves Bank Secrecy Act and anti-money laundering compliance. We have worked aggressively with other regulators to provide greater flexibility and regulatory clarity to explore new technology, such as artificial intelligence, to make our system safer and reduce the burden of compliance. We have also made it clear that banks can and should collaborate, particularly community banks, to make the most of that expertise and resources.

**Q:** You have spoken extensively about how crypto is changing the way banking business is conducted. Can block-chain technologies aid risk supervision? Do you see crypto perhaps creating new means of enhancing non-financial risk management and the accountability of actors in the financial system?

**A:** Consider this. Today, a simple mortgage payment may change hands from homeowner to their bank to the mortgage servicer’s bank to the mortgage servicer and then to mortgage holder, or holders for mortgages that have been securitized. That is at least five steps in a relatively simple process in which errors can occur and compliance issues can arise. Crypto-enabled blockchain networks can eliminate all the middle steps. When you take a process from five steps to one, you cut risk of the process by 80 percent. Is that better? Of course, it is.
Now, add on top of that inherent risk reduction the ability to build compliance checks and audits into the process, and then you really have something.

**Q:** You have been outspoken about banks doing more to support financial access and economic opportunity, yet the financial service industry and regulatory system have had a long legacy of erecting barriers that prevented the flow of capital to communities of color. What are your views on the “social” function of the industry?

**A:** Banks and financial services institutions absolutely have a responsibility and the means to tear down barriers to financial inclusion and to contribute to making the world a better place. I applaud the philanthropic work of banks and individuals who have committed tens of billions of dollars this year alone to social justice activities and who are creating more economic opportunity for the underserved, often minority populations, among us.

It’s not enough though. I’m not sure that I have the answer, but I have an answer in the form of Project REACh. I created Project REACh to convene bankers, civil rights leaders, technologists and businesspeople to identify these barriers and find market-driven solutions to reducing them.

The project is becoming a movement and is showing great promise in helping 45 million Americans who are ‘credit invisible’ to gain access to mainstream financial services, facilitating meaningful partnerships that help minority-owned depository institutions prosper and shrinking the barriers to affordable, sustainable homeownership. The key to success in Project REACh lies in taking the perspective that encouraging innovation, participation, and entrepreneurship is far more effective in achieving these sort of policy goals than punitive regulation.

**Q:** In November last year, the OCC proposed a rule requiring large banks to provide fair access to their services over concerns that bank decision-making had become politicized. What does your proposal attempt to solve and what’s the danger?

**A:** Over the years, the OCC has heard multiple complaints about banks cutting off access to essential banking services for entire industries or populations without providing transparent reasons for doing so. Our proposed rule would simply codify agency guidance that has, for nearly a decade, said that is not okay. Banks are special and enjoy privileges and powers because the federal government stands behind them. As such, they need to provide fair access to their services, just as the Dodd-Frank Act required. All our proposed rule asks is that banks conduct objective, quantifiable risk assessments of individual customers when provisioning their services.

I don’t think anyone really wants large banks that control vast amounts of capital and credit to make policy judgments about what industries and businesses survive. Those decisions should instead be made by our elected officials or by market forces.

**Q:** In recent years, many have come to the view that firm culture is a matter that warrants supervisory attention. What’s your own view in this regard? And what do you see as the appropriate role for regulators in this context?

**A:** A healthy risk culture is critical to the safe and sound operation of a bank and that culture starts at the top. The OCC’s heightened standards for large banks make it clear that executives are responsible for fostering a healthy risk culture. It’s something examiners are trained to look for, and it something the agency discusses with the executive teams and directors of the institutions it supervises at every opportunity.

*At the time of this writing, Brian P. Brooks was the Acting Comptroller of the Currency (U.S.)*
In April 2021, the FDIC announced a partnership with Duke University to advance technological innovation. FDIC Chief Innovation Officer Sultan Meghji said, “We share a common interest to better understand the opportunities and the risks of new technologies and to build a first-of-its-kind strategic innovation program.”

SECURITIES & EXCHANGE COMMISSION

The SEC has for years emphasized the importance of sound culture in financial institutions. In 2018, former SEC Chairman Jay Clayton said:

There are many reasons why having a clear mission is beneficial to culture and improving culture. I’ll cite one in particular. It fills in the gaps. Organizations with the most comprehensive compliance programs and policies and procedures will inevitably encounter circumstances not contemplated by their policies and procedures. In those situations, what drives how people will act? The law and regulations? What if those also do not contemplate the situation? Or, more significantly, what if the law permits a range of actions with some that, while legal, can cause significant harm. In these circumstances, those on the front lines, those making decisions, need a touchstone.

Commissioner Elad Roisman has argued that culture is too abstract to regulate. Striking a posture distinctly at odds with prevailing global trends and, indeed, much current thinking among U.S. agencies, Roisman argued. “If the leadership and individuals fail to have an effective compliance system, rest assured we will find out and address violations that occur. But we should focus more on remedying concrete problems like that, rather than on vaguer notions of ‘culture’.”

Though the agency has not explicitly delved into punishing institutions for poor culture, it has focused on individual accountability among executives, as discussed in the Banks Under Pressure subsection, and whistleblower regimes, which have been effective at improving the culture in financial institutions in other jurisdictions.

There has been recent debate among SEC commissioners about whether and how the agency should bring enforcement actions against individuals, with particular focus on compliance officers which have at times been viewed by SEC Enforcement leaders as having duties that make them a quasi-extension of the SEC’s own reach into firms.

REFERENCES

Commissioner Hester Pierce spoke of her fear that personal liability could discourage new entrants into compliance officer roles, for fear of being held accountable for compliance failures. In an effort to diminish personal liability exposure, such compliance staff may be discouraged from taking ownership of risk and compliance outcomes.271

The SEC amended its rules to require that the information provided to it by a whistleblower falls “beyond what would be reasonably apparent” from publicly available information where the SEC is to pay ‘bounty’ monies aimed at encouraging whistleblowing.272 This change came into effect in December 2020, two months after the agency had awarded a $114 million whistleblower payout, more than double the previous record.273 Then, in April 2021, the SEC issued its second-largest ever whistleblower reward – more than $50 million – for information on violations involving “highly complex” transactions.274

Former SEC Chief of the Whistleblowing Office Jane Norberg said of these awards, “One thing I hope the program has accomplished is that whistleblowing is becoming more accepted as the fabric of normalcy.”275

The SEC has been focused on developing advanced tools and technology for monitoring and supervising its regulated entities. In two late 2020 cases, it brought charges against two issuers that had been found to have had falsified their earnings per share. In another, the SEC found that Hilton Worldwide Holdings had failed to disclose travel-related perks for its executives.276 The use of advanced analytics was key in these actions.

In February 2021, the SEC expanded its enforcement staff’s ability to investigate wrongdoing. In recent years, SEC staff were required to get approval before beginning an investigation. In what is taken as an early indication of a stepped-up enforcement posture that is to be expected under a Biden administration, under the new rules, SEC supervisors will be permitted to carry out a 60-day inquiry before that must be closed or converted into a formal investigation.277

The SEC issued an alert to remind broker-dealers of their AML obligations in March 2021. In its review of firms’ implementation of AML guidelines, the regulator found deficiencies in procedures and controls for identifying and reporting suspicious activity.278

It is likely that we will see even more activity from the SEC in these areas in the future. In January 2021, President Biden nominated Gary Gensler, the previous head of the Commodity Futures Trading Commission, to lead the SEC. Gensler, who has since been confirmed, is expected to be significantly tougher than Jay Clayton, who ran the regulator for four years under President Trump.279

In April 2021, Gary Gensler picked Heather Slavkin Corzo, a former labor-union investment official, as his policy director, further cementing expectations that the SEC will be much more progressive than under Gensler’s predecessor.280
In 2019, the CFTC announced the separation of its innovation lab, “LabCFTC,” from its general counsel’s office. In November 2020, as part of the CFTC’s efforts to lead innovation in the financial regulatory sector more broadly, LabCFTC hosted Empower Innovation 2020. The event discussed innovation at the Federal Reserve Board and the Treasury Department, with emphasis on a law enforcement perspective regarding cryptocurrencies. The CFTC is just one of many regulators to establish an innovation office or lab in the last few years.\textsuperscript{281}

In September of 2020, the CFTC issued guidance on how it plans to evaluate corporate compliance programs. This included discussion as to how the CFTC will seek to determine whether a company had an adequate compliance program in place prior to an infraction, and examination of steps taken to resolve the issue after the violation had occurred.\textsuperscript{282} In May, the CFTC had released a framework for how it would calculate fines in the wake of a violation.\textsuperscript{283}

Both instances of guidance reflected the perspective of then-CFTC Chairman Heath Tarbert, who called for a hybrid approach to regulation part rules-based and part principles-based, as circumstances demand.\textsuperscript{284}

In October 2020, the CFTC announced that it would reduce financial penalties of companies whose employees engaged in misconduct if they self-report misconduct and cooperate with investigators.\textsuperscript{285}

In 2018, FINRA’s Office of Financial Innovation (OFI) began studying the potential impact AI may have in the securities industry, culminating in a whitepaper released this past June\textsuperscript{286} wherein FINRA lays out challenges and opportunities for AI adoption. This included discussion of AI’s potential form impact in the context of compliance and risk management. At a November 2020 conference, FINRA discussed bringing together regulators and industry leaders to explore in tandem the future AI might play in the industry.\textsuperscript{287}

Canada’s Office of Superintendent of Financial Institutions (OSFI) has identified four key goals in its 2019-2022 Strategic Plan, one of which is aimed at improving financial institutions’ resilience to non-financial risks (NFR). To achieve this, the regulator intends to continue in its development of regulatory and supervisory approaches to technology risk and to adopt new approaches to the mitigation of culture and conduct risk.\textsuperscript{288}

In its Annual Report 2019-2020, OSFI reports on its first year of progress towards achieving these goals. Despite the coronavirus pandemic, OSFI Superintendent Jeremy Rudin writes that OSFI has made “progress on this plan, which was realized through the ongoing commitment, dedication and professionalism of our employees.”\textsuperscript{289}
In order to improve culture and conduct risk resiliency in the financial sector, OSFI studied the approaches of prudential regulators in other jurisdictions as to how best to regulate and supervise technology and non-financial risk.290

As discussed in our 2020 Compendium, OSFI also began an industry culture assessment program as part of its research work in the spring of 2019. The assessment considered culture and conduct risk management frameworks, communication mechanisms, software tools, key performance and risk indicators, and the various initiatives firms may have undertaken so as to better gauge their cultures.291

According to its 2020-2021 departmental plan, OSFI now intends to implement the various recommendations that follow from this culture assessment, in an effort to improve the degree of understanding financial institutions may obtain with regards to culture and conduct risks.292

ONTARIO SECURITIES COMMISSION (OSC)

The OSC published the charter for its new Office of Economic Growth & Innovation in October 2020. The Innovation Office has the stated goal of “supporting economic growth and innovation in Ontario’s capital markets,” and is expected to be fully functioning by March 2021.293

The OSC’s Innovation Office plans to reduce regulatory barriers and costs by supporting the development of regtech, which it sees as benefiting both regulated entities and the OSC itself. In the press release announcing the Innovation Office, OSC acting Chair and CEO Grant Vingoe said, “The OSC has a role to play in creating conditions that attract capital, talent and new ideas to Ontario’s capital markets.”294

The charter for the innovation office includes plans for an Ontario Sandbox, allowing industry participants to gain access to data and to test new solutions with fewer regulatory barriers.295

FINANCIAL CONSUMER AGENCY OF CANADA (FCAC)

The Financial Consumer Agency of Canada (FCAC) published a new Supervision Framework, in February 2020, to ensure its responsibilities are carried out in a proactive, accountable, and transparent way.296 The agency placed emphasis on compliance culture, and a willingness and ability to comply with market conduct obligations when preparing Market Conduct Profiles.297

COLLABORATION AND INNOVATION

The Ontario Securities Commission (OSC), Alberta Securities Commission (ASC), and Autorité des marchés financiers (AMF) announced plans to join an initiative to enable cross-border examination led by the Global Financial Innovation Network (GFIN).298

In a release, the regulators said, “Eligible firms will be able to simultaneously test and scale innovative products or services in multiple jurisdictions, while also gaining insights into how their business might operate in these markets.”299

United Kingdom

REGULATORY BACKGROUND

2020 was an especially challenging year for the United Kingdom, as the country began the year facing negotiations and preparation for leaving the EU at year end, then to be confronted by the COVID-19 pandemic.
As elsewhere, UK financial regulators were faced with the challenge of supporting firms during the pandemic-driven downturn while maintaining financial system soundness. In a speech at the 6th Annual Culture and Conduct Forum, Jonathan Davidson, Financial Conduct Authority (FCA) Executive Director of Supervision (Retail and Authorizations) spoke on the importance of sound culture in financial services firms. With regard to the challenges of both the pandemic and Brexit alike, Davidson said, “We place great emphasis on leadership and how they respond to these challenges. Purposeful leaders give the same careful attention to their external strategy and purpose and their internal culture and capabilities.”

Efforts to support the financial sector did not prevent regulators from pursuing significant supervisory actions in 2020, however. The FCA and the Prudential Regulation Authority (PRA) fined Goldman Sachs £96.6 million for risk management failures connected to 1Malaysia Development Berhad (1MDB) and its role in three fundraising transactions for 1MDB. The 1MDB scheme and the repercussions that Goldman has faced for it are discussed in more detail in the United States section of this report.

The FCA also filed criminal charges against NatWest Bank for failing to maintain the proper anti-money laundering controls. This is the first prosecution under a 2007 money laundering rule. Previous infractions were largely resolved through settlement.

The leak of the so-called ‘FinCEN files’ also impacted many UK banks in September of 2020. These files seemed to indicate that HSBC, the UK’s biggest bank, had moved millions of dollars from the US to Hong Kong for a Ponzi scheme, despite suspecting criminal intent.

In October 2020, Parliament’s Treasury Committee launched an inquiry into economic crime, with a view to inquiring into some of the alleged misconduct detailed in the FinCEN files, and to examine the UK’s anti-money laundering systems more generally, with attention to how related risks may be impacted by the Covid crisis.

Mel Stride, Chair of the Treasury Committee, said the committee would examine progress made by supervisors, law enforcement, and the government. “It’s important that the relevant bodies are held to account and scrutinised effectively to ensure that the UK is a clean place to do business and that consumers are protected from economic crime,” Stride said.

Despite the negative attention called to firms listed among the FinCEN files, some have said that the large presence of UK banks in the files should be taken as a positive indicator. While it may make the UK seem like a high-risk country in which to do business, they contend, in fact it shows that these UK institutions are complying with their anti-money laundering obligations and taking proper steps to record and report suspicious transactions.

In the wake of the many instances of misconduct in the previous year, the Serious Fraud Office, the UK’s financial crimes agency, called for companies to invest in programs aimed at preventing misconduct. SFO Director Lisa Osofsky indicated that, when evaluating compliance programs, the SFO judges how deeply ingrained a firm’s compliance function is and how it is evidenced in the company’s culture: “Are they [compliance staff] part of the company’s DNA? Or do they just adorn a very nice couple of binders that are held on a bookshelf that don’t really do much more than provide window-dressing?”

**REGULATORS COLLABORATE**

The Bank of England (BoE) and FCA have long been vocal on the importance of sound institutional culture to financial system stability. In a 2015 speech given at the Lord Mayor’s Banquet for Bankers and Merchants, then BoE Governor Mark Carney said, “Widespread mistrust has also had deeper, indirect costs. Markets are not ends in themselves, but powerful means for
prosperity and security for all. As such they need to retain the consent of society – a social licence – to be allowed to operate, innovate and grow. Repeated episodes of misconduct have called that social licence into question.  

“From next year,” Carney added at the time, “senior managers of banks and insurers will be held directly accountable for failures in their areas of responsibility. And the best firms are improving the ‘tone from the top’, launching conduct training and revamping control structures.”

Shortly thereafter, in 2016, the “Senior Managers and Certification Regime” (SMCR) was launched, to hold senior bankers personally accountable for risk management failures that take place under their watch. The SMCR’s end goal was to encourage senior managers to take ownership over improving culture at their firm.

Although the regulators have issued relatively few fines under the SM&CR, the PRA has said that most senior managers believe the SM&CR has led to changed behavior for the better. Critics, who may agree that the SM&CR has been effective at deterring crime, nevertheless complain that the preventative effect of the SM&CR seems to be a departure from the punitive purpose that they believe program originally intended to fulfill.

The FCA and PRA were forced to delay deadlines associated with the SM&CR in 2020 due to the coronavirus pandemic. However, FCA Executive Director of Supervision, Retail and Authorisations said, “We continue to place great importance on the certification regime and the conduct rules and see this as an opportunity to raise the bar permanently around conduct, competence and culture in the financial services industry.”

The FSB published a review of the UK’s compensation reform and its implementation of the FSB’s Principles and Implementation Standards (P&S) for Sound Compensation Practices. It concluded that, while the SM&CR and the UK’s remuneration regime has improved transparency and accountability for remuneration practices, they could still be more effective. For example, the review found that the regulators could streamline data collection processes and consider new supervisory practices to assess the effectiveness of the regimes.

The SM&CR is not the only program through which the FCA and PRA look to encourage focus on culture and conduct at the executive level. In 2019, the regulators set a new record for the number of ‘Dear CEO’ letters they issue, increasing by 20% over the previous year.

In May 2020, the FCA, PRA, BoE, Payment Systems Regulator and Competition & Markets Authority announced the The Regulatory Initiatives Grid, a document published at least twice a year to outline details of upcoming regulatory initiatives.

The FCA and the Bank of England have also encouraged investments in AI to help banks and other financial institutions to deal with crises and effectively manage risk.

In October 2020, the conduct regulator and central bank launched the “Fintech AI Public-Private Forum”. In a speech at the launch of this forum, BoE Deputy Governor for Markets & Banking Dave Ramsden said, “[W]hile the COVID crisis has had, and will continue to have, a profound impact on the economy, and on the households and businesses that drive it, it has also increased and focused interest in the potential uses of AI in tackling some of the many immediate problems and challenges precipitated by the crisis.”

The FCA also announced that it would be joining the Digital Regulation Cooperation Forum (DRCF) starting in April 2021. The DRCF is made up of
other regulators in the UK which will work jointly on various research projects into supervisory frameworks, AI, and more.\textsuperscript{319}

The UK’s FCA and Financial Reporting Council (FRC) worked together to update reporting guidance for companies and auditors. Mark Babington, FRC executive director of regulatory standards, said in a press release: “While companies and auditors face increased challenges in preparing their accounts, the joint measures allow for additional time to ensure high-quality reporting.”\textsuperscript{320}

In March 2021, the FCA and PRA published a policy statement titled, “Building operational resilience.” Therein, the regulators set forth steps for firms to ensure operational resilience, as operational disruptions could “pose a risk to market integrity” and “cause instability in the financial system.”\textsuperscript{321} While the policy largely focuses on processes and systems, some believe a sound culture to be a key part of operational resilience.

\textbf{FINANCIAL CONDUCT AUTHORITY}

Former FCA CEO Chris Woolard argued that strong regulatory and supervisory systems are essential to the success of the financial system: “Maintaining a strong and robust regulatory and supervisory system [goes] hand in hand with the UK’s position as a global financial centre.”\textsuperscript{322}

The past year has been a transformational period for the UK’s FCA, and the changes are ongoing, with details of an agency-wide transformation program due to be announced, as we go to press (April 2021). In an address to City Regulators in November 2020, incoming FCA Chief Executive Nikhil Rathi said, “Transformation of the FCA and the way that we work will underpin all of our efforts – maximising our use of data and technology, making the FCA more diverse so that we can bring a full range of perspectives and ideas to our work, and using the lessons of this extraordinary year to build on the best elements of our organisational culture.”\textsuperscript{323} In February 2021, in a clear signal of expected best practice in diversity and inclusion, the FCA announced four, all-female appointments to its own senior executive roles.\textsuperscript{324}

The FCA announced a new data collection platform, RegData, calling the new platform key to its data strategy and hopes for the more expansive and sophisticated use of data and analytics to improve its regulatory and supervisory capabilities.\textsuperscript{325} The FCA continues to pioneer ‘machine-readable’ publishing of regulatory instruments, to encourage and support regulated firms’ adoption of regulatory technologies.

At the same time, between the challenge of maintaining supervision during the pandemic and that of supporting firms during the worst downturn since the Global Financial Crisis, the last year saw the FCA pursuing far fewer enforcement actions than it had in previous years. From March 2020 to May 2020, for instance, the FCA opened 36 new enforcement cases, down from 148 during the same period in 2019.\textsuperscript{326}

By December 2020, the FCA had issued fines to ten wrong-doers over the year, the lowest number since its creation in 2013. The regulator also levied its third-lowest amount in fines in any year, at just £183.6 million. However, the FCA stated that enforcement had continued as usual and observed that the number of enforcement cases and fines varies year to year.\textsuperscript{327}

Alongside the Bank of England, the FCA delayed implementing new Senior Management and Certification Regime rules from December 2020 to March 2021. The new rules were delayed to permit institutions to focus on necessary pandemic response efforts.\textsuperscript{328}

\textbf{DIGITAL TRANSFORMATION}

In May 2020, Steve Green, head of the FCA’s central data services, innovation, strategy and competition division, said that the regulator is still working to improve its data strategy and usage as a means to make it a more effective regulator: “We are looking
Q. Chris, in both the Woolard Review, and one of your last major speeches as an executive at the FCA, you talked about “Outcomes Based Regulation.” (OBR) What do you mean by that?

A. Thanks Stephen. There are two components to this. First, regulators often get locked into quite narrow views based on the tight legal construct of a product. To make regulation work well, we need to take a step back and look at how a product is sold and also how it is used by consumers. We should seek to give consumers protection and businesses certainty based on how the product operates in the real world.

A good example of this in the UK is home collected credit, which is a single loan from a compliance and legal perspective but, in reality, it is used multiple times per year by many customers, much more like a credit card or overdraft line. Moreover, the business models of many firms in this market rely on this customer behaviour. I would argue it’s far better to take a regulatory stance based on how the product is used than a narrow legalistic reading.

The second part, then, is to cut through the decades-old argument of “should you have principles-based regulation or rules-based?” For me, the right answer is you should have both. There are many situations where, as a regulator, you want to set some broad parameters for how the market should be operating and the principles of competition and consumer protection. There are, however, times when you have to be very precise about expectations. A good example is UK forbearance rules that have operated as broad principles for many years, reflecting very different business models of some lenders, but during the Covid-19 emergency these were made much more prescriptive to achieve a consistency across all lenders.

Q. In your latter example, what really drives the choice between rules and principles?

A. As the name suggests, for me it is all about what outcome the regulator is seeking. That requires some deep thought. Often, the public or political clamour is for absolute protection from harm – which no system of law enforcement can ever guarantee – and, even if you could do so in regulated markets, it would imply the ‘stability of the grave’. In reality, regulating is often akin to refereeing a sports match – you want the game (in this case the market) to flow within some broadly accepted notions of behaviour and conduct. In the financial services case, this means we should see the emergence of new products and services focussed on changing consumer demands. But there will also be behaviours that are dangerous or harmful that need to be prevented, and we need to have clear penalties for transgression of those rules.

Q. That sounds all terribly pragmatic – do you think that can really work?

A. Yes, and I worry when policy makers get too entrenched in any one position. We can see examples where getting pinned too closely to a set of detailed rules drags regulation into narrow legal battles that ignore the bigger picture, for example, sometimes in the US. On the other side of the same coin, being too principles-based can be just as fraught, especially as emerging technologies mature and become more mainstream. Many regulators also have a range of
civil powers they can resort to, for example via action in the courts or general consumer law. In every case, regulators should be asking themselves what’s the right outcome, and what’s the right tool.

For a UK example, faced with the prospect of court action between insurers and their customers that would have dragged on for many years, and during which time many small businesses may have become bankrupt, the FCA took the novel step of intervening in the Business Interruption market so as to arrange for a fast-track process, through the courts, which would ensure certainty in the market. Inevitably, these kind of interventions will be rarely used, but form a powerful part of the regulator’s toolkit.

Q. Given the obvious importance of achieving desired outcomes, why is OBR not already the norm in regulation?

A. That’s a really good question. In part, outcomes are hard to define and success is hard to measure. For natural reasons, firms and policy makers often prefer hard and fast rules – for the regulated this offers the sense that “I complied with the rule, so I must be safe” while, for regulators, rules provide clear evidence that they are trying to manage a situation.

So, rules clearly have their part in this, and can be incredibly effective. But they need to be subordinate to the overall purpose the rules intend to serve. There is no point having 100% compliance if the outcome is not good or effective.

We can all think of different examples but, to give one, we know that despite huge resources deployed by regulators and firms, AML rules as a whole do a relatively poor job of helping detect and stop money laundering. (the UN estimates around 1% is stopped worldwide) There are emerging technologies that help do a much better job, especially when data is pooled among firms. But, in most countries, a system of checks by individual banks is mandated, rather than any co-operation among them.

Q. Looking forward, how do you see an outcomes-based approach helping with the big global challenges that financial markets will face?

A. I think there are three big global challenges: business after the pandemic; the rise of new technologies; and how financial services firms will play their part in the climate change agenda. All three of course are interlinked, overlap and are nuanced, but I’ll try and illustrate each one quickly.

The cliché of the pandemic is that it has brought the future forward. Regulators around the world have learned to adjust their approach – for example, with regard to wholesale trades happening from home, or financial advice given and recorded remotely. In reality there is far more to come, especially as retail banks adjust to even more business being done online and we see less reliance on cash and the operation of their branch networks. This is really going to require governments, regulators and firms to work with society to develop a degree of consensus about what outcomes they want from the banking system.

And it’s not just in greater amounts of business being done online where technology matters. As the Libra proposition exposed in 2019, virtual currencies and payment systems can reshape the landscape. Technology players will become more and more systemically important to parts of the financial system. Principles provide a useful guide to thinking about the consumer and societal outcomes that we want in this context, but there will need to be a level playing field between Big Tech and Big Finance, and the outcomes will almost certainly need underpinning with new rules that are fit for a digital age – and the removal of those that are not.

Last but not least, the whole ESG agenda is increasingly important particularly with regard to how financial services firms play their part in the fight against climate change. At the moment much of the attention has been focussed on ethical investment, or stress-testing against global warming.
scenarios, but meeting the Paris Accord targets will require most developed and developing economies to make huge investments in industry, housing and transport. There will need to be some very clear strategic thinking about how the financial sector – including insurers and long-term savings institutions – should support this agenda, and what will need to change in order to facilitate that.

There will be risks and multiple trade-offs that regulators, governments, firms and ultimately consumers will need to navigate and resolve. But by establishing clearly defined outcomes we aim for, and agreed principles by which they are to be achieved, we will enable the detailed rules that many firms will need in order to act with confidence.

Christopher Woolard is the former interim CEO of the UK’s Financial Conduct Authority and was a member of the board and executive director for the past eight years. He was a member of the Bank of England’s Financial Policy Committee and was the first chair of IOSCO’s Fintech Network. He led the FCA’s immediate response to the pandemic, including relief for mortgage and credit consumers, and the successful court action to settle business interruption insurance liabilities. His final role for the FCA was to chair the Review of Unsecured Credit (The Woolard Review) published in February before [insert next role when public]. At New Year 2021, he was awarded a CBE by HM the Queen for services to financial regulation and fintech. Subsequent to this interview, it was announced Chris had joined EY as a Partner and Chair of its Global Financial Services Regulatory Network. He will also become a non-executive trustee of Which?, the UK Consumers’ Association.

at expanding the use of data across the depth and breadth of our activities so we can manage our mission more efficiently, react more quickly and adapt to future so we can pivot at speed.”

However, in September 2020, the FCA admitted that it had faced a “range of challenges” while pursuing its data strategy. The FCA stated that it plans to work to be “One FCA” by improving the agility and speed of decision making in the regulatory agency.

WORK FROM HOME

While the FCA exercised some leniency with regulated institutions in 2020, they also cracked down on new risks that had arisen due to the pandemic. For example, the regulator made it clear that, both during the pandemic and into the future, banks are expected to apply the same standards of surveillance and conduct risk monitoring to employees working from home as would be the case in the typical work environment. In the May 2020 release of Market Watch, a newsletter on conduct and transaction reporting issues, the FCA wrote:

We recognise the uncertainty created by the coronavirus crisis and operational challenges arising from the public policy on social distancing. However, we expect all market participants, including issuers, advisors and anyone handling inside information to continue to act in a manner that supports the integrity and orderly functioning of financial markets. This includes complying with all their obligations under relevant regulation including the Market Abuse Regulation (MAR).
In January 2021, the FCA stated that banks must record all employee communications while working from home. This requirement is essential and yet very difficult to implement and enforce, when traders and bankers opt to use encrypted messaging apps like WhatsApp for work-related communications. The situation becomes more complicated still when these employees decide to use a different app, like Signal. When thousands of UK traders and bank employees began using Signal instead of WhatsApp, employers had to scramble to find new ways to monitor their communications.

The regulator has made it clear that it finds the use of WhatsApp and other apps like Signal at work “suspicious,” and that it views office and home work environments as equivalent when it comes to workplace monitoring and supervision. Companies must also be especially vigilant as remote working has caused instances of “burnout” to increase, with failure to give due regard to employees’ mental health and other home stresses potentially damaging corporate cohesion.

In February of 2021, the FCA called for financial firms to renew their focus on conduct issues, warning against “lockdown fatigue.” David Blunt, FCA Head of Conduct Specialists has argued that the lockdowns could cause a dip in the psychological safety experienced among employees of financial firms: “The impact of COVID-19 is creating a huge workload for those considered to be high performers, while the remote environment potentially makes it much more challenging for those who were previously considered low performers to change that perception.”

If companies are not careful to continue investing in their culture while in a remote working environment, some fear that it could decay as employees have significantly less informal contact with each other. Those who have furloughed staff could face even greater challenges, as they might have little to know contact with their colleagues at all.

CULTURE AND (MIS)CONDUCT

Mark Teasdale, FCA Director of Wholesale Supervision, explained four drivers of culture at firms:

- **Leadership** including the tone that is set from the very top of the firm, and how effectively that tone cascades through the organisation.
- **People policies**, and in particular the types of behaviour that are incentivised or disincentivised within the firm, and how this is done. This most obviously includes remuneration, but also extends to a far broader set of considerations including progression, promotion, recruitment, diversity and inclusion, speak-up culture and psychological safety.
- **Governance**, in the broadest sense of how decisions are made within a firm.
- **Purpose**, which I will spend a little time describing.

In a paper entitled “Messages from the Engine Room,” the Financial Conduct Authority (FCA), reported on its engagement with less-senior staff on topics of purpose, conduct and culture at individual roundtable session with 18 wholesale banks. Staff emphasised the importance of clear purpose to themselves individually and for the business units they were part of. There was more need for senior management support for their doing the right thing than repetitive directives to do so. The FCA found that only 44% of respondents believed that employees at all levels of their firm could raise concerns without fear of retaliation, indicating a widespread lack of psychological safety in these institutions. While 95% of respondents rated their ability to identify conduct risk as high or very high, many could not speak in depth about conduct issues. For 1/3 of respondents, conduct was rarely discussed, even after training, town halls, or large incidents of misconduct in the news.
In March 2021 the FCA announced a redraft of the Conduct Questions, to include a new Sixth Conduct Question, addressing diversity and inclusion (details expected May 2021). Risk Expert Roger Miles argued that this is a signal that the FCA is itself doing what it expects its regulated entities to do: “Such behaviour might be expected of any responsible employer organisation, but the FCA’s initiatives include a gamechanger for everyone else too: regulated firms will now be held to account by similar standards. Specifically, the FCA is adding a sixth question to its five conduct questions, which will now require more than 60,000 regulated firms to report on how diversity considerations inform routine business practices.”

In October 2020, the FCA began investigating 14 firms and six individuals for their role in the so-called “Cum-Ex” tax fraud scandal. The firms and individuals are alleged to have run dividend stripping schemes in Denmark, Germany, France, and Italy — rapidly trading shares to duplicate dividend tax refunds.

In an unprecedented move, in November last year the FCA banned three men convicted of sexual offences from working in the financial industry for life. In announcing the action, FCA Executive Director of Enforcement and Market Oversight Mark Steward said, “The FCA expects high standards of character, probity and fitness and properness from those who operate in the financial services industry and will take action to ensure these standards are maintained.”

The expulsion of these three men from the financial industry is a part of a larger push to improve culture and punish non-financial misconduct, whether or not it occurs within the office.

In December, the regulator fined Barclays £26 million over its treatment of customers who were experiencing financial strains due to the pandemic. The FCA requires that consumer credit firms make an effort to understand customers’ financial difficulties and to show forbearance to those who have missed payments or are struggling. According to the FCA, Barclays and affiliates failed in this regard.

In February 2021, the FCA released a new version of its Code of Conduct (COCON). The COCON sets out rules for applicable firms and employees, as well as the regulator’s methods for assessing compliance. Generally, the rules require that employees act with integrity and diligence, be transparent with regulators, and treat customers fairly. Under the COCON, senior management must ensure that the business of the firm is under control and compliant, and share appropriate information with their regulators.

The FCA is also looking to double down on its efforts to encourage whistleblowers to come forward, after it received its highest number of whistleblower reports in years in 2019, including reports of unacceptable behavior in the workplace, which rose 35% over the previous year. Also in February, the FCA launched a campaign, titled “In confidence, with confidence,” to encourage whistleblowers to report wrong-doing. As a part of the campaign, the FCA has released materials and toolkits for firms to share with employees and use to encourage individuals to come forward.

The FCA has also used its regulatory power to promote diversity and inclusion in the financial sector. FCA CEO Nikhil Rathi defends this posture, arguing, “We care because diversity reduces conduct risk and those firms that fail to reflect society run the risk of poorly serving diverse communities. And, at that point, diversity and inclusion become regulatory issues.” As noted above, a Sixth Conduct Question will address diversity and inclusion in firms, from May 2021.

In November last year, the FCA published a study concluding that corporate governance reporting among listed companies needed to be improved. The FCA noted therein an interest in board diversity
as governance concern. In March this year, the FCA announced that it will consider setting diversity requirements for listed companies in the UK.\(^{354}\)

The FCA also announced a new rule in December 2020 enhancing climate-related disclosure for listed companies. Companies will be required to report on whether their disclosures are consistent with Taskforce on Climate-related Financial Disclosures (TCFD) recommendations, and explain why if they are not.\(^{355}\)

**TURNOVER IN FCA LEADERSHIP**

In the last year the FCA has undergone significant reorganization and leadership change, presenting the regulator with an especially tumultuous transition amidst the additional strain of Brexit and the pandemic. Chief Operating Officer Georgina Philippou stepped down\(^{356}\) in November while Executive Director for Supervision of Investments Megan Butler stepped down from that post and transitioned into a new Executive Director of Transformation role.\(^{357}\)

Some critics of the regulator have argued that past missteps suggest that the transformation role would have better gone to an external candidate.\(^{358}\)

After Philippou’s departure, the FCA publicly posted that it was searching for a “change agent” for the Chief Operating Officer role on LinkedIn.\(^{359}\) In February 2021, the FCA announced that it was appointing four new, all-female members to the executive team to help drive its transformation.\(^{360}\)

In this announcement, CEO Rathi said, “As we continue transforming the FCA – building a data-led regulator – their global experience and leadership, drawn from a variety of backgrounds, will be vital in ensuring we can act more quickly to reduce harm to consumers and ensure market integrity.”\(^{361}\)

**REGULATORS FACE GREATER SCRUTINY**

In December 2020, an independent review of the FCA’s supervision of mini-bond issuer London Capital & Finance (LCF) found that the FCA “did not effectively supervise and regulate” the issuer before its 2019 collapse. LCF had marketed high-risk, unregulated mini-bonds to private investors, which led 12,000 investors to lose a total of £236m.\(^{362}\)

Bank of England Governor Andrew Bailey had been FCA Chief Executive during the relevant time frame and has thus come under scrutiny in the wake of the independent LCF report. The head of the independent inquiry stated that Bailey failed to adequately justify the FCA’s past failure to protect the investors harmed by LCF.\(^{363}\)

In response to this report, FCA Chair Charles Randell said that the regulator acknowledges it could have done better in supervising LCF, and apologized for its mistakes.\(^{364}\) Randell went on to say, “The FCA Board and I have every confidence that continuing the transformation of our organisation is the right way to bolster trust in the FCA and realize our ambitions for change.” The regulator also cut performance-related bonuses for executives in the wake of this scandal and is considering pay cuts.\(^{365}\)

In the wake of the LCF scandal, it was also reported that the FCA had waited more than two years before taking action on warnings about the investment business of Neil Woodford. Once a highly respected fund manager, Woodford failed to maintain adequate liquidity in his funds and had thus left £3.7bn from hundreds of thousands of investors improperly locked up in his fund as they sought redemption in the wake of the fund’s poor performance.\(^{366}\)

The fund was frozen in May of 2019, while Woodford sought to unwind illiquid positions, but was ultimately shuttered in October 2020. Though the FCA had interviewed Woodford executives in 2014, who had left the firm due to complaints regarding its
compliance culture, the FCA did not take any action until 2016, leaving the regulator facing further public criticism.\textsuperscript{367}

Some have called for the establishment of a “Office for Responsible Financial Regulation,” a statutory body to scrutinize regulatory decisions and activities. The body would consult with academia, industry, and regulators to determine if regulator actions were meeting broader objectives.\textsuperscript{368}

**FINANCIAL SERVICES CULTURE BOARD**

In a blog post entitled “The sound of silence,” three Financial Services Culture Board (FCSB), previously called the Banking Standards Board (BSB), behavioural scientists examined the results of the FSCB’s 2019 Employee Survey relating to employee’s willingness to speak up. The post reports that of those employees who had wanted to raise a concern at UK banking firms in the previous year, 23 percent remained silent.\textsuperscript{369}

The FSCB released the results of its Assessment 2020 in March 2021.\textsuperscript{370} This assessment uses employee surveys to determine “how far each of our nine characteristics is demonstrated by the firm and relative to other firms.” The nine characteristics measured through the assessment are: honesty, respect, openness, accountability, competence, reliability, responsiveness, personal and organisational resilience, and shared purpose.

Among its key findings, the FSCB reported that the greatest improvements since 2016 had been around questions regarding leadership and the handling of feedback. In a happy note, in 2020, 77 percent of UK bank employees reported believing that their leadership meant what they said, up from 62 percent in 2016. However, the FSCB also found that while 91 percent of White British employees felt accepted in the workplace, only 78 percent of Black employees said the same.\textsuperscript{371}

**FINANCIAL REPORTING COUNCIL**

The Financial Reporting Council (FRC) announced in 2020 that it examined 88 cases in the 12 months preceding March 31, almost double the number of cases in the previous 12 month period. FRC Director of Enforcement Elizabeth Barrett said, “This year’s audit enforcement review shows an increased use of constructive engagement, to provide a timely and proportionate way of addressing deficiencies and the wider deployment of non-financial sanctions to drive audit quality.”\textsuperscript{372}

In September 2020, the FRC released a review of the implementation of the new UK Stewardship Code 2020, a code which sets principles for investment professionals who handle money on behalf of investors and those who support them. The code came into effect at the beginning of the year and was discussed in some detail in the previous version of this Compendium. While some reports evidenced good “stewardship activity,” the FRC found that few showed the implementation of all principles or completed all reporting requirements.\textsuperscript{373}

In a November 2020 review of corporate governance reporting, the FRC found firms’ reporting under the terms of a new corporate governance code to be inadequate.\textsuperscript{374} The FRC complained, “[S]ome companies continue to treat the Code as a box-ticking exercise. Where this happens, reporting is formulaic and companies do not seize the opportunity to meaningfully explain why they do not comply with its provisions.”

The review also stated that many companies had failed to provide sufficient evidence to support their assertions regarding the importance of diversity to their companies.\textsuperscript{375}
The FRC announced in June 2020 that it was hiring white collar crime expert, and former FCA director of investigations Jamie Symington to improve the capabilities of its enforcement division.376

In December 2020, the FRC released a letter stating that auditors were failing to challenge companies on their numbers sufficiently and that this was evident in 80% of audits in the past two years that had been found to be subpar.377

In this letter, FRC Executive Director of Supervision David Rule wrote, “Developing the right mindset and professional behaviour is critical. Both of these attributes are heavily influenced and reinforced by a strong audit culture of scepticism and challenge.”378

After a review of Deloitte’s audit work for software company Autonomy, for instance, the FRC found that the firm and two of its audit partners had committed grave misconduct in their vetting of Autonomy’s financial statement leading up to a failed acquisition by HP. The FRC ordered Deloitte to pay a record $21 million, as their auditors had signed off on disclosures which had disguised losses from sales as marketing costs.379

In April 2021, the UK government launched a consultation on reforms to its Audit and Corporate Governance Regime. A new regime under leadership of an Audit, Reporting and Governance Authority (ARGA) is to be established. Currently undergoing an industry consultation process, intentions are that this new regulator would have a remit to review annual reports and accounts, and that it would be equipped with the power to request changes without a court order.380

The new regime under ARGA would also require that directors report annually on their firm’s internal controls and produce an operational resilience statement vis-a-vis the short and long-term risks faced by the company, perhaps to include relevant ESG related disclosures.381

In the FRC’s annual report, the agency touted a “transformative year,” as it had already made great strides in improving audit quality and corporate reporting in its transformation to the ARGA.382

These reforms seem timely, as many have called for an overhaul of the sector in the wake of the audit failures surrounding the Wirecard scandal.383

BANK OF ENGLAND

In a January 2011 article published in Nature, Bank of England (BoE) Chief Economist Andy Haldane and the late Robert May, Baron May of Oxford, wrote, “In the wake of the global financial crisis that began in 2007, there is increasing recognition of the need to address risk at the systemic level, as distinct from focusing on individual banks.”384

As this statement evidences, the Bank has long understood the nature of contagion dynamics and ripple effects that unmitigated financial risks may unleash upon the financial system as a whole. In recent years, the Bank has begun to also acknowledge that unmitigated non-financial risks are of equal significance for system integrity and have potential to cause systemic shock if not appropriately addressed by regulators and policy-makers.

In his remarks at a Banking Standards Board panel in March 2017, former BoE Governor Mark Carney gave voice to such concern when he observed that the financial crisis had revealed:

Too many participants neither felt responsible for the system nor recognised the full impact of their actions. Bad behaviour went unchecked, proliferated and eventually became the norm. The economic consequences have been enormous. Global banks’ misconduct costs have now reached over $320 billion – capital that could otherwise have supported up to $5 trillion of lending to households and businesses.385
In Focus
On Company Purpose & Culture

By JONATHAN DAVIDSON and OLIVIA FAHY

Over the last 3 years at the FCA we have been exploring outstanding issues that are preventing the adoption of healthy cultures in financial services, encouraging leaders to reflect on their firms’ cultures, and act to transform them for the better. Our engagement with academics, industry leaders and other multi-disciplinary experts has led to the consensus that, while there is no one-size-fits-all culture, a healthy culture shares common elements.

HEALTHY CULTURES ARE PURPOSEFUL, SAFE, DIVERSE, AND INCLUSIVE

The focus of these remarks is going to be on company purpose, but first we will explain what we mean by safe, diverse, and inclusive.

By safe, we mean that for a culture to be healthy, leaders at all levels need to foster an environment in which employees feel comfortable to express their opinions, and crucially, feel that they are listened to when they do speak up.

We have been exploring the theme of psychological safety as a key characteristic of a healthy culture since 2018, guided by the research of Harvard’s Amy Edmondson. We believe it to be so important because it creates an environment which facilitates productive disagreement and a free exchange of ideas – in other words, an inclusive environment which welcomes the expression of opinion, embraces diversity of thought and provides freedom for creativity and innovation without fear of punishment or recrimination.

Diversity and inclusion are often paired together and referred to as ‘D&I’ for ease, but they are two distinct characteristics of a healthy culture that each require urgent attention. The constant reference to ‘D&I’ is not always helpful, as we risk reducing these important topics down to an acronym that is used without giving thought to what it really means, and so it becomes just more corporate jargon.

There is a tendency to focus on the more measurable ‘D’ – for example, by putting quotas or other targets in place to increase diverse representation within organisations – but, while this is important, the ‘I’ is equally so and perhaps more so. Without psychological safety, inclusion suffers, and the value of diversity is lost. It is no use increasing representation of minority groups if their voices are not heard nor listened to. You cannot create true diversity of thought without inclusion.

So, on to the topic of purpose...

Three years ago, when we launched our Transforming Culture initiative, it was rare to hear the concept of ‘purposeful cultures’ discussed in the same sentence as financial services. But, during the time since, there has been a huge increase in attention to the topic and, now, it is rare not to hear it discussed when considering the elements needed to drive a healthy culture.

In 2019, we set up a working group to explore the concept of purpose and consider the business case for purposeful cultures. The working group was made up of representatives from firms and professional bodies,
as well as academics and subject matter experts. In between the working group discussions, members of the group convened roundtables within their sectors to bring more voices and insights to the discussion. The group, and other contributors, produced a set of essays that we published as a Discussion Paper in 2020.1

WHAT IS THE ROLE OF SUPERVISORS?

The question most regularly asked when people hear that a regulator is taking an interest in purpose is, ‘what are the regulatory consequences’?

At the FCA, we describe purpose as ‘what a firm is trying to achieve – the definition of what constitutes success’. A firm’s purpose is its own responsibility, and should not be prescribed by a regulator, but we want firms to recognise its importance in driving behaviour and the culture of an organisation. Firms and leaders who don’t recognise the importance of purpose may be more likely to drive behaviours in their organisations that could lead to misconduct.

So, purpose is one of four drivers of culture upon which we focus in our supervision of firms, alongside leadership, approach to people, and governance.

To understand culture, we assess the effectiveness of these four drivers in reducing the potential for harm that could arise from a firm’s business model or strategy. When considering the effectiveness of purpose, we look at: how a firm describes its aims through its narratives; how these are understood by staff and whether they are aligned with good outcomes; how purpose is reinforced, communicated and demonstrated by leaders; and the extent to which a firm acts as a good market participant. If a firm’s purpose and associated business model, strategy or activity is contributing to – or exacerbating – the risk of potential harm, then firms can expect increased supervisory scrutiny.

But our answer to the question of ‘what are the regulatory consequences’ is that firms shouldn’t be looking at purpose because they fear there may be regulatory consequences if they do not. Rather, they should be focusing on it because it’s good for business.

HOW CAN LEADERS DRIVE PURPOSEFUL BUSINESSES?

Many of the essays in our above-referenced Discussion Paper discuss the business benefits that follow from a focus on purpose, and there is an increasing body of research which demonstrates that there are solid business reasons for being purposeful. Purpose shouldn’t just be viewed as a new buzzword, or the whim of a CEO or the regulator. It is an opportunity to create more sustainable businesses that add value to society.

But how can firms go about being more purposeful, where should they start? To drive a truly purposeful business, leaders need to consider the future and how they are going to create value for society. Leaders need to ask themselves what they want to do and achieve as an organisation, and how they want to make a difference.

The purpose of a firm sits at the heart of its business model, strategy and culture. There can be a tendency to determine business model and strategy first, and to then try and retro-fit purpose. But this is the wrong way around. Organisations need to ask themselves what their purpose is, and then determine a business model and strategy that aligns with it. This shouldn’t be difficult, as purpose should be determined at an organisation’s inception; it might be refined, or perhaps even lost, over the years, but it should exist. As one CEO put it to us, “you might have to recover your purpose, but you shouldn’t have to discover it”.

We have had many discussions with firms and thought leaders on what is needed to make business and culture purposeful. After all, many firms do have
an articulated purpose, some even go so far as to display it on the walls, so what more is needed? Two characteristics have come through time and again – purpose needs to be authentic and meaningful.

We have probably all experienced training sessions where admirable sounding purpose statements are read aloud, only then to be told that they belonged to firms that had experienced some of the worst corporate failures as a result of their behaviours and culture.

A purpose statement will only take you so far. It is the manifestation of purpose that makes a difference – actions speak louder than words. People need to see and hear that the organisation is living its purpose – from the behaviour of leaders and employees, to the business practices they espouse and engage in. There is no point in espousing a valuable social purpose if your business practices don’t align with it.

Firms also need to offer meaning through purpose. Gone are the days when making as much money as possible was to be seen as the most attractive thing a firm could offer.

We heard a story from another leader recently, for instance, who was describing a discussion with a new graduate cohort. The leader asked one graduate what had made them choose to work at the firm, amongst all the similar and well-paying competitors. The graduate answered: because the firm had stopped using plastic cups. A focus on purpose is not just a regulatory demand, it is increasingly being demanded by employees, consumers and shareholders alike.

Employees want to work for organisations whose purpose resonates with their own individual sense of purpose. Consumers want to be able to trust that firms are not only looking after their money, but also looking after their employees and other stakeholders, treating them fairly while engaging in ethical business practices. Shareholders want to invest in firms that can make them money by doing good and by adding value to society.

HOW DO YOU KNOW WHETHER YOU’RE ACHIEVING YOUR PURPOSE?

To know whether your organisation is delivering against its purpose, leaders need to be able to define and measure success. And so, it follows that purpose must be measurable, as well as meaningful and authentic. There is a tendency to couch purpose in corporate buzzwords and inspiring phrases but, sometimes, it is the simple things that can be most impactful. It’s easy to write a purpose statement that sounds impressive, but you also need to consider how to action it and evidence that you are delivering upon it. What is it that you are doing, and how does that make a positive difference and add value to society?

We are at a turning point. The covid-19 crisis has triggered an evolution in business models so that firms may remain operational and viable amidst the economic impact of the pandemic. In our view, the firms most likely to succeed will be those that consider what it is that they want to evolve towards, and which then work to do so over the long-term – with purpose – rather than those that allow themselves to evolve passively, or with a focus on optimising profits in the short-term.

While Covid-19 might be the most immediate challenge we are facing, it isn’t the only one – there are challenges from the macro-economy, from the accelerating change in digital technologies, and from changes in most financial services markets. We also face many important social challenges, such as the need to break barriers around diversity and inclusion and to make progress in relation to climate change and sustainability. But with challenges come
opportunities – opportunities to have a positive impact, drive change and make a real difference for the future.

To that end, I have just changed roles from Supervision to be a Senior Advisor to the FCA on how financial services can make a purposeful and profitable contribution in the transition towards a zero-carbon economy, and best address other environmental and social challenges that face humanity.

Financial firms and financial markets play a central role as the invisible enabler for the transformational shifts we need in capital and resource (re)
deployment, business model transformation and risk management. I believe that the financial services industry can make the biggest difference if we approach this purposefully and collaboratively.

Jonathan Davidson served as Executive Director of Supervision – Retail and Authorisations at the UK Financial Conduct Authority before stepping into his current role advising FCA leadership.

Olivia Fahy was Culture Lead in the Supervision function within FCA before moving to the private sector.

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In the course of the Covid pandemic and in the wake of more recent misconduct scandals, non-financial and conduct related risk has won even more attention for its potentially systemic impact. Some have argued that regulators should thus work to promote the adoption of superior risk management tools, giving a boost to regtech in markets like Singapore, Hong Kong, and Australia, as reported herein.

The Bank, however, is reluctant to wade too deeply into the promotion of any particular tools, and has called for regtech companies to press their own case. BoE Deputy Governor Sam Woods sees this as the more sustainable method of pushing innovation: “A technology shift that is led by a small number of people in the public sector making choices does not strike me as a good technology shift.”

PRUDENTIAL REGULATION AUTHORITY

Mr. Woods, who also serves as CEO of the Prudential Regulation Authority (PRA), has argued that, in order to work effectively in a world that continually changes, regulators must be tough and adaptable: “A changing world requires a tough but flexible regulatory regime that can adapt itself rapidly as needed – both to remove unnecessary barriers to innovation and to give policyholders reasonable protection from any new risks that arrive with it. The alternative is a more sluggish regime, more conservatively calibrated to compensate for its lack of manoeuvrability.”

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In Focus
For a sustainable business, build a resilient culture

By ALISON COTTRELL

After a year in which ‘unprecedented’ became one of the most overused words in our vocabulary, resilience is a characteristic that remains at a premium for both individuals and firms. The sources of uncertainty, unpredictability and change have been multiple; economic, political, regulatory, technological, societal (including Black Lives Matter) and, of course, Covid-19, which continues to shape our daily lives in both its direct and indirect effects.

As became quickly apparent, this is a pandemic that is at once unifying and divisive; affecting all of us but each of us differently, and with longer term consequences that are still emerging. More immediately, however, we are all working, acting and interacting in different ways to only twelve months ago. Some of these changes may last only as long as the social distancing they are a response to. Others, however, will be less readily unwound. We have invested in skills, IT, processes and structures, and have developed new habits, preferences and expectations. Whether as individuals or organisations, our ways-of-working ‘toolkit’ is heavier now than the one we carried with us into early 2020.

Surviving and thriving in an environment where the only constant is change requires resilience; the capacity to learn, respond, adapt, anticipate and maintain perspective. Personal resilience is sometimes described as a combination of optimism and realism (to which we might also add getting enough sleep and knowing when to ask for help).

But organisational resilience is not achieved simply through hiring individually resilient employees. Tolerate a working environment in which people are routinely tired; keep them out of the loop on decisions or changes until the last minute; encourage group think; reward favourites; behave unpredictably or tolerate a blame culture, and you will quickly ensure that any resilience your employees still possess will be left outside the door every time they enter the (real or virtual) office.

An organisational culture that fosters collective resilience and enables a firm not just to cope with unexpected setbacks but to learn from and build on them does not happen by accident or because the firm hired optimistic and realistic employees. It requires leadership.

The Financial Services Culture Board (FSCB) – or as we were known until April of this year, the Banking Standards Board (BSB) – is now in its sixth year of working with member firms to help them assess their own unique workplace cultures and collectively raise standards of behaviour and competence. Given our initial focus, these firms have to date been primarily in the UK banking sector. We have also, however, been working with a growing number of firms and other organisations from outside banking and outside the UK. Responding to this wider interest, we have now expanded our scope to enable firms from across financial services to work with us individually and collectively as members, and amended our name accordingly.
Our core information-gathering exercise, the FSCB Employee Survey,\(^1\) received in 2020 (and in the UK alone) more than 73,000 responses across 31 firms. This Survey does not set out to ‘measure’ culture. Each firm’s culture will be unique; a product of its leadership, its mix of employees, its history and its environment. There is no single template for a ‘good’ culture and multiple ways of having a bad one. The value of attempting to measure culture and to compare and aggregate the results across firms would, in this context, appear questionable.

If we cannot sensibly measure organisational culture we can however judge it, and there are things that we can measure to help inform that judgement. The FSCB Assessment framework defines a ‘good’ culture as one that produces good outcomes for customers and clients. It identifies a set of organisational characteristics that we would expect to be associated with good outcomes, and prevalent in an environment in which employees are equipped and motivated to serve their customers or clients well, i.e. honesty, reliability, competence, resilience, respect, responsiveness, openness, accountability and shared purpose. The questions that we ask in the FSCB Survey are designed to explore how far employees see these characteristics demonstrated within their firm. The results can be tracked both over time and relative to other firms and analysed by business area and demographics. We also ask a small number of one-off additional questions in any year to explore specific issues in more detail; in 2020, this included questions relating to inclusion and to the firm’s treatment of its employees during the pandemic.

Drawing on this unique and extensive data set, the FSCB can identify common or emerging themes that inform its ongoing practical work with members. This work may involve utilising the FSCB’s own data science and behavioural science teams, facilitating peer learning and the sharing of experience between members, learning from experience from other sectors, working with academics and subject matter experts, or partnering with or supporting other organisations and networks. Among the themes, however, organisational and personal resilience has been a consistent feature, its importance only reinforced over the past year.

Looking across the FSCB’s findings as a whole – and while these draw on the banking sector, they relate to how people behave in groups rather than in a specific sectoral context so have, we hope, applicability well beyond banking and financial services – and drawing also on wider research, what can we say about what matters for organisational resilience? Three points in particular emerge for leaders and managers.

**Fairness**

A sense of fairness is deeply rooted in us, even as very young children. Unsurprisingly, therefore, whether people feel that they (or their colleagues) are being treated fairly by their employer, has fundamental implications for the culture of the organisation and its resilience.

In all walks of life, acts of fairness and kindness tend to be reciprocated. Unfairness also produces a reaction; behaviour that would be viewed as unethical by employees in one firm, may be regarded by those in another as an acceptable way of ‘righting the balance’. If some teams or groups of people are seen as more favoured than others, collaboration may be stymied, effort diverted to competing for status or recognition, and/or employees disengage or leave. Unfair hiring or promotion practices, meanwhile, will limit the availability of talent to the firm and the range of views and experience it has available to draw on, reinforcing a tendency to groupthink and undermining its resilience.

Our sense of fairness also affects our health and wellbeing. In a longitudinal study of UK senior civil servants, the question most closely correlated with subsequent ill health was whether the respondent felt they had been unfairly treated.\(^2\) In our own work with
member firms, we have found that employees from business areas that score poorly in the FSCB Survey on personal resilience questions, are more likely to refer in focus group discussions to unfair treatment than are employees from business areas in the same firm with stronger personal resilience scores.

The shift in 2020 to working from home brought for many firms sometimes unexpected benefits in terms of faster decision making, more flexibility and greater autonomy for employees. New working arrangements, however (and especially as and when some staff return to the office for at least some of the time), bring new challenges of their own, including around fairness. More autonomy may mean less consistency in the way that things are done around the firm; some individuals or teams may also have more flexibility than others or be perceived as having better working environments, greater influence or more opportunities to be recognised and rewarded. Fairness and autonomy are not opposites. Neither, however, are they unrelated. Striking the right balance will be central to the success of post-Covid 19 workplace arrangements. How to tell whether the working environment is seen as fair or not from perspectives other than our own, takes us to our second point.

**Respect**

The principle that other people matter and are worth listening to – whatever the status of the speaker or the listener – is a second key attribute of a resilient culture. Employees will not share learning, ideas or (even more importantly) mistakes, or ask questions or challenge something they are not comfortable with, if they think no-one is listening; nor will they do so if they think that the listener will, as a consequence, make them feel small, or even worse. If diversity is about the breadth of knowledge and experience available to the firm, inclusion determines how far this knowledge and experience is actually utilised; the wisdom of crowds only works when everyone has an independent view that they want to express and feel safe to do so. Speaking out or going against the norm is always a challenge and creating an environment of psychological safety can be as difficult in a small, family-like organisation as in a large and complex one.

The extent to which people feel included, listened to and respected can vary considerably not only between organisations but within them. People in under-represented groups may face particular challenges, as our Survey findings illustrate.

- In 2020 we asked employees across the UK banking sector whether they felt accepted at work and able to be themselves at work.
  - 91% of respondents who identified as White British answered yes to both questions. This fell to 84% among respondents identifying as being of mixed/multiple ethnicity, 83% among those identifying as Asian/Asian British, and 78% of Black/Black British respondents.
  - 90% of respondents who said that they did not have a disability\(^3\) felt both accepted and able to be themselves. Among those who said that they did have a disability, this fell to 77%.

- As in 2019, employees who identified as White British answered most of our Survey questions more positively than those who identified as being of any other ethnicity. The largest differences came on questions relating to ethical behaviour and speaking up.
  - 9% of White British employees said that it was difficult to make progress in their firm without flexing their ethical standards, compared with 23% of Black/Black British or Asian/Asian British respondents.

- Employees identifying as Black/Black British or Asian/Asian British were more likely than White British respondents to be worried about the negative
consequences of speaking up, and less likely to feel comfortable about challenging a decision made by their manager.

- Employees with a disability answered our core Survey questions more negatively than those without. This characteristic had a greater explanatory effect in several questions than any other demographic factor we collected. The gap was particularly marked on questions relating to personal resilience.

- 36% of employees without a disability said that they often felt under excessive pressure at work. This compared with 54% of employees who said that they did have a disability.

15% of respondents without a disability said that work had a negative impact on their health and wellbeing. Among employees with a disability, this proportion was two and a half times higher, at 39%.

Research suggests that a sense of not being listened to is also associated with higher staff turnover and exhaustion. Our own FSCB Survey finds a close correlation between questions about being treated with respect, and those relating to both wellbeing and speaking up.

The much greater use now of video calls into people’s homes has opened up new channels of communication, especially in terms of senior leaders engaging directly with staff. It can, however, make some aspects of listening harder; in particular, picking up non-verbal cues or having unscheduled conversations. Creating new informal channels of communication, ensuring that line managers have the skills and confidence to ask questions and to listen in a very different working environment, leading by example when it comes to asking questions, admitting mistakes and accepting challenge, becomes all the more important in an on-screen world – and even more so, going back to our first point, when some people may be in the office and others not. And as ever, what matters is not only doing something, but being seen to keep on doing it; which brings us on to our third point.

**Consistency**

What leaders and managers do matters more for the culture of the organisation than what they say. The behaviour of those in positions of influence needs to be consistent with the firm’s values if the latter are to mean anything. From a resilience perspective, however, consistency matters not only in terms of what is said and what is done, but also in what is said and done from day to day.

Unpredictable genius can achieve great things. Most of us, however, are not geniuses, and unpredictability on the part of a leader or manager comes at a cost to those around them. When the mood or response of someone with authority cannot be anticipated on a day to day, or even hourly, basis, time is spent trying to guess what they might want, interpreting their words and actions (however unintentional), avoiding risk and responsibility, hiding mistakes, building alliances, preparing for multiple scenarios and generally worrying rather than being productive, innovative and collaborative. Leaders can be geniuses! But for a genius organisation that learns, adapts and continuously improves, they need also to be consistent, reliable and predictable in their values and behaviour – especially at a time when every other aspect of their employees’ lives may feel particularly uncertain and unpredictable.

Navigating the past year has, for many organisations, been like learning to walk in a different way; putting the weight on different muscles, continuously rebalancing in response to external and internal information, and trying to stay upright while retaining a sense of direction and momentum. The pace may sometimes have been erratic, but many firms have also surprised themselves at how fast in places they have been able to run. This is, however, a marathon.
rather than a sprint. Sustainable performance requires resilience, and organisational resilience demands a culture in which fairness and respect are consistently displayed by those in positions of influence. Building and maintaining a good organisational culture is a core responsibility of boards and leadership teams, and one that they owe to their customers, clients, investors, stakeholders and employees. It is also a challenge. And in 2021, it is also an opportunity.

**Alison Cottrell** is the founding CEO of the Financial Services Culture Board (FSCB), a non-statutory membership body established in April 2015 to help raise standards of behaviour and competence across the sector – initially within banking, and now across financial services more widely. The FSCB provides the boards and senior teams of member firms with evidence, support and challenge to help them manage the culture of their organisations and identify and learn from good practice. Alison began her career in the City of London as an economist covering fixed income and currency markets. Prior to taking up her current post she was Director of Financial Services at HM Treasury with responsibility for a wide range of policy areas, and combined this role for a period with that of Director of Corporate Services, focusing on staff development, engagement and culture.

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3 Defined in this context as both (a) having a physical or mental health condition or illness that has lasted or is expected to last for at least twelve months, and that (b) affects daily activities.
The European Central Bank (ECB) President Christine Lagarde has broadened the focus of the ECB since taking the helm, and has pushed into social issues such as climate change and gender equality. To defend these efforts, Lagarde said, “In addition to the narrow angle from which we have historically looked at monetary policy over the course of previous decades, we need to enlarge the horizon and be courageous in tackling some of these issues, although they are not the traditional areas that monetary economists look at.”

**The European Banking Authority**

In a keynote speech at the “XVII international professional conference on good corporate governance”, Chair of the European Banking Authority (EBA) Jose Manuel Campa said, “As you know, good governance is fundamental for good outcomes. Therefore, good governance should always be a priority for regulators and supervisors. Good governance has to set the culture and manner in which institutions operate.”

Since 2016, the EBA has included conduct risk metrics in its biennial stress tests, albeit in a high-level, outcomes-based approach, measured in costs of litigation. In its latest tests (2018), the EBA’s data shows that banks had estimated their conduct risks to represent €35 billion in an adverse scenario. The EBA projected an estimated €69 billion at minimum. “The result of the bank’s parallel test will by definition be a lower number than the supervisor’s test” suggests Clifford Chance regulatory partner Simon Gleeson, due to the framing of the exercise.

The EBA announced its methodology for the 2021 stress test in November 2020. The exercise began in January, and the results are due to be published in June. The stress test focuses both on financial and non-financial risk. The EBA will project the losses due to conduct risk, much as it did in 2018, requiring that banks report on past losses due to conduct or operational risk, and that they project future losses due to these risks.

In November 2020, the organization published a discussion paper on incorporating ESG into risk management, governance, and supervision. In the announcement, the EBA wrote:

*The EBA sees the need for enhancing the incorporation of ESG risks into institutions’ business strategies and processes and proportionately incorporating them into their internal governance arrangements. This could be done by evaluating the long-term resilience of institutions’ business models, setting ESG risk-related objectives, engaging with customers and considering the development of sustainable products. Adjusting the business strategy of an institution to incorporate ESG risks as drivers of prudential risks should be considered as a progressive risk management tool to mitigate the potential impact of ESG risks.*

In March 2021, the EBA launched public consultation on draft technical standards for ESG disclosures. The draft proposes quantitative disclosures of climate change risks and disclosures on mitigating actions with counterparties. It also includes qualitative information on embedding ESG considerations in everyday life at a firm: in governance, risk management, strategies, and business models.

The organization has also called upon the European Commission to develop a standard framework for AML/CFT across the EU.
Germany

THE WIRECARD STORY

In a February 2020 speech at the German Symposium at the London School of Economics, Felix Hufeld, former President of Germany’s Federal Financial Supervisory Authority (BaFin), argued that, in order to avoid the next crisis, regulators and supervisors must:

• increase the resilience of the [financial] system altogether – that is precisely what regulators are doing
• vigorously apply close and strict supervision – this relates to our own task as supervisors
• stay on guard, listen very carefully to early warning indicators, and don’t accept when people tell you that everything is fine [italics added]
• and finally, don’t listen to industry calls for deregulation - particularly, if they try to make it sound more agreeable and more moderate by giving it a name other than deregulation.

However, it seems that BaFin may itself have failed to apply the “close and strict supervision” for which Hufeld had called. And it almost certainly ignored numerous “early warning indicators” when it comes to the now defunct fintech firm Wirecard.

BACKGROUND

Wirecard was founded in 1999 as a payment processing company. The company had 323 employees in 2005, and the lion’s share of its business came from payment processing for online gambling and pornography. By 2018, however, Wirecard was the largest financial technology company in Europe.

The company’s runaway growth seemed, at first blush, to have resulted both from substantial acquisitions and the advanced technology it brought to market, as compared with competitors. With about 5,000 employees, the company claimed to process payments for some 250,000 merchants worldwide. Then, on June 18, 2020, Wirecard reported that €1.9 billion in cash on its books was somehow “missing.”

How did this happen? ▶ P. 145

IGNORING EARLY WARNINGS

For years, notices, tips, and articles accusing Wirecard of mismanagement had swirled. For instance, as far back as 2008, two men were prosecuted for publishing attacks on Wirecard alleging balance sheet inconsistencies. Several years later, short-seller Zatarra Research & Investigations raised questions about anti-money laundering practices at the fintech company.

But while the stories kept coming, most of these reports were dismissed as being driven by self-interested parties hoping to manipulate the market. In September 2018, Wirecard replaced Commerzbank in Germany’s DAX30 index of the country’s most valuable publicly-traded companies. Wirecard was closely followed by both wholesale and retail investors, and investment analysis were overwhelmingly bullish on its business model up to the point of its collapse.

In January 2019, the Financial Times reported that a Wirecard executive was under investigation for forging documents. Several weeks later, Wirecard’s Singapore offices were raided by police, after a Financial Times report alleged forgery and accounting irregularities.

According to short-seller David Einhorn, “There were many voices yelling ‘Fraud!’ at the top of their lungs... Rather than investigate the fraud allegations, the auditors continued signing the annual financial statements. The German authorities launched a criminal investigation into the relationship between short sellers and the press and, for a time, they restricted short selling of the stock.”
James Freis joined Wirecard on June 18, 2020 as member of the Management Board to help professionalize the company and oversee its regulated entities. While he was supposed to start on July 1, he was called in early. Freis quickly determined that Wirecard was embroiled in a massive internal fraud. And, within a day, after reporting the situation to Wirecard’s Chairman and Supervisory Board, he was appointed CEO. Though, Freis isn’t sure why no one noticed before him: “So many people could have and should have stepped up and said something.”

**REGULATORY FAILURES**

Rather than pursuing the repeated allegations against Wirecard aggressively, the response to the unfolding scandal by German regulators appears to be a mix of explicit neglect and outright hostility towards the Wirecard’s critics and accusers.

The Financial Reporting Enforcement Panel (FREP), Germany’s private sector accounting watchdog, armed with quasi-official power, told Wirecard that it did “not want” to investigate the accusations made in the short-seller report in 2016. Instead, FREP asked Wirecard to prove that the allegations were unfounded.

In response to these allegations, and other evidence uncovered by a parliamentary inquiry that FREP had neglected its duties in its handling of Wirecard, FREP Chair Edgar Ernst stated that the watchdog did not have the remit, nor the funds, to discover fraud. Ernst added, “Before the Wirecard scandal, I never noticed this.”

Because Wirecard was essentially a technology company supporting payment services, it was not subject to subject to licensing and consolidated financial supervision, but rather to more limited market oversight of publicly listed companies. BaFin directly supervised a small banking subsidiary, Wirecard Bank, and there were musings over the years whether the Wirecard group should have been subject to consolidated supervision as a financial holding company.

In March 2016, on the heels of the Zatarra report, BaFin submitted a memo to Germany’s finance ministry, which assigned cultural motives to the charges leveled against Wirecard. It stated, “It is striking that the suspect individuals (which besides natural persons also include Anglo-American ‘hedge funds’), all appear to share a rather homogeneous cultural background — mainly Israeli and British citizens.”

This added to the suspicions of many who felt that BaFin’s protection of Wirecard was an attempt to nurture a homegrown success story. To the regulator’s critics, it appeared that BaFin would use almost any argument to support their favorable views of Wirecard.

In the memo submitted to the Finance Ministry, BaFin alleged that reporters and short-sellers attacking Wirecard had neglected to disclose their short positions in the company’s stock, and argued that they were engaged in market manipulation.

In February 2019, as investigators were closing in on key Wirecard executives, BaFin announced plans to temporarily ban short-selling on Wirecard stock as a result of the volatility introduced by the Financial Times’ reporting. This was the first time that BaFin had ever banned short-selling on an individual stock.

Though the Bundesbank, Germany’s central bank, advised BaFin that Wirecard’s share price swings did not present any threat to financial stability, that assessment appears to have been largely ignored.

In April 2019, BaFin filed complaints against the journalists at the Financial Times who reported these irregularities, accusing them of market manipulation. The short-selling ban was supported by the European Securities and Markets Authority.
(ESMA) at the time. However, it was reported that BaFin presented facts about the short-selling prohibition to ESMA quite selectively. Specifically, BaFin had not made the organization aware of the Bundesbank’s warnings or that BaFin itself was investigating Wirecard for market manipulation at the time. Meanwhile, even as BaFin was investigating outsiders for market manipulation, BaFin staff were allowed to trade in Wirecard shares. From January to June 2020, 2.4% of BaFin staff investment activity involved Wirecard shares or derivatives.

It was reported that, even in late 2020, Wirecard had a close-knit relationship with Germany’s top law enforcement agency. Wirecard issued credit cards to Germany’s Federal Criminal Police Office (BKA) to use during criminal investigations. While it seems that Wirecard acted properly in its business with the BKA, it is an example of how firmly entrenched Wirecard was in Germany’s establishment, and how it was able to maintain its image.

There has also been fallout in other countries. While Markus Braun, Wirecard’s longtime CEO, remains in police custody but has not been charged with a crime as of yet, a Singaporean businessman responsible for looking after over $1 billion in Wirecard’s missing funds has been charged with falsifying documents.

It is also notable that the Bangko Sentral ng Pilipinas (BSP), the Philippine’s central bank, amended its operational risk guidelines to include people risk, considering Wirecard had claimed that its missing $2.1 billion was being stored in bank trustee accounts in the Philippines.

**AUDIT FAILURES**

The blame for Wirecard’s years of misrepresentation cannot be placed squarely with regulators. With respect to the primary issue of misstatement of revenue and profit reflected in the missing funds in the trustee accounts, EY, Wirecard’s auditor for a decade, failed to independently verify the information provided to them by Wirecard and third party trustees. For example, the auditor never requested account information from the Singapore bank where Wirecard claimed to have €1 billion in cash. Instead, it relied on documents and screenshots from these trustees and Wirecard. Nor did EY apparently uncover the magnitude of other fraud and irregularities that have since come to light after Wirecard’s collapse.

A special audit, conducted by KPMG, concluded that a large portion of Wirecard’s business and account balances could not be verified. KPMG also learned that EY had begun investigating suspected fraud and bribery at Wirecard in 2017. That investigation had its origins in a series of whistleblower warnings that Wirecard managers may have committed fraud. The investigation was, however, never undertaken fully and eventually fizzled into nothingness, largely thanks to Wirecard’s success in stifling the investigation.

The company continued to receive clean audit results from EY. That investigation had its origins in a series of whistleblower warnings that Wirecard managers may have committed fraud. The investigation was, however, never undertaken fully and eventually fizzled into nothingness, apparently thanks to Wirecard’s success in attempting to stifle the investigation. The company continued to receive clean audit results from EY. This matter is one of many under investigation by a parliamentary committee of inquiry established by the German Parliament in September 2020 to investigate the collapse of Wirecard.

EY is awaiting a court decision to allow their employees to report on the details of their work without breaking confidentiality agreements, since the parliamentary committee has called several high-ranking employees to testify. However protected its staff may be in revealing the details of their work, they might still be held liable for their inaction in auditing Wirecard.
After Wirecard, EY Chairman and CEO Carmine Di Sibio said that auditors should play a larger role in uncovering fraud: “Whilst the primary responsibility for the prevention and detection of fraud is with the management and supervisory boards, audits should play more of a role in the future to detect material frauds.” Other auditors, such as PwC, have pledged to step up their own efforts to detect fraud in their audits.

In December 2020, German prosecutors opened an investigation into the EY partners who had led the audit work at Wirecard. This investigation came two months after Germany’s auditor watchdog, Apas, sent a letter to the prosecutors alleging criminal behavior by EY’s auditors. The letter states that there was evidence that EY may have violated its legal obligations for reporting and due diligence.

In February 2021, in an effort to repair its reputation after its audit failures at Wirecard, EY announced that it was reorganizing its German partnership. The head of EY Germany was moved to a European role, and the German leadership was split into two roles. Commenting on the changes, EY Global Managing Partner Andy Baldwin said, “We recognised that we wanted to make some leadership changes, and that now is the right time to do them.”

A special investigator’s initial findings, filed to the German Parliament in April 2021, showed that EY had signed off on Wirecard’s 2017 audit despite key questions remaining unanswered from an EY anti-fraud team’s investigations into activities in Wirecard’s India subsidiary. The investigation also found that EY had missed multiple fraud indicators. After this report, the parliamentary inquiry committee which commissioned the probe voted to give the investigator more time with which to expand his investigation.

Bafin has defended its handling of Wirecard by saying that it did not have full jurisdiction over the fintech company, and that it only had supervisory authority with regard to Wirecard Bank, a subsidiary entity.

Those calling for BaFin to be shut down argue that the regulation model is not fit for purpose, as some financial technology companies are today larger than many banks and just as crucial to financial system stability. If such tech firms are not regulated in the same way as traditional financial firms, these critics assert, the Wirecard situation is almost bound to repeat itself.

Addressing such critics in his 2021 New Year’s Address, BaFin’s Hufeld explained how the regulator plans to avoid a repeat of the Wirecard case in the future:

> In close cooperation with the Federal Ministry of Finance, we will undertake concrete initiatives – in the area of financial reporting enforcement, for instance. As a governmental supervisory authority, BaFin’s powers in this area are to be strengthened extensively. In future, BaFin is to be granted powers to intervene faster, and competencies are to be clearly defined.

In late January 2021, Hufeld and his deputy Elisabeth Roegele were forced out at BaFin, as plans were taking shape for a wholesale reorganization of the regulatory agency.
stated he wants “a financial supervisory authority with bite” and that a reorganization of BaFin will make it “more powerful, more rigorous and more effective.”

Some have criticized Schoz’s plan, saying that it addresses the issues raised by ESMA’s report insufficiently rigorously. These critics argue that BaFin’s independence should be seen as a foremost concern.

Ignazio Angeloni, for instance, a former member of the European Central Bank’s Supervisory Board, notes that BaFin is somewhat unique among large European economies for combining both market integrity and market stability goals. Angeloni goes on to suggest this may create a conflict of interest between aggressively pursuing sanctions for misconduct while also supporting the market.

Mark Branson, Head of Switzerland’s Finma, was tapped in March 2021 to replace Hufeld as president of BaFin. Branson will be faced with the task of fundamentally overhauling the regulator to make it more powerful and effective at supervising financial institutions of all types.

As of April 2021, it seems that BaFin is facing a criminal probe into its supervision of Wirecard, especially in as far as the short selling ban it imposed in 2019 and the harm the ban to German investors.

BaFin and EY were not the only organizations to face a major overhaul in the wake of the Wirecard Scandal. Germany’s finance ministry threatened to end its relationship with FREP, which is also under fire for allowing its president, Edgar Ernst, to sit on the supervisory boards of private companies. Ernst announced in February 2021 that he would step down from FREP by the end of the year.

**AFTER WIRECARD**

Confronted by the Wirecard Scandal and the coronavirus pandemic, BaFin had an especially difficult 2020. However, the regulator did take action to improve its supervisory and regulatory capabilities in that time. In December 2020, for instance, BaFin announced its digital agenda, in partnership with the Bundesbank, aimed at improved banking supervision. In order to promote greater use of technology in the course of bank supervision, BaFin announced plans to invest in greater capabilities in their acquisition, processing, and analysis of data. BaFin also indicated that it would like to develop a dashboard which facilitated easier access to this data by firms and regulators alike, to increase analytic opportunities.

In a move initially seeming to signal that the regulator was taking its supervisory responsibilities more seriously, BaFin filed a complaint against Greensill Bank for suspected balance sheet manipulation in February 2021. The complaint relates to the interim findings of a forensic probe of Greensill’s balance sheet, conducted by KPMG. However, it has subsequently emerged that whistleblowers reported suspected fraud at Greensill bank to BaFin as early as second-quarter 2020.

Credit Suisse, the Swiss multinational investment bank, froze $10 billion in investment funds fueling Greensill after an Australian insurer decided not to renew policies covering $4.6 billion in corporate bonds backed by Greensill. Early reports arising from subsequent inquiry found that Credit Suisse executives had overruled its own internal risk managers in approving a $160 million loan to Greensill, which the bank is now unable to pay back.

Credit Suisse has since announced that it would overhaul its asset management business and withhold bonuses from some senior executives as it works to get past the Greensill scandal. Switzerland’s Financial Market Supervisory Authority (FINMA) has also opened a probe into Credit Suisse’s risk.
management processes, following the Greensill and Archegos scandals, the latter of which is discussed in the United States section herein.454

Unlike many other countries, German criminal law does not provide for corporate liability, rather German companies can only be fined under the schemes set forth in regulation. Under the draft of the new Corporate Sanctions Act (CSA), companies could be prosecuted if either one of their managers committed a criminal offense or someone else committed a criminal offense while performing duties on behalf of the company when good risk management could have prevented the actions.455

In the original draft of the bill, the CSA contained a “corporate death penalty,” which would force liquidation of the company. While this was removed, its mere presence in the original draft signals the seriousness of maintaining a social license to operate as a company, and that it can be easily revoked.456

**Netherlands**

**MISCONDUCT AND INDIVIDUAL ACCOUNTABILITY**

In 2018, leading Dutch multinational bank, ING, entered into a €775 million settlement with Dutch prosecutors after customers were found to have laundered hundreds of millions in criminally-obtained funds through ING accounts.457 At the time, no settlement was reached with the then-CEO of ING, Ralph Hamers. A month after taking over as CEO of Swiss giant UBS, in January 2020 it was announced that Hamers would face personal prosecution for the alleged risk management lapses that occurred while he was chief executive at ING.458

“The facts are serious, no settlement was reached with the director himself, nor has he taken public responsibility for his actions,” the Dutch court ruled. “The court considers it important that in a public criminal trial the standard is confirmed that directors of a bank do not go unpunished if they have actually led serious prohibited behavior.”459

This was not the only occurrence of personal accountability for executives in the past year. Dutch prosecutors also announced in January 2021 that they were considering prosecuting ABN AMRO, another Dutch Bank, board members for their short-comings in meeting their AML obligations.460

**DE NEDERLANDSCHE BANK**

At the start of 2020, De Nederlandsche Bank (DNB) announced that it would adopt a more data-driven approach and focus on opportunities to incorporate new digital technologies into its supervision work. In so doing, it will engage banks, insurers, pension funds, and payment institutions through an Innovation Forum (the “iForum”) that was launched at the end of 2019.461

In its Supervision Outlook 2020, the DNB laid out its priorities for the year ahead and described efforts to become a “smart supervisor” by automating routine tasks where possible and adopting a data-driven supervisory methodology.462

More recently, in opening statement to the Economic and Monetary Affairs Committee of the European Parliament, former DNB Executive Director of Supervision Frank Elderson said:

*The pandemic is accelerating the digital transformation in a way that is likely to reshape our economies and societies. Technological innovation in finance is a good thing. It will enable cheaper, faster and more secure services, increase competition and financial inclusion, and thereby enhance peoples’ welfare.*463
Our View
Financial Innovation and Financial Integrity: Lessons Learned from Wirecard

By JAMES H. FREIS, JR.

Financial services are essential to the functioning of the real economy and to the delivery of the benefits of innovation and increasing productivity. Be it through intermediation between savers and borrowers, facilitating payments from consumers to producers of goods and services, or in delivering the recent waves of unprecedented stimulus and relief-aid in times of crisis, we all depend upon and benefit from efficient and resilient financial services which evolve to meet market demand, including the demand for quicker and less expensive performance.

Financial services firms are highly regulated because they play this critical role. It is a privilege to be entrusted with the responsibility of handling other people’s money, and, traditionally, the financial services industry was one which commanded great public respect. This fell dramatically in recent decades, largely as a result of myriad misconduct scandals. It is widely remarked that the coronavirus pandemic gave a massive boost to already ongoing digitalization efforts across the industry. Less well recognized is that the pandemic has afforded the industry a much-needed opportunity to win an uptick in reputation and public trust.

What can and should we do to maximize this opportunity to evolve, both in terms of profitability and in the industry’s value to society? Here are a few thoughts drawn from a long career spent promoting the integrity of financial markets, as well as specific experience gained at Wirecard: a now-defunct global fintech ‘champion’ focused on the growth in digital payments. Given trends in accelerating digitalization, Wirecard might have been expected to be a key winner; instead, it collapsed in a massive fraud scandal.

The Digital Economy Challenges Traditional Notions

In the increasingly digital economy, companies and a virtual workforce are challenging traditional notions of how we govern, value and oversee enterprises incorporated locally but with global reach. Within the financial services sector, there is a trend towards disintermediation, with established incumbents striving to respond effectively to challengers that are making use of technology to offer services to consumers more directly, and at lower costs. Financial regulators, globally, are experimenting with different approaches to oversight of these market developments. Yet, even with increasing cross-border cooperation, it can be a stretch to apply the traditional framework to the digital economy, including the system of laws for the incorporation and licensing of entities.

What Wirecard had in common with many digital companies was that certain revenues and costs were not necessarily linked to a particular geography or corporate structure. It was unlike a factory, bringing in raw materials and applying capital and labor to produce goods, or a service establishment, catering
to local customers. Rather, Wirecard legitimately supported online purchases, such as tickets from global airline carriers. Or, even farther physically removed, if you purchased a software license, and clicked to pay as you wish with MasterCard, Visa, PayPal, ApplePay, Alipay, etc., in many transactions it was Wirecard that would front the money to the merchant (less a fee) and then collect funds through a chain of intermediaries running back to the end consumer.

From a cost perspective, a digital company like Wirecard has some central overhead, but also enjoys great latitude in allocating costs for software development or marketing. Thanks to COVID, a large portion of the labor costs in the digital economy associated with staff working from home or otherwise virtually. Notably, some of the largest digital firms do not expect to go back to a traditional office model any time soon, if ever.

Investors, both retail and institutional, struggle to apply historical valuation methods or metrics to a broad range of traditional and newly investable asset classes. Among these are businesses believed to have the potential to continue to grow in scale and benefit in the digital economy, which can reach valuations in the billions without yet turning a profit. This is especially true in a phase of investment that aims to support rapid growth, when trust in the entity and its leadership is at a premium.

### Wirecard: Aspire, yet Verify

Wirecard exploited the mystique of being a fintech darling to establish itself as a blue-chip company, rising to 24 billion euro in market capitalization by posing a scalable business model within the growth sector of online and digital payments. Some questioners of its income stream were rebuffed as ignorant of innovation, technology, or both, and even some of Wirecard’s largest lenders and proponents later admitted they did not fully understand its business model. The ongoing investigations into Wirecard continue to detail allegations of inflated income and revenue, as well as misappropriation of assets.

Upon the exposure of inflated purported income and the subsequent initiation of insolvency proceedings, Wirecard became known as the “German Enron.” It is the largest financial scandal in modern Germany history. Two decades ago, Enron, the American energy company, was exposed for using accounting tricks to hide debts and losses. Enron’s ensuing bankruptcy was the then largest in U.S. corporate history, and perceived audit failures led to the dissolution of Arthur Andersen and manifold reforms under the Sarbanes-Oxley Act. Wirecard has triggered similar seismic shifts.

While Wirecard had some advanced technology and talented technology developers, neither its business model nor the relevant financial exposures were overly complex – and certainly not in contrast with the structures that brought down Enron, or, a decade later, Lehman Brothers. Yet auditors and control functions, internal and external, failed to recognize or to react in a timely enough manner either to Wirecard’s implausible claims regarding revenues and assets, or to what may be described as fairly classic vehicles for fraud and self-enrichment.

We must recognize that audit firms were not designed to address many of the realities of today’s cross-border digital economy. Notwithstanding global branding, each of the “Big Four” audit and accounting firms is actually made up of a network of legally independent firms in different jurisdictions. This is by design and aims to limit the respective liability of each entity. But this implies that auditors are operating within structures far more parochial than those of many executives, investors, or even online consumers.

Market integrity demands that we may reasonably rely upon professional auditors who review quantitative financial results. But we should consider...
carefully audit mandates on more qualitative issues. This is perhaps especially true in connection with reviews of internal controls—controls which are undoubtedly necessary for a digital company and a remote workforce. We nonetheless should strive to mitigate the risks of a checklist approach that misses the forest for the trees.

From a qualitative perspective, a company’s corporate and governance structure should be aligned with its declared revenue and cost models, and consistent with its commitments to stakeholders. This includes respecting the duties of management and boards at the level of a holding company as well as its global subsidiaries.

For truly global digital companies, effective audits require teams with tailored experience specific to such a company’s governance priorities, revenue and cost models, and its stakeholder expectations, rather than today’s broader mandates aimed at higher fees based on antiquated audit sub-contracting. In the leading trend of ESG investing, “Governance” expectations for digital companies remain far more ambiguous than those for evolving “Environmental” and “Social” norms. Alignment of the foregoing structures would offer a valuable indicator of effective governance and sustainable business models.

Structures are critical, as is assessing whether they are working

Any sizable organization requires structures within which to operate efficiently. A consensus has thus evolved for the so-called Three Lines of Defense model for operational risk management, operating: (1) within business lines; (2) among dedicated risk and compliance personnel; and (3) with examination exercised by an autonomous audit function. This tripartite approach must still be adapted to the unique exposures of each organization. Structures can be assessed beginning with an organizational chart, but that provides little insight into the underlying operational realities among staff day to day – in particular how the critical components along the Three Lines are working together as a whole.

The Basel Committee defines Operational Risk as that stemming from failure at the level of systems, processes and people. Most efforts are directed at process and system. Both are more easily defined and assessed than is the people element. But it is among people, and the culture that binds them, that many performance outcomes are decided. Regardless of the role—as executive, director, employee, auditor, advisor, or regulator—formal operational structures will fail without the right people being both willing and able to challenge conventional thinking in our evolving and increasingly digital world.

There exists today a developing appreciation of culture as a driver of organizational outcomes, and many efforts are now underway to try to derive better metrics by which to assess culture and to gauge what outcomes it is most likely to promote within a given organization. But we are early in these efforts and the ability to measure the ‘human element’ behind the functioning of an enterprise and its constituent units and corporate functions is only now beginning to emerge.

Here is where diversity, inclusion and psychological safety become critical. True diversity of experience is proven over and over again to contribute to innovative organizations and successful performance outcomes. Wirecard had had its share of skeptics, a few whistleblower incidents, and a number
of vocal critics, yet the consensus view continued to support its story of sensational growth in revenue and profits. The most notable lesson here on the topic of culture is the failure of individuals to speak up and challenge this misleading narrative, particularly as many likely knew enough to have formed dissenting views. And— not just internally, or among those in specific auditor oversight and control roles, but also among a range of external parties, including from advisors and counterparts whose work with Wirecard lent it unwarranted legitimacy.

Innovative application of technology will continue to drive evolution in the financial services industry, but one positive differentiator remains a constant – trust in the integrity of your counterpart and its leadership.

James H. Freis, Jr. is the Founder of Market Integrity Solutions LLC and former Director of FinCEN. He unveiled the internal fraud at Wirecard and served as its last CEO.

Ireland

CENTRAL BANK OF IRELAND

In a February 2021 speech at the Institute of Directors, Central Bank of Ireland (CBI) Deputy Governor Ed Sibley said, “Our priorities are informed by our overarching aim for the financial system to be resilient and trustworthy, for it to sustainably serve the needs of the economy and its customers, and for firms and individuals within the system to adhere to a culture of fairness and high standards.”

Sibley went on to explain that the CBI intends to improve governance, risk management, and culture in the firms it oversees. The central bank plans to do this by implementing:

- Conduct Standards which will set out the behaviour the Central Bank expects of regulated financial services providers (RFSPs) and the individuals working within them;
- A Senior Executive Accountability Regime (SEAR) which will ensure clearer accountability by placing obligations on firms and senior individuals within them to set out clearly where responsibility and decision-making lies for their business;
- Enhancements to the current F&P Regime to strengthen the onus on firms to proactively assess individuals in controlled functions on an ongoing basis, and to surmount some current limitations of the F&P Regime; and
- A unified enforcement process, which would apply to all contraventions by firms or individuals of financial services legislation.

In its 2019-2021 Strategic Plan, the CBI states that it would like to be “One Bank: Trusted by the Public, Respected by our Peers, and a Fulfilling Workplace for our People.” In order to achieve this vision, the central bank identified five strategic themes “critical to the successful delivery of [its] mandate,” including engaging and influencing, and enhancing organizational capabilities.

ENFORCEMENT ACTIONS

In March this year, the CBI fined wealth management firm J&E Davy €4.130 million after an investigation into a 2014 transaction involving 16 employees, including senior management, who had engaged in a private transaction with a Davy client for personal gain. According to the CBI, Davy had misrepresented
the seriousness of the misconduct in response to the regulator’s inquiries. The investigation found that Davy had severe deficiencies in its conflicts of interest management, personal dealing framework, and its compliance department’s ability to monitor and intervene in such deals. Days later, after Minister for Finance Paschal Donohoe called for Davy to address the outcome of the investigation, Davy’s CEO, Head of Bonds, and a non-executive director resigned. In response to the CBI’s findings, Ireland’s National Treasury Management Agency (NTMA) rescinded Davy’s mandate as a primary dealer of government bonds, forcing the firm to close its bond desk. Primary dealers are required to make markets for government bonds, and are given opportunities to win mandates on large, government-syndicated debt deals. In the announcement of this action, the NTMA wrote that its primary concern is “to maintain the reputation of Ireland as a sovereign issuer in the bond market and the orderly functioning of the market for Irish government debt.”

Davy, Ireland’s largest stockbroker, began a search for a new owner after the misconduct scandal. CBI Deputy Governor Rowland Derville told Oireachtas Committee on that Ireland needs a stronger regulatory framework to hold individuals accountable for breaches in the wake of the governance failings at J&E Davy. The deputy governor also announced that the CBI had concluded 141 enforcement actions, with fines totalling more than €128 million.

Of the Davy scandal, one critic commented:

“The inability of the banking sector to self-regulate is something many would wish was not a reality. If the sector could self-regulate, it would have a degree of autonomy to maximise the return for its shareholders without breaking the law or breaching public trust. It could remain a viable business entity and benefit from increased levels of public and regulatory trust. Society would even likely benefit by way of jobs and investment in the local community.

Instead, we appear to be stuck in a financial sector equivalent of Groundhog Day. This is a sector that is no stranger to breaches of public trust, reputational damage and reprimands. One would be forgiven for thinking only somebody with nothing to lose would engage in behaviour likely to draw the attention of regulators.”

In March 2021, the central bank levied its largest ever banking fine—€37.7 million—after its investigation found that Ulster Bank Ireland DAC breached its regulatory obligations toward its customers with tracker mortgages, a type of variable-rate mortgage. CBI Director of Enforcement and Anti-Money Laundering Seána Cunningham wrote, “The Central Bank will intervene where firms seek to evade their obligations to consumers. Where firms cause serious harm to their customers, in circumstances where there were repeated opportunities available but not taken to rectify and remedy this harm, this requires an appropriate and deterrent sanction.”

INDIVIDUAL ACCOUNTABILITY

The CBI’s proposed Senior Executive Accountability Regime (SEAR) is modeled on the UK’s Senior Managers and Certification Regime and includes an enhanced ‘Fitness and Probity Regime’ for relevant individuals. The SEAR seems to have been put on hold to deal with the coronavirus pandemic, but the CBI has renewed its focus on bringing this regime into effect, partially fueled by the Davy controversy.

In her related statement to the legislative committee, Deputy Governor Rowland argued that public sanctions and enforcement actions are important in deterring misconduct in the financial sector as a whole. Rowland also stated that an individual accountability framework would serve as an effective tool to improving culture at financial institutions:
We regard the Individual Accountability Framework, including the introduction of conduct standards for individuals and the Senior Executive Accountability Regime (SEAR), as necessary enhancements to our supervisory and enforcement toolkit to support effective culture in regulated firms.  

In April 2019 the CBI published a “Dear CEO” letter which addresses firms’ obligations under the Fitness and Probity Regime, noting a lack of general awareness of such among firms. The letter states that the CBI expects CEOs and boards of firms to explain how issues documented in the letter have been considered, and to demonstrate steps taken to address shortcomings.

The F&P regime requires that firms ensure that their staff are fit and proper. It also sets out an approval process through the CBI for senior management, and empowers the CBI to remove employees who do not meet the fitness and probity standards.

Another “Dear CEO” letter was released by the CBI in November 2020. In this letter, the CBI reported on its review of firms’ compliance with the standards set forth with the F&P Regime. The Central Bank expects all firms to ensure their compliance with these guidelines. In the CBI’s continued engagement with firms on their implementation of these standards, it will carry out supervisory action if weaknesses are identified.

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The CBI’s Ed Sibley said, “The F&P Regime is a cornerstone of the regulatory framework in Ireland. The Central Bank will not authorise firms, and will not approve persons to perform senior functions in regulated firms, where they do not meet our Fitness and Probity Standards.”

Under the current Administrative Sanctions Procedure, in order to fine individuals for misconduct, the CBI must clear a “participation hurdle” which requires that it prove that specific acts of wrongdoing on the part of a firm in fact took place, and prove that specific individuals were seen to be participating actively in the alleged wrongdoing. Under this requirement, there have been relatively few enforcement actions against individuals to date.

However, under SEAR provisions, the CBI can bring action against an individual without having to link their misconduct to the behavior of their firm. It is also anticipated that SEAR will impose rules on the conduct of all staff in firms, and create stricter rules for senior individuals due to their influence over the firm’s culture.

In her speech to the Banking & Payments Federation of Ireland (BPFI) Membership Forum, Deputy Governor Rowland said of the CBI’s plans for future enforcement action, “Looking ahead, we will continue to prioritise enforcement action where we see serious instances of consumer or investor harm arising from the behaviour or failings of firms and individuals.”

The IBCB was established in 2019 with funding from the ‘Big Five’ Irish retail banks, with the aim of rebuilding trust in the sector through the transformation of culture and behavior. For Justice John Hedigan, Chair of the IBCB and former judge at the European Court of Human Rights, after a decade of crisis and scandal that has led to a great loss of public trust in the Irish banking sector, “this is no time for business as usual.”

Discussed extensively in last year’s edition of our annual study, the IBCB released its first annual report in October 2020, outlining its activities focused on bank customers and employees. The report presents the IBCB’s research on the trust that bank customers and employees have in the institutions, and lists three themes for how banks can improve the trust of each group. Those include speaking up, ethics and behavior, and staff pressure and resilience.
In his keynote speech at the 21st International Conference of Banking Supervisors, Pablo Hernández de Cos, Governor of the Bank of Spain, explained the risks of the increasing digitization of finance. He addressed cybersecurity, reliance on third-party providers, and what the challenges of digitization mean for regulators and supervisors. Governor de Cos remarked:

_The implications of these developments for supervisors are threefold._

_First, proactive supervision must be the primary response to these changes, as the traditional regulatory framework may not be sufficient._

_Second, greater consideration should be given to the regulatory perimeter to ensure that the oft-cited mantra of ‘same activities, same risks, same rules’ is actually operationalised._

_And third, cooperation among different authorities – spanning both monetary and regulatory authorities – will be even more important, given the cross-sectoral and cross-cutting nature of the policy issues raised by these technological innovations._

Spain’s Council of Ministers approved a draft bill, in March 2020, for the creation of a regulatory sandbox that would allow financial institutions and fintech companies to trial new solutions without risk of violating regulations. This bill was approved in November 2020, creating a space for the implementation of innovative technology projects in the financial services sector. In order to be approved, technology projects must contribute to innovation, be advanced enough to be tested, and aid financial services firms in regulatory compliance or improving client outcomes.

The Bank of Spain has been relatively silent on culture and conduct reforms, however, it is often the case that regulators have private meetings with firms encouraging reforms.

It is notable, however, that Banco Santander, Spain’s largest bank, has led the way in acknowledging the importance of sound bank culture. BBVA, Spain’s second largest player in the sector, has also emphasized the value of corporate culture in recent publications.

Santander released its “Culture Report 2019” in July 2020. This report defines the culture it looks to cultivate, and outlines the methods it uses to cultivate this culture on a global scale. In order to maintain the culture that the bank has worked hard to create, Santander has built a comprehensive culture governance regime. This regime is made up of a Responsible Banking, Sustainability & Culture Committee to assist the board of directors and two steering groups to measure culture embeddedness and to ensure progress toward core inclusivity objectives.

BBVA Head of Culture and Employee Communication Enrique González argued that, when digitalizing the bank’s operations, it was equally important to reform the organization’s culture: “BBVA spearheaded the digital transformation process that has taken over the sector. A change this great must be complemented by an accompanying cultural transformation. Building a culture that is aligned to the type of company you want to be.” Much like Banco Santander, BBVA’s status as a global financial institution posed a great challenge when it came to instituting one shared purpose. While the work had the support of senior management, as González states, that is not enough: “With more than 100,000 employees and a
footprint that spans more than 30 countries — it is essential to embed these values and behaviors into our processes.”

Spain was not without its own instances of banking misconduct in 2020. Four employees of the Chinese state-owned ICBC were fined and sentenced to jail in July 2020 for their involvement in money-laundering operations on behalf of Asian criminal organizations. The bankers, including two senior executives, were fined $22.5 million for helping to move more than $150 million for multiple such organizations through its Madrid subsidiary.

**France**

**BANK OF FRANCE**

The Bank of France has been relatively silent on the topic of culture and conduct risk. And while they have also been fairly quiet on the topic of regtech and suptech, in a fintech conference speech in October 2020, Deputy Governor of the Banque de France Denis Beau remarked, “As a central banker and supervisor in charge of ensuring monetary and financial stability, I feel it is important to support this fintech ecosystem and facilitate its smooth integration into the broader financial ecosystem.”

Deputy Governor Beau, who also serves as Chairman of the French Prudential Supervision and Resolution Authority (ACPR), explained that, to facilitate this ecosystem’s growth, the Banque de France and ACPR plan to do two things: first, they must serve as “useful players” in the ecosystem; and second, they must create a regulatory framework and supervisory practices that cultivate both innovation and stability in the financial system as a whole.

**FINANCIAL MARKETS REGULATOR**

In a report titled “Provision of non-financial data: mapping of stakeholders, products and services,” released in December 2020, the AMF’s Anne Demartini writes, “Over the past decade, the development of sustainable finance, combined with the increase in regulatory texts on non-financial reporting and transparency, has contributed to a sharp increase in demand for non-financial data.”

In an accompanying position paper published with the Netherlands Authority for the Financial Markets (AFM), the regulatory authorities advocate for EU-wide standards for ESG data providers. The report suggests various transparency requirements, ensuring that data providers are more transparent on the methodology and context of their data usage. The regulators also encourage organizational and operational requirements, such as internal governance improvements and requirements to identify and manage conflicts of interest.

During his remarks at the ACPR-AMF Forum Fintech in October 2020, Chairman Ophèle said, “The Autorité des Marchés Financiers has for many years endeavoured to foster innovations, while managing the new risks that they pose.” Ophèle supported the European Commission’s proposal for a “pilot regime” to provide certain exemptions to institutions implementing new technologies. While regulators cannot be too lax, Ophèle continued, they must also open this exemption to all types of market participants and remain “cautious and humble” in the face of innovation.

**INDUSTRY LEADERSHIP**

France’s largest banks have taken the lead on acknowledging the importance of sound bank culture and its role as a driver of conduct. Société Générale (SocGen), the country’s third-largest bank by assets, is one such. Lorenzo Bini Smaghi, SocGen Chairman
A sound organisational culture strengthens alignment of attitudes and behaviours within an organisation to positive corporate values. It ensures consistency and quality in how financial institutions execute their policies and processes, and how they make decisions on a daily basis at all levels within the organisation. Examining organisational culture has thus been an increasing focus for a number of financial regulators, to minimise misconduct and internal control failures at financial institutions.

MAS closely partners with the industry to elevate culture and conduct standards in our financial institutions. The Association of Banks in Singapore Culture and Conduct Steering Group (ABS CCSG) and the Insurance Culture and Conduct Steering Committee (ICCSC)1,2, both established in 2019 and chaired by banks and insurers respectively, are two industry working groups at the heart of such partnerships.

In April 2020, the ABS CCSG commissioned the Banking Trust Index for Singapore – the first standardised measure of public trust for banks in Singapore. The first reading of this Index, published in March 2021, showed a high level of public trust in our banks. It also highlighted opportunities for banks to further strengthen public trust. For example, by making greater societal impact beyond providing banking services, such as giving back to the communities in which the bank operates. Through annual measurements according to this Index, banks hope to track progress in our collective effort towards building good culture, conduct and consequently public trust, and to promptly address any issues identified.

Specifically, we:

- **Promote and cultivate** a culture of trust and ethics in the financial industry through the promulgation of good practices and active collaboration with industry;
- **Monitor and assess** culture and conduct within financial institutions, focusing on both “hardware” (frameworks, policies, and procedures) and “software” (tone-from-the-top, leadership, and attitudes); and
- **Enforce and deter** lapses in risk management, misconduct, regulatory breaches, or offences through supervisory or enforcement actions.

**BUILDING MOMENTUM BY PARTNERING INDUSTRY PLAYERS**

MAS adopts a three-pronged approach in supervising organisational culture, recognising that good culture is driven by both internal leadership and self-discipline among staff within financial institutions, as well as by effective supervisory efforts by the regulator.
The ABS CCSG and ICCSC have lined up a series of initiatives for 2021. The ABS CCSG will publish an industry guide on metrics and indicators that banks can adopt to monitor and measure their culture and potential conduct risks, and to assess the effectiveness of their existing controls. It also plans to organise industry roundtables to raise awareness on how ethical dilemmas should be managed – for instance, where a staff’s desire to achieve performance targets could conflict with his or her duty to act in the customers’ best interests.

The ICCSC will focus largely on initiatives to strengthen the tone-from-the-top within insurance intermediaries and to align values between intermediaries and insurers, so as to promote fair dealing and good sales practices. To this end, it plans to issue best practice guidance to help intermediaries enhance corporate governance, hiring practices, and ultimately their culture and conduct standards.

Both the ABS CCSG and the ICCSC will also rally swift and effective adoption of MAS issued guidelines and information papers. This includes a recent information paper, published in 2020, on the culture and conduct outcomes and good practices that financial institutions should cultivate in specific areas such as governance, hiring, communication channels and performance management.

A common criticism of conduct supervision is that it tends to be reactive, as disciplinary actions are taken ex-post, when the misconduct has already been committed. We hope to make conduct supervision more pre-emptive, by using machine learning technology for analysis of larger and multiple datasets.

Our on-site inspections for the latter areas typically involve in-depth conversations with a large number of employees across all levels of seniority and across the three lines of defence. Qualitative data from these conversations are analysed to distil insights on organisational values and shared norms, as well as areas of potential concern. The work is resource-intensive, but it brings a level of understanding that we would otherwise not have gained. Common themes and patterns emerging from these conversations are shared with senior management for reflection and action – a common one being how organisational values, even though regularly communicated by senior management, are not translating into desired behaviours on a day-to-day basis. These insights have been well-received by the senior management and boards that we have engaged.

Our approach to off-site supervision is also increasingly data-driven. We collect, aggregate, and analyse information such as complaints statistics, whistle-blowing cases and breaches of risk limits to gather insights on culture and conduct within financial institutions. These insights in turn determine the areas where deeper dives through on-site inspections could be conducted to uncover potential culture issues.

In the next phase of work, we are looking to further strengthen our approach to culture and conduct supervision in the following ways:

STRENGTHENING SUPERVISORY APPROACH AND BUILDING CAPACITY

Today, MAS has well-established methodologies and capabilities to assess traditional risk areas such as financial, operational and money laundering risks of our regulated entities. In contrast, our supervisory approach for the less tangible areas such as tone-from-the-top, leadership, attitudes and behaviour are more nascent and still evolving.
• **Develop a framework to assess financial institutions’ organisational culture in a structured and consistent manner.** The framework and supporting methodology will leverage behavioural science and organisational psychology concepts and techniques, accompanied by an intervention framework to guide supervisory actions in addressing cultural risks in a financial institution.

• **Deepen expertise in the area of culture supervision.** Our supervisors, while attuned to analysing financial data, are extending their capabilities to collect and analyse non-financial and qualitative data relevant to the culture of financial institutions. This requires learning and application of new knowledge areas – for example, an understanding of how heuristics and biases could lead to excessive optimism and risk-taking when making decisions. MAS has set up a behavioural science unit to help supervisors better understand how culture and conduct issues affect financial institutions.

• **Monitor emerging culture and conduct risks.** We are monitoring risks arising from financial institutions’ digitalisation efforts which have accelerated in the current COVID-19 environment. One risk to watch out for is the potential for financial institutions to embed subconscious nudges within their digital platforms to unduly pressure customers into taking up products and services. For example, time limits to complete transactions could increase the risk of hasty financial decisions. We do not think this is prevalent now, but nonetheless bears close monitoring, amongst other potential risk areas.

**LEVERAGING TECHNOLOGY FOR MORE EFFECTIVE SUPERVISION**

In recent years, regulators have been turning to newer techniques for culture and conduct supervision. Advancements in data science and technologies such as artificial intelligence are fundamentally changing the type of data that supervisors can efficiently collect and analyse, opening up possibilities for fresh data-driven insights on the culture of financial institutions.

Recognising the immense potential that technology offers, MAS coined the term “SupTech” in 2017, and has since gone on to expand our capabilities to harness technology for more effective supervision, including in the area of culture and conduct supervision. Some examples are as follows.

• **Dashboarding and Visualisation** - At the most basic level, MAS monitors a broad range of data and metrics, including complaints received by MAS and financial institutions, misconduct cases, financial disputes, and product revenues, among others. Dashboarding and visualisation tools allow us to quickly identify trends, outliers, as well as specific issues of concern from these voluminous datasets.

• **Natural Language Processing** - To analyse the misconduct reports that MAS receives from financial institutions each year, MAS uses a combination of Natural Language Processing (NLP) techniques such as topic modelling, sentiment analysis, and regular expressions to tease out various misconduct modus operandi, and monitor these for spikes and trends of concern.

• **Automatic Speech Recognition** - MAS is also exploring the use of Automatic Speech Recognition technology to automatically transcribe the interviews and conversations we have with financial institutions’ staff, then running these through NLP and machine learning models for topic classification and other analyses. This will significantly improve the efficiency of our inspection work that places heavy reliance on interviews with staff of financial institutions and help us to identify more quickly common themes and patterns that may be indicative of cultural issues.
A common criticism of conduct supervision is that it tends to be reactive, as disciplinary actions are taken ex-post, when the misconduct has already been committed. We hope to make conduct supervision more pre-emptive, by using machine learning technology for analysis of larger and multiple datasets:

- Drawing upon supervisors’ instincts and inputs for predictive factors such as the working experience and misconduct history of the representative, MAS tested different factors and developed a simple multi-factor logistic regression model to score the likelihood that a representative (who sells and provides advice on investment products) would commit a misconduct over a specified period of time. The scores are used by supervisors to identify higher risk transactions or samples for scrutiny.

- For market manipulation cases, MAS often seeks the views of appointed experts in the industry to obtain a specialist assessment of the trading behaviour of the suspects. However, it can take time for the expert to complete the analysis and provide an opinion. Developed in-house in 2018, Project Apollo is an Augmented Intelligence system that can perform automated trade analysis and assess the likelihood that certain types of market manipulation have occurred. It is used, alongside other analytical and investigative tools, in the prioritisation of inquiries and investigations as well as internal case assessment.

These machine learning models offer supervisors useful insights, but the human is still required to be “in the loop” for the final assessments and decision-making. For instance, in the case of the misconduct predictive model, the supervisor will review the scores and make a decision on which samples to choose for review. The decision is not left to the machine. Similarly, for Project Apollo, investigators use the output to guide their decision-making as they build their case, before eventually pairing it as a complement to the report from a human expert.

**CONCLUSION**

While we have progressed in our culture and conduct supervision, much more work lies before us for all involved. The regulatory community can benefit from working closely together to share good ideas and sharpen our approaches. The industry must also own this journey because rules and regulations can only go so far in influencing behaviour, and it is the day-to-day decisions at the financial institution that determine the final outcomes in risk-taking and how consumers are treated. In this regard, I am heartened that the financial institutions in Singapore have been proactive in drawing up and promulgating best practices in this area.

The ultimate goal is clear – a financial sector where sound organisational culture drives prudent risk management and excellent customer service. Strengthening this will remain a priority in our supervisory agenda.

Ms Ho Hern Shin is the Deputy Managing Director in charge of Financial Supervision at the Monetary Authority of Singapore (MAS, where she oversees the Banking & Insurance, Capital Markets, and the Policy, Payments & Financial Crime Groups. Prior to this, she was Assistant Managing Director for the Banking & Insurance Group and, earlier, served in functions across MAS including policy formulation and supervision of anti-money laundering, technology, cybersecurity, and environmental risks within the financial sector, as well as serving as head of HR and Organisational Development for some years.
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of the Board of Directors, said, “My colleagues on the Board and I pay especially close attention to the subject of Culture and Conduct. It is strategically important to safeguard the Group’s image and ensure that each member of staff, at every level of the organisation, acts with integrity on a day-to-day basis in the interest of our clients, stakeholders and shareholders.”

French banks have also led the way on diversity and inclusion. BNP Paribas, France’s largest bank, has been clear on the importance of diversity. It has also emphasized that diversity programs will not produce the desired results without an equal focus on inclusion.

Singapore

REGULATORY BACKGROUND

In a survey conducted by advisory firm Duff & Phelps, Singapore was rated by peers as boasting the top financial sector regulatory system in Asia. It might not be surprising, then, that a survey commissioned by the Association of Banks in Singapore (ABS) found that more than 60 percent of respondents (consumers) reported high trust in Singapore’s banking system.

This number comes from the “Banking Trust Index for Singapore” (BTIS), a survey the ABS commissioned in 2020. In contrast to many of the countries discussed herein, government and banks are shown by the BTIS to be the most trusted institutions in Singapore.

As the various contributors to this report make clear, the conduct of firms is a key contributor to consumer trust in banks, and as the Monetary Authority of Singapore (MAS) has emphasized, to firm culture. As such, it is no surprise that regulators and industry associations in Singapore have been insistent regarding the importance of sound bank culture in recent years.

In 2019, for example, MAS and the ABS formed a Culture and Conduct Steering Group to establish a coordinated and industry-wide effort to promote better culture and conduct among banks across the city-state.

The Culture and Conduct Steering Group (CCSG) is currently chaired by Shee Tse Koon, Country Head of DBS Bank in Singapore, who stated that, despite there being no known significant misconduct in the Singapore banking industry, it is important for the industry to be “proactive in ensuring ongoing customer confidence in our financial ecosystem.”

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Reflecting these new priorities for the industry, OCBC in March 2019 became the first Singapore bank to set up an ethics and conduct committee at the board level. The committee aims to ensure that OCBC’s business practices are aligned with the group’s core values. Chaired by the group’s chief executive, the committee will implement initiatives to enhance existing policies and programs on ethics and conduct, as well as roll out new ones to ensure these core values are always embedded in the DNA of each and every OCBC Group employee.

These efforts to cultivate and maintain a sound culture have become even more important in the past year. In remarks offered to Starling for inclusion herein, MAS Managing Director Ravi Menon explained the culture and conduct implications of the Work-From-Home model in financial institutions:

The shift towards remote working triggered by the COVID-19 pandemic has fundamentally changed the way people work. Many financial institutions will gradually transit to hybrid working arrangements, combining working from home and from the office. This has potentially significant implications for culture and conduct. Financial institutions must not ignore how changes to work processes, greater digitalisation, and less frequent face-to-face interactions might affect trust, identity, resilience, connectedness, and risk governance – both positively and negatively.

MAS and the ABS have published a paper to raise awareness and share good practices on managing new risks and harnessing new opportunities arising from emerging work arrangements. We will continue to step up culture and conduct supervision, especially leveraging technology to sharpen our insights and enhance our effectiveness.

In the paper Menon referenced, MAS and the ABS laid out possible risks which could arise from the remote working environment adopted by banks in response to the coronavirus pandemic. The paper identified operational, cybersecurity, misconduct, and legal as the four key areas where financial institutions should be proactive in mitigating the risks presented by the “new normal.”

It is clearly more difficult to manage risks effectively and to maintain effective business continuity plans in a remote working environment. The adoption of third-party collaboration tools to enable employees to work remotely has also introduced new risks. Many financial institutions have thus opted to institute new controls in an effort to bring the risk within their appetite limits in this new landscape.

Meanwhile, Singapore has been a hotspot for FinTech innovation in cross-border payments and RegTech and SupTech, as evidenced by the Singapore Center of the BIS Innovation Hub, launched in 2019.

The Singapore Centre is working on three projects:

- **Foundational Digital Infrastructures (FDI):** To create a blueprint for a next-generation global public digital infrastructure that explores how digital identity, payments and data-sharing can be open, interconnected and available across borders.

- **Platform for settling cross-border payments using multiple CBDCs:** To create an international settlement platform through which central banks would issue multiple wholesale CBDCs. Regulated banks and payment service providers would then use the platform as a common settlement infrastructure, enabling participants to purchase, exchange, transact and redeem these different CBDCs.

- **Regulatory reporting platform and data analytics utility:** To create an open-source proof-of-concept and prototype that will enable real-time data analytics using artificial intelligence and machine learning tools that supervisors can deploy to use and validate for risk assessments specific to their requirements.
In Focus
More than a measure of trust – The Banking Trust Index for Singapore

By ONG-ANG AI BOON

Trust is foundational to banking and the Banking Trust Index for Singapore was conceived as we needed to know where we stood with our customers and the community, and to find out from them what more we can do to build on that foundation.

The study was first mooted two years ago, not long after The Association of Banks in Singapore (ABS) established the Culture and Conduct Steering Group (CCSG) in May 2019, as a platform to identify culture and conduct best practices, monitor trends and collaborate with our regulator, the Monetary Authority of Singapore (MAS). The Steering Group comprises members from 14 banks in Singapore, who collectively have responsibilities in business, risk management, compliance and human resources.

Building trust among our customers is one of the key objectives of the Steering Group, and right from the outset, we recognised that a standardised means to measure public trust towards banks in Singapore would be very useful. This was especially so as the industry and the CCSG had commenced on various initiatives to promote and elevate the culture and conduct standards among banks in Singapore.

Measuring for better performance

The BTIS was thus set up as an annual barometer to gauge public perception trends over time and to understand the drivers behind trust in banks. This would, in turn, inform and guide the industry’s efforts to further progress in the area of culture and conduct. We were clear that the BTIS had to be more than just a headline score – we wanted insights into how banks could improve their culture and conduct practices, the areas to work on in order to strengthen organisational culture, promote desirable employee behaviour and mitigate misconduct.

Findings of the survey, when completed, would need to be published to demonstrate our commitment to promote sound culture and raise conduct standards among banks in Singapore, and consequently help instil confidence among our customers when interacting with banks.

With these goals in mind, we commissioned Edelman Data and Intelligence to conduct the study, noting the company’s established methodology and long global track record for measuring trust. We also thought that Edelman’s experience in conducting trust surveys across international markets would avail better cross-jurisdictional contextualisation of the findings and offer richer insights.

In the run up to the customised quantitative survey, several preparatory steps were taken. An analysis of the media landscape was conducted to ascertain how major events and developments might influence trust perception. This was particularly important given the global pandemic and the impact on the economy. Interviews and online focus groups with
different consumer segments were also organised to gather qualitative inputs and enable deeper and more nuanced analysis of recurrent trust themes and drivers.

The survey was conducted from 4 November 2020 to 2 December 2020, and polled the views of more than 3,500 Singapore residents on more than 28 dimensions. The questionnaire was designed to allow multiple ways of analysing the perception and level of trust among the different target audiences and the different sub-segments in the banking industry.

Statistical modelling, involving factor and relative weight analyses, was then employed to surface the unconscious perceptions of trust and unearth the drivers that contributed the most to trust in the banking Industry.

**Inaugural results show strong trust in banks**

The inaugural results were published on 5 March 2021, and they showed strong public trust in banks in Singapore.

The industry achieved an Edelman Net Trust Score (ENTS) of 56, which represents a score in the upper quartile. The survey found that 63% of respondents had high trust in the banks, with 7% of the respondents having low trust (The ENTS is derived from the difference of these two percentages). The remaining 30% of the respondents were moderate in their views.

The banking sector’s trust score was bettered only by the government, and ahead of the other major institutions in Singapore: non-governmental organisations, businesses in general, and the media.

Driving the good result was banks’ ability to offer a variety of products and services, use reliable and innovative technologies, and stay financially resilient. Respondents also trusted banks to handle customers’ data with integrity, and their leadership and employees to operate with professionalism and ethics.

One notable finding from the study was that the high trust in the Singapore government and banks’ leadership contributed to the high trust towards the banking industry. This speaks much about the strength, stability and reliability of the government in Singapore, and the trust in the regulator of the banking and financial sector, that is MAS. Perhaps rather unique to Singapore is the strong, symbiotic partnership between the public and private sectors to develop Singapore as a financial centre, with good long-term objectives and pro-growth policies and regulations.
Building on trust

On top of providing a snapshot of trust levels in the banking industry, the BTIS report also identified a number of areas we could focus on to enhance public trust in banks.

The report found that customers expect more than just secure and reliable services, but a deeper relationship with banks in which there is transparency and accountability when mistakes occur, and commitment to prioritising customers’ interests. There is also an expectation for banks to serve a higher purpose, in which their business objectives include furthering societal interests.

These are important inputs for the industry and banks, as well as the ABS CCSG, and we will be acting on them. Some of the immediate areas following the BTIS that we will be focusing on include:

- Enhancing accountability in the implementation of MAS’ Guidelines on Individual Accountability and Conduct that were published last September. Embedding a strong culture of responsibility in banks starts with individual accountability on the part of senior managers and employees, supported by a robust and conducive governance framework.
- Further entrenching the prioritisation of customers’ interest through initiatives including (i) publishing an industry guide on risk metrics that banks can adopt for a culture and conduct dashboard to measure culture and identify hotspots; and (ii) organising industry sharing sessions to raise awareness and encourage greater discussion on how good judgement may be exercised in dilemma situations not covered explicitly by rules.

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**Trust is the most valuable currency for a financial institution.**

**Ravi Menon**, Managing Director, Monetary Authority of Singapore

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*Performance of the Pillar is calculated from the total responses that have picked the top 2 boxes out of a 7-point scale, in rating the performance of the Banking Industry.*
• Continue integrating environmental considerations in banks’ business activities and risk management processes, as guided by MAS’ Guidelines on Environmental Risk Management, and injecting greater purpose to their business.

We have been much encouraged by the first iteration of the BTIS. The findings have provided more than a measure of where banks stand with our customers and the community. We have gained rich insights into how banks in Singapore, working with MAS, can further raise culture and conduct standards and build on the trust our customers and the community place in us.

In the words of Mr Ravi Menon, Managing Director, MAS: “Trust is the most valuable currency for a financial institution. It is earned through right conduct – serving customers with integrity, fairness, and transparency. I am heartened that our banks have reached out to the public to understand their level of trust and identify areas for improvement, and have published the results. MAS is pleased that the survey indicates a high level of trust in our banks – this is a valuable commodity that the industry must preserve. The report has also highlighted several areas where the banks can do better, to further strengthen public trust. MAS will work with the banks on these areas and support their efforts to raise standards of culture and conduct.”

Mrs Ong-Ang Ai Boon is the Director of The Association of Banks in Singapore.

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1 The ENTS is a 200-point scale, ranging from negative 100 (if all respondents have strong distrust of banks) to positive 100 (if all respondents have strong trust in banks).
“Together with the industry, the MAS set about creating a Fintech ecosystem that embraced both incumbents and insurgents,” Menon said last August. “We wanted to facilitate the digital transformation of established financial institutions so that they can innovate and compete with the best.”

MAS has also expanded upon programs to financially support fintech and regtech innovation, committing S$250 million over the next three years to a program to accelerate innovation under the enhanced Financial Sector Technology and Innovation Scheme (FSTI 2.0). Under the FSTI, MAS administers the “Digital Acceleration Grant,” which provides funds to smaller financial institutions and fintech companies to adopt solutions. Through various other initiatives under the FSTI, MAS funds similar projects at financial institutions of all sizes.

MAS was lauded in a report by the Financial Stability Board (FSB), in which the international standard setting body spot-lighted several examples of how the regulator has deployed regtech and suptech solutions. One example was a model developed by MAS which can predict the risk of misconduct by financial advisors over a period of two years. In another example, the regulator developed a tool to analyze trade data to find potential red flags.

While promoting the use of regtech and suptech solutions in the financial industry, MAS has maintained focus on preventing risks to consumers. For instance, in order to avoid discrimination in AI systems, such as with credit scoring and marketing, MAS has announced the creation of “fairness metrics and assessment methodology” as the first phase of its Veritas initiative, a framework for financial institutions to promote responsible adoption of AI and data analytics. MAS Chief Fintech Officer Sopnendu Mohanty said as part of the announcement of Veritas, “Veritas is the first industry-wide collaboration to provide a mathematical way to validate AI and data analytics solutions against the principles of Fairness, Ethics, Accountability and Transparency. We hope Veritas will speed up the adoption of AI in financial services in the right direction.”

The role of technology has long been emphasized as a key driver for future job creation and economic vitality in Singapore, and the government has taken an active role to foment advancements of the technology ecosystem. A key consideration for this is the government’s desire to attract innovative firms from overseas to set up operations in Singapore. Indeed, given the geopolitical situation in Hong Kong, many firms are looking to expand their presence in Singapore to diversify and spread their risk.

In a speech at the Singapore Tech Forum 2020 Prime Minister Lee Hsien Loong discussed the government’s work pass initiative, which aims to allow – and encourage – foreigners to start, operate, or lead a Singapore-based business.

“The Tech.Pass scheme is aimed at highly accomplished tech talent, the movers and shakers of the tech world - people who usually play different roles at once: founder, investor, employee, consultant, academic,” he said.

Technology innovation aimed at corporate governance challenges may also have a prominent place in the near term, as Singapore looks to address several past challenges in this regard.

Outside of banking, there have been a number of significant instances of corporate misconduct in recent years. The number of new listings on the Singapore Exchange (SGX) has decreased, while delistings as a result of governance and accounting scandals have surged. This has created what some have termed an “existential crisis” for SGX, at a time when exchanges elsewhere in the world, and in Asia specifically, are thriving.
SGX is unique in that it is self-regulated, with a subsidiary, Singapore Exchange Regulation (SGX RegCo), handling all frontline regulatory functions. SGX RegCo is responsible for ensuring that its regulatory and enforcement framework for listed companies continues to be relevant and effective in upholding its regulatory goals, which includes being able to deliver efficient and timely regulatory outcomes.

In this regard, SGX RegCo has taken steps to finalize needed updates to strengthen its enforcement framework. A consultative process regarding its ESG reporting framework was also launched in 2021, with the intention of making ESG disclosures from listed companies “more meaningful” by standardizing and improving the comparability of reports.

SGX RegCo has also tightened requirements around auditing for companies listed on the exchange. All listed companies must now hire an auditor which is registered with Singapore’s Accounting and Corporate Regulatory Authority (ACRA). Under the new requirements, companies may also be required to bring on a second auditor if accounting discrepancies are believed to be “pervasive.”

SGX RegCo CEO Boon Gin Tan said that the goal of these programs is to develop a marketplace where the regulator is hardly noticed. “This means the market and participants are effectively self-governing,” Tan explained. “We want new jurisdictions and new products to be introduced on our platform, and to do so, the market community must also be ready to handle the associated risks.”

One way the SGX RegCo is looking to streamline its regulatory activity is through use of AI/ML to adapt information from listed companies’ disclosure using an automated process. This technology will streamline the regulator’s data analysis, allow it to direct its regulatory resources more efficiently. The regulator also leverages AI/ML and regtech to enhance its ability to surveil the market and supervise listed entities.

In the area of enforcement, MAS’ enforcement approach is shaped by the three principles of MAS’ enforcement philosophy:

- Early Detection of Misconduct and Breaches of Law
- Effective Deterrence
- Shaping Business and Market Conduct

The 2019-2020 priorities were focused on 5 key areas: corporate disclosures, business conduct, AML/CFT, insider trading, and brokerage houses internal controls.

MAS stepped up on the detection and review of corporate disclosure failures. MAS and ACRA also established a joint forum to facilitate the review of accounting-related and disclosure issues, as well as coordinate enforcement efforts.

For failure to comply with business conduct requirements, MAS took enforcement actions against two financial institutions, including imposing a civil penalty of $11.2 million. MAS also issued prohibition orders against 24 former representatives of financial advisers for dishonest business conduct.

Arising from AML/CFT thematic and focused inspections conducted on various financial institutions, MAS investigated and took enforcement actions against financial institutions with significant deficiencies in AML/CFT controls and senior managers who fell short of their duties. This would include actions taken for its 1MDB review where two banks were ordered to shut down, fines totaling $30 million imposed on numerous financial institutions, as well as prohibition orders issued to numerous individuals. In October 2020, Goldman Sachs made the largest payment by any financial institution to the Singapore government to-date for a crime related
matter, in the amount of USD 122 million, after the firm’s Malaysia unit pleaded guilty to violating bribery laws. In light of the leak of the FinCEN files, which show nearly 1800 suspicious transactions that flowed through Singapore banks, MAS announced that it would investigate the reports and take appropriate action. Major banks in Singapore, including Deutsche Bank, had handled about $6 billion in suspicious transactions.

MAS has successfully pursued insider trading charges against three former representatives of financial institutions who carried out a front-running arrangement. MAS also imposed a civil penalty on an individual for selling shares in an overseas listed company while in possession of insider information.

To improve brokerage houses’ internal controls, MAS worked with brokers to disrupt suspicious trading activities and engaged the industry on key observations from the disruption process. MAS and SGX Regulation also jointly published the MAS-SGX Trade Surveillance Practice Guide to help brokers implement good practices in their trade surveillance operations.

Last year, MAS also increased its efforts to hold individuals in the financial sector accountable. In one case, MAS banned two bankers from the industry for life for fraud and dishonest conduct. In another, the regulator barred four individuals from the financial services industry for market misconduct.

However, accountability is not reserved for individuals who explicitly participated in illegal activities. MAS has also introduced a framework to hold senior managers and executives accountable for the actions of their employees and for the business conduct they are responsible for.

In 2018, MAS consulted on its intended individual accountability regime for senior managers. The final guidelines for this regime, which will be discussed in the MAS subsection below, were released in September 2020 and are due to come into effect in September 2021.

**Monetary Authority of Singapore**

The Monetary Authority of Singapore (MAS) has continued all of the initiatives it began in 2019 and initiated new work in 2020 around culture, conduct, and regulatory technology.

**CULTURE CONSIDERATIONS**

Continuing in its commitment to the promotion of sound culture, in September 2020 MAS released a paper entitled “Information Paper on Culture and Conduct Practices of Financial Institutions”. The paper sets out its approach to culture and conduct, the outcomes towards which financial institutions should work, and provides examples of acceptable practices for the institutions to consider adopting.

MAS set out nine outcomes which financial institutions should strive towards. These include expectations for financial institutions to identify and empower staff who are responsible for driving culture and conduct, as well as to incorporate culture drivers and conduct risk as part of their risk management framework.

In its approach to culture and conduct MAS has identified three pillars: promote and cultivate, monitor and assess, and enforce and deter.

In order to promote and cultivate sound culture, MAS engages in a regular dialogue with financial institutions, and collaborates with industry associations to “promulgate good market practices.” To monitor and assess the culture in financial institutions, MAS goes beyond a financial institution’s frameworks, policies, and procedures (i.e. the “hardware”), to also focus on the values, attitudes,
and behavior of its board, senior management and staff (i.e. the “software”). The last pillar, enforce and deter, consists of supervisory and enforcement actions against institutions where poor risk management, misconduct, or regulatory breaches are found.\textsuperscript{538}

MAS plans to improve its ability to supervise culture and conduct in the next year, by further strengthening the culture supervision framework, build capacity for supervisors in the area of culture supervision, and monitor emerging culture and conduct risks arising from FIs’ digitalisation efforts. MAS will issue a public consultation on proposals to mandate reference checks for individuals employed in the financial industry, beyond representatives. The purpose of the proposal is to mitigate the “rolling bad apples” phenomenon, which refers to individuals who engage in misconduct but are able to obtain subsequent employment elsewhere without disclosing their earlier misconduct to the new employer.\textsuperscript{539} \textsuperscript{p. 243}

**INDIVIDUAL ACCOUNTABILITY**

MAS has released new “Guidelines on Individual Accountability and Conduct,” setting forth principles on the promotion of individual accountability among senior managers, strengthening the oversight of material risk personnel, and reinforcing conduct standards of employees. The guidelines include five key outcomes for a strong individual accountability and conduct framework:

- identify the senior managers who are responsible for the institution’s core functions.
- ensure that senior managers are “fit and proper” for their role and are held accountable for the employees and business conduct they oversee.
- create a governance framework that supports senior managers’ performance of their roles.
- ensure all material risk personnel are fit for their roles, and are subject to effective governance and incentive schemes.
- establish a conduct framework which effectively promotes and sustains desired conduct enterprise-wide.\textsuperscript{540}

**Hong Kong**

**REGULATORY BACKGROUND**

In its Hong Kong Banking Outlook 2020, KPMG wrote, “In 2020 and beyond, the successful banks will be the ones that proactively manage conduct risk, understand the current day-to-day behaviours of their employees, and assess whether their culture is encouraging, rewarding and shaping those behaviours in a way that is aligned with the values of the organisation.”\textsuperscript{541}

Regulators across the Asia-Pacific region have strongly emphasized the importance of culture and conduct in recent years, and those in Hong Kong have been particularly prominent in this regard. As discussed in some depth in our report last year, the Hong Kong Monetary Authority (HKMA) launched a bank culture reform program, which continued to expand in the past year.

**HONG KONG MONETARY AUTHORITY**

Under section 7(2) of the Hong Kong Banking Ordinance (Chapter 155 of the Laws of Hong Kong), the functions of the HKMA include, among other things, promoting and encouraging proper standards of conduct, sound and prudent business practices amongst banks, and taking all reasonable steps to ensure that any business carried on by banks is conducted with integrity, prudence, and the appropriate degree of professional competence.

In a speech at an Annual Banking Conference held in September 2020, Chief Executive of the HKMA, Eddie Yue, discussed three key transformations occurring
In Focus
Japan’s Digitalization, Financial Hub & Corporate Governance Policies

By MATSUO MOTONOBU

The “Three Arrows” of what has been called ‘Abenomics’ have helped Japan’s economy to recover significantly from what some have called ‘stagnation.’ As we look to what the economy will require next, following the coronavirus pandemic, we see significant policy changes currently underway in Japan. In this article, I will explain three substantial changes to the Japanese financial scene.

1. JAPAN’S DIGITALIZATION STRATEGY

Under Prime Minister Suga, a new ‘Digital Agency’ is being formed. It should begin operations this year, aiming to become the ‘control tower’ from which the country’s many digitalization efforts will be directed.

The Digital Agency will set priorities and plans for the formation of a digital society with the needed government support structure. To achieve this, the Digital Agency will supervise numerous projects related to the development and management of state information systems.

For instance, the government has already eliminated many written, stamped, and face-to-face procedures, promoting teleworking instead. Japan will embark on further reforms over the next five years to unify and standardize local government systems, establish a nationwide cloud migration, and improve operational efficiency and services to Japan’s citizens and residents.

As an example, we will digitalize medical care and education. We will introduce IT terminals for all elementary and junior high school students and implement online education according to children’s wishes and developmental stages. ‘My Number’ cards – the Japanese national ID – are critical to the success of our digitalization efforts and will begin to be integrated with national insurance cards in March. Four years from now, we will start integrating with driver’s licenses as well. Japan has set aside significant funding to support these measures.

2. JFSA’S REGTECH AND SUPTECH STRATEGY

Japan’s Financial Services Agency (JFSA) is working on upgrading its data strategy and analytical capabilities to gain a more accurate picture of the financial situation at firms across the country.

We have established new rules and frameworks for collecting, managing, and utilizing data for this purpose. And we have abolished past stamp-based government procedures and plan to review all written, stamped, and face-to-face processes throughout the financial services industry to identify opportunities for further digitalization.

Financial Services Agency
We will also effectively combine our on-site and off-site monitoring of firms and we aim to work proactively to incorporate remote-friendly methods and to avoid being limited to traditional on-site monitoring methods.

RegTech and SupTech will play an essential role in this connection, as we look to develop practical monitoring methods in specific fields, such as risk management related to foreign currency liquidity, and securities management.

To encourage innovation in the financial services sector, the JFSA will enhance its FinTech Innovation Hub (FIH) to identify and address regulatory and technological issues. We will also improve our regulatory framework and develop infrastructure to encourage further digital innovation.

Tokyo’s Transformation to become Asia’s Financial Hub

Japan’s household assets total more than 19 trillion dollars. But the government intends to improve Japan’s attractiveness for business and wealth creation, with some focus on the asset management industry. For instance:

1. REVISION OF THE TAX SYSTEM

Inheritance Tax – we expect to amend the country’s tax law in this Diet session so that assets residing outside of Japan are exempt from Japanese inheritance tax, regardless of a foreign national’s years of residence in Japan, when their heir is a non-resident of Japan.

Corporate tax – an unlisted, non-family asset management company, including those 100% owned by a listed company, will be able to deduct its performance-based compensation, so long as calculation methods are transparent in its business operations and are disclosed.

Income tax – when profit distribution of carried interest has a sound economic rationale, that profit should be taxed as a capital gains tax at a 20% rate, comparable to practice in many major developed countries.

2. FAST MARKET-ENTRY TRACK

The JFSA is working to support foreign market participants’ entry into Japan’s economy, and, in this direction, we are adopting the use of the English language in related supervisory work.

The JFSA will amend the law to establish a new fast market-entry track for foreign businesses that manage funds where those are sourced principally by foreign professional investors. The JFSA has established a Financial Market Entry Support Office to provide consultation, registration, and supervisory guidance – in English – to businesses newly entering Japan. (marketentry@fsa.go.jp, tel. +81-3-3506-7109)

Moreover, we are relaxing our requirements for residence status and expanding incentives to promote the greater residency of foreign nationals in Japan. Special applications for residency status will also be established such that foreign businesses may act more quickly to assemble the human resources necessary to start doing business in Japan.

Corporate Governance Reform

In April 2022, the Tokyo Stock Exchange will shift to a new standard of market segmentation, namely: the prime market, standard market, and growth market.

The prime market is for the Companies with a high level of market capitalization, a high level of free float, and a high quality of corporate governance, committing to improving corporate value through constructive dialogue with investors. Draft revision of the Corporate Governance Code was published at the end of March and will be finalized by June 2021 after a public consultation process. After a transition
period, the prime market will be held to the Code’s higher standards. Prime market listed companies will be required to appoint independent directors to their boards, filling at least one-third of their board seats on a “comply or explain” basis, and will be encouraged to fill a majority of their board seats with independent directors.

The new Corporate Governance code will also recommend that listed companies focus on skills in light of a firm’s business strategy and operational complexities when appointing new directors. They should publish a “skill matrix” that details the combination of directors’ skills. They should also be required to set out measurable goals for ensuring diversity in the promotion of core human resources. This includes promoting women and foreigners, with attention to mid-career hires into managerial positions. And firms should then report on their progress toward these goals.

Matsuo Motonobu is the Secretary-General of Japan Securities and Exchange Surveillance Commission, Japan Financial Services Agency

in the banking sector: the adoption of fintech, the deepening of cross-border banking, and the expansion of green finance.  

Since the HKMA initiated the Bank Culture Reform in March 2017, with a view to cultivating the right culture and values in banks, the HKMA has continued to promote a customer-centric culture. Like other regulators elsewhere, the HKMA does not assert any ‘one-size-fits-all’ approach when it comes to culture, instead expecting that individual banks will adopt a holistic and practical framework to foster sound cultures, with particular attention devoted to what the HKMA refers to as “three pillars”: (1) governance, (2) incentive systems, and (3) assessment and feedback mechanisms.

As noted in our past years’ reports, the HKMA issued a circular in March 2017 to the Chief Executives of all authorized institutions (Al) relating to its “three pillars” for sound corporate culture. In late 2018, the HKMA issued another such circular, outlining its plan to gauge bank culture reform progress. The three-pronged supervisory measures announced in this plan consists of requiring banks to conduct a self-assessment of their efforts to establish sound cultures; conducting focused reviews with respect to key areas of bank culture; and undertaking culture dialogues with senior management and/or board members of banks responsible for bank culture.

In 2019, the regulator put this plan into effect. The HKMA has commenced culture dialogues with banks since 2019 to discuss the effectiveness of their culture enhancement efforts, as well as to provide its supervisory feedback on conduct and culture gathered through its ongoing supervision. It has also completed the self-assessment exercise and published a comprehensive report on Review of Self-assessments on Bank Culture in 2020, to provide a range of practices and common themes identified for reference by the industry. Building on the insights from this self-assessment exercise, the HKMA also launched a focused review on the incentive systems of front offices in retail banks in 2021. The “Culture Reform” section that follows below will cover the results of banks’ self-assessment exercises and details of the focused review.

The HKMA has also taken a data-and-technology-driven approach to its supervisory duties. In 2019 it launched a newsletter, “Regtech Watch,” and
retained advisory services from KPMG with a view to promoting the adoption of regtech tools among financial institutions in Hong Kong. And, in 2020, the HKMA established a Digitalisation Office to oversee the digital transformation of the agency. The “Supervisory and Regulatory Technology” section of this report, below, outlines the HKMA’s efforts to increase the use of SupTech and regtech in its jurisdiction.546

Hong Kong faces many of the same challenges as do other major global financial markets, and this includes issues of misconduct. In January 2021, police arrested seven Hong Kong bankers on allegations of laundering HK$6.3 billion, or about $813 million, in criminal syndicate funds.547 In total, more than 10,000 Hong Kong bank accounts were used to collect and launder more than $1 billion in 2020.548

However, Hong Kong financial institutions also faced unique challenges introduced by the complex geopolitical environment they operate in. For example, demand for compliance staff increased by one-third in the three months preceding September 2020 as compared to the previous three-month period. Some say this is likely because they are determining how to stay in line with US sanctions while not violating national security law, as many firms operate in both environments.549

CULTURE REFORM

In a November 2020 speech, HKMA Executive Director of Banking Conduct, Alan Au, discussed the importance of sound culture in the “new normal” that the Covid pandemic has established. Specifically, he spoke of the increasing digitalization of financial services, coupled with the lack of physical oversight of staff activities, as key factors which have made sound bank culture something that “matters more than ever.”550 Au went on to discuss seven themes from banks’ culture self-assessment exercise:

1. Further work is needed to ensure incentive systems are designed to promote sound culture and prevent incidents of misconduct
2. Stronger links are required to connect banks’ Hong Kong operations with the culture efforts of their headquarters or upstream entities as well as their downstream operations, as appropriate
3. Deeper analysis is expected to benchmark themselves against the findings from the reviews of the major overseas misconduct incidents
4. More focus is needed to facilitate the undertaking by relevant staff of the continuous professional development under the Enhanced Competency Framework or by other professional bodies to complement efforts to promote sound culture
5. More effort is needed to tackle the key challenge of culture assessment to identify the gaps between current progress and desired culture
6. More work is needed to promote an environment which provides “psychological safety” to encourage staff to speak up without fear of adverse consequences
7. Sustained effort is required in driving cultural changes and banks should be mindful of “culture fatigue”551

The HKMA’s report on bank self-assessment efforts finds that 90% of banks report using some dashboard of indicators to help assess the bank’s culture and conduct proclivities. These are established predominantly through the use of data regarding known regulatory breaches, customer complaints, and employee surveys. Only some 10% of banks make use of more sophisticated data sources, such as staff performance statistics and communications surveillance.552

Recognizing the importance of banks’ ability to manage operational risk challenges including conduct risk, the HKMA, in collaboration with the banking industry and the Hong Kong Institute of Bankers (HKIB), launched the Enhanced Competency Framework on Operational Risk Management (ECF-ORM) in December 2020. The ECF-ORM is aimed at
supporting banks in developing talent and improving their staff’s core competencies in operational risk management, which include promoting a positive risk culture, risk awareness and ethical behavior.\textsuperscript{553} The ECF-ORM also recognizes several existing training programs related to operational risk for exemption, including Institute of Operational Risk Certificate which introduces students to operational risk management, including how it fits into a firm’s enterprise risk management (ERM) program.\textsuperscript{554}

Additionally, consultation began for the HKMA’s updated guidance for banks’ codes of conduct in February 2021. To reiterate that staff commitment to integrity is important to a bank’s reputation, it is emphasized in the consultative document that, “The Code of Conduct should reflect the professional standards and values that promote ethical and responsible professional behaviour among the AI’s staff and guide them in the discharge of their duties.”\textsuperscript{555}

The proposed revisions to the Code of Conduct include, among others, more detailed guidance on the disclosure and management of conflicts of interest. For example, staff members would be required to disclose whenever they or their family members have done anything which might create a conflict of interest. Staff with access to customer information would also be expected to disclose any investments which might cause a perceived conflict. Those who failed to report such potential conflicts in a timely manner may be subject to disciplinary action.\textsuperscript{556}

In March 2021, the HKMA began a focused review into the incentive systems of front offices at retail banks. The review will seek to understand the incentive systems in the front offices of 20 retail banks and how those incentive schemes drive the behavior of employees. In particular, the HKMA will review if the schemes minimize potential misconduct and mis-selling of financial products.\textsuperscript{557}

\section*{SUPERVISORY AND REGULATORY TECHNOLOGY}

In the 2021 update to its Hong Kong Banking Outlook, KPMG wrote, “[T]he successful banks in 2021 will be the ones that embrace innovation with regard to Regtech, understanding that there will be success and failure along the way, and take bold steps to sponsor initiatives that can unleash the full potential of Regtech throughout their organisation.”\textsuperscript{558}

Indeed, the HKMA has been seeking to serve as a driving force behind regtech innovation in Hong Kong’s financial sector. In July 2020, the regulator sent a letter to authorized firms, asking them to support the development of regtech solutions. This was the beginning of an engagement with KPMG advisory on a series of projects to promote regtech adoption by financial services firms.\textsuperscript{559} The HKMA commissioned a whitepaper from KPMG to advise it in this regard, resulting in 16 suggestions in the following key areas:

\begin{itemize}
  \item boosting awareness by issuing practical guidance and organizing targeted events;
  \item promoting innovation among the local and global Regtech community and facilitating access to infrastructure;
  \item enhancing regulatory engagement with the Regtech ecosystem through ongoing dialogue and collaboration;
  \item developing the talent pool by formalizing a Regtech training and skills framework; and
  \item sustaining adoption via continued industry engagement and effective tracking of progress.\textsuperscript{560}
\end{itemize}

In his remarks at the Hong Kong FinTech week 2020, Deputy Chief Executive of the HKMA Arthur Yuen stated that the regulator plans to implement all 16 recommendations outlined in the KPMG whitepaper, pointing to the ability of data technologies to improve banking operations, customer trust, and outcomes.\textsuperscript{561} Concurrently, the HKMA published a roadmap for implementing the recommendations over two
years. The roadmap includes hosting a large scale-event to raise awareness of regtech, launching a regtech adoption index, organizing a global regtech challenge, and more.\textsuperscript{562}

At the same conference, Yue spoke of a new initiative: the creation of a Commercial Data Interchange (CDI), an interoperable platform allowing data providers to, with the consent of data owners, share data with all banks, rather than relying on individual connections between banks and data providers. Yue said such CDI will lead to reduced fraud and lowered compliance costs while enabling banks to offer new financial products.\textsuperscript{563}

In this speech, Yue said, “I call on all of you to put your most innovative ideas, your best technology, and your brightest people to work on fintech solutions for our city.” This is all a part of the HKMA’s vision to develop Hong Kong into a global fintech hub.\textsuperscript{564}

In January 2021, the HKMA released a report on regtech adoption for improving Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) activities, featuring case studies from banks where technology has successfully been used to enhance existing practices in this area.\textsuperscript{565}

One of the report’s recommendations is to foster a culture of creativity and innovation, where everyone is open-minded and collaborative. In the “Looking Ahead” section of the report, the HKMA writes, “To continue supporting its roadmap to accelerate [regtech] adoption in the banking sector, the HKMA will keep regtech as a key focus in its 2021 AML/CFT supervisory programme.”\textsuperscript{566}

In its December 2020 edition of “Regtech Watch,” the HKMA outlined regtech use cases specific to the Coronavirus pandemic. The four use cases explored include: remote access and collaboration platforms, compliant business communications, automated processing of relief loans, and social distancing and contact tracing. All are examples of where the HKMA believes that regtech might help companies to deal with the increase in conduct, financial, and cybersecurity risks that the pandemic has introduced.\textsuperscript{567}

THE FINANCIAL SERVICES AND THE TREASURY BUREAU

The Financial Services and the Treasury Bureau (FSTB) in Hong Kong announced in January 2021 that it would open applications for a Fintech Proof-of-Concept Subsidy Scheme, which was subsequently launched in February. Financial services firms are being encouraged to use the scheme to test innovative solutions in such fields as regtech, trade financing, and cross-border payments. FSTB Secretary Christopher Hui said, “The pandemic has also spurred wide adoption of fintech. As an international financial center, Hong Kong is an excellent place to groom one’s fintech business.”\textsuperscript{568}

SECURITIES AND FUTURES COMMISSION

Securities and Futures Commission (SFC) CEO Ashley Alder said in May 2020 that the remote working environment necessitated by the coronavirus pandemic could greatly increase banks’ operational risk exposure: “Some of the technology infrastructure isn’t particularly well adapted to working from home... no doubt that there is an increase in operational risk, notwithstanding the fact that it has gone well so far.”\textsuperscript{569}

In November 2020, the SFC announced plans to issue a Code of Conduct for Investment Banks covering how they calculate their fees for capital raisings. Currently, banks can determine their compensation based on various performance metrics, including how well stocks perform after a listing. The new Code of
Q: Kathy, you were credited by Prime Minister Abe with coining the term “Womenomics,” at a time when the word ‘diversity’ did not feature largely in the Japanese vernacular. Where does Japan need to go from here?

A: Two decades on from the launch of our 1999 report, *Womenomics: Buy the Female Economy*, we have seen female labor participation in Japan surge by more than 70%, to exceed U.S. and European levels. But while Japan has made substantial progress in boosting the quantity of working women, with a record-high female labor participation rate, it still has a long way to go when it comes to quality of opportunity, since there is still a dearth of female leaders in the country. For instance, the ratio of female managers in Japan stands at just 15% - less than half that of the US and Europe - and the percentage of female board directors is less than 10%, which also pales in comparison to most other developed nations.

Reflecting the under-representation of women in senior roles, and the fact that women account for the vast majority (70%) of part-time workers, Japan also suffers from the largest gender pay gap (25%) in the G7.

Another significant barrier to gender equality is unconscious biases and gender role stereotypes. For instance, despite the fact that the level of girls’ education is very high in Japan, the ratio of 15-year-old girls who want to study science is half that of boys, which helps to explain why Japan has the lowest ratio of female researchers in the OECD. Due to entrenched gender role stereotypes, females are not encouraged by their parents and teachers to pursue STEM fields, even if they demonstrate interest or aptitude in these areas.

Q: What signs are there that these priorities are seeing meaningful uptake? What should government, business and society be doing next? What role do institutional investors play?

A: Japan is facing a “demographic tsunami” – its labor force population is expected to shrink by as much as 40% by 2055. As such, there is now a heightened sense of urgency around maximizing the economic potential of women, older workers, and foreigners.

In terms of policies that the government should pursue to further promote ‘Womenomics,’ they include:

- Establishing Parliamentary gender quotas
- Tightening gender diversity disclosure requirements
- Requiring gender pay-gap disclosures
- Promoting female entrepreneurship
- Rectifying tax disincentives
- Making flexible labor contracts more readily available, and
- Loosening immigration rules to allow for more foreign caregivers

Meanwhile, the private sector also needs to pursue concrete initiatives to promote more women in leadership and managerial roles such as:

- Leadership commitment to diversity and proactively managing women’s careers
- Performance-based evaluations (as opposed to seniority-based)
- Engaging male champions for diversity initiatives
- Gender diversity target-setting, and
• Promoting more flexible work environments

Lastly, Japanese society at large must also take concrete steps to:

• Dispel Womenomics myths – such as, the more women work, the lower the birth rate
• Encourage more girls and women in STEM education and careers
• Correct gender role stereotypes in the media

![Japan workforce shrinking faster than other countries](image)

UN estimates after 2020, based on median estimates of mortality and birth rates. World Population Prospects, 2017 Revision, UN, June 2017. Source: Japan Institute for Labour Policy and Training, UN.

Q: You’ve noted a marked shift in attitudes among today’s Japanese youth, and increased attention to ESG concerns, arguing that this has created tailwinds that should advance the cause of Womenomics. Can you say more about that?

A: One of the strongest tailwinds that will likely promote furthering of Womenomics progress is the explosion of ESG investing. While ESG investing initially took off in Europe, followed by the US, Japan has been playing catch-up over the past several years and, since 2011, it has been one of the fastest-growing ESG markets globally, with the number of signatories to the United Nation’s PRI (Principles of Responsible Investing) growing at a rate of 23% CAGR since 2011. This means that investors and asset owners are increasingly tracking diversity metrics included in ‘Social’ and ‘Governance’ categories, such as management and board diversity.

One important development occurred in 2017, when Japan’s Government Pension Investment Fund (GPIF) – the world’s largest public pension fund – invested a total of ¥1 trillion towards three Japanese equity indices based on ESG factors, one of which was the MSCI Japan Empowering Women Index (WIN). The WIN index comprises companies whose gender diversity initiatives have encouraged more women to enter or return to the workforce. Since the GPIF’s investment behavior tends to lead the rest of the industry, other Japanese pension funds as well as asset managers suddenly started focusing on gender diversity for the first time ever as part of their investment processes.

A second important tailwind for Womenomics is the distinct shift in attitudes of younger Japanese towards work/life balance. For instance, in 1987, 38% of single Japanese men (aged 18-34 years) believed their future spouse should be a full-time housewife, and only 11% believed their spouse should be a working mother. By 2005, however, the same survey showed a reversal and, as of 2015, 34% of men actually indicated a preference that their spouse be a working mother, while only 10% wanted their spouse to stay at home. This suggests that attitudes of millennials and the younger generations are already turning in a positive direction, and that the desire for greater work-life balance is no longer just for women, but for all of Japanese society.

![Japan’s female labor participation rate has surpassed the US and Eurozone](image)

As of February 2019 for Japan and US, September 2018 for Eurozone. Source: OECD.
Q: While we may agree that leveling the playing field for women in the workforce is a social good in and of itself, you have often couched the argument for increased participation of women in the workforce in economic terms. Can you say a bit about this?

A: The economic dividends from closing Japan’s gender employment gap are potentially massive. If Japan’s labor participation rates for females (67% as of 2017) increased to equal that of males (83%), this would add 5.8 million more employees to Japan’s workforce. Since more workers generally means more aggregate income, we estimate the potential positive impact on Japan’s GDP to be 10%. Furthermore, if more women could work in full-time roles as opposed to part-time, this would also boost incomes. If we assume the ratio of monthly regular working hours of Japanese women vs. men rose from 81% to the OECD average of 85%, this would lift Japanese GDP a further 4-5%.

In other words, under a ‘blue-sky’ scenario of a closure of the gender employment gap and an increase in the ratio of women’s working hours, Japan’s GDP could increase by as much as 15% or ¥75tn (US$750bn).

Q: In addition to the macro-economic case for Womenomics, you’ve also emphasized that there is a micro-economic business case to be considered. Can you say more about that?

A: We have shown that companies with more diverse leadership tend to perform better. For example, based on data for Japanese listed firms, those that ranked in the highest group in terms of female manager ratios (>15%) boasted the highest 5-year average sales growth (>6%), as well as the highest 3-year average ROEs (>9%), while firms in the lowest group had very low or negative average ROEs.

This conclusion is consistent with similar studies conducted overseas, and given the highly homogenous nature of Japanese society, this makes sense. Incorporating cognitive diversity into decision-making processes drives increased innovation, productivity and overall performance, while also helping to mitigate risks – conduct risk among them.

Q: There is oft-cited evidence that firm culture shapes employee behavior and sets the conditions for material outcomes for firms, their investors, and other stakeholders across society. What has your own career experience suggested in this regard?

A: Based on my personal experience, there is a great deal of truth in that statement. I worked at Goldman Sachs for over 26 years, and I always felt that the firm invested a great deal of time and energy in creating a strong corporate culture that emphasized integrity, excellence and teamwork. Like most organizations, the ‘tone’ of the firm was set at the very top, and this was very much the case when it came to the firm’s diversity and inclusion agenda.

For a global financial services firm, human capital is the single most critical resource, so in order to attract and retain the highest-quality talent globally, one needs to create a culture that is open to persons with diverse backgrounds and perspectives. Not only did Goldman Sachs set explicit gender and race targets
for hiring, but in January 2020, CEO David Solomon announced that the firm would not take private companies in the US and European markets public unless they had at least one diverse board director.

Importantly, the rationale for this and all of the firm’s other diversity initiatives were grounded in a simple economic rationale - that is, diversity is not optional; rather it is imperative for the sustainable growth and competitiveness of the franchise.

Kathy M. Matsui is Adjunct Professor at the Kyoto University Graduate School of Management & former Vice Chair, co-head of Macro Research in Asia and Chief Japan Strategist for Goldman Sachs. A member of the APAC Management Committee and Goldman Sachs Japan Co., Ltd. Executive Committee, she helped oversee the firm’s $500 million commitment to narrow the gender investing gap. Kathy was ranked No. 1 in Japan Equity Strategy by Institutional Investor multiple times. She is credited by Prime Minister Shinzō Abe with having coined the term “Womenomics” and was chosen by The Wall Street Journal as one of the “10 Women to Watch in Asia.”

Conduct is part of efforts to review book building processes, tighten supervision, and enhance overall conduct in the capital raising process.570

**HONG KONG EXCHANGES AND CLEARING (HKEX)**

Reflecting its own interest in curbing misconduct, the Stock Exchange of Hong Kong (SEHK) has sought powers to increase its ability to punish listed companies, as spelled out in an August 2020 consultation paper. While the SEHK is not seeking the authority to fine companies, it is looking to develop a spectrum of disciplinary actions that enable it to protect market integrity. Some of the sanctions the SEHK is seeking to impose include publicly expressing that a director is unsuited to their position, denying firms access to market facilities, or delisting an issuer’s securities entirely.571

SEHK parent, Hong Kong Exchanges and Clearing (HKEX), is also eager to make use of new technologies to improve market integrity. Lukas Petrikas, managing director of HKEX Innovation and Data Lab, has argued that artificial intelligence will greatly improve disclosure and data quality for investors: “AI can improve transparency, reporting quality and confidence in the securities markets, in line with our mission to ensure a resilient and robust market for all.”572

**Japan**

**CORPORATE GOVERNANCE REFORM**

Prime Minister Shinzo Abe came to power in 2012 inheriting a Japanese economy that had been stagnant for decades.573 He instituted a series of reforms, dubbed Abenomics: a three pillared strategy based around monetary easing, fiscal stimulus, and structural reforms.574

Among these structural reforms – the “third arrow” of Abenomics – the government introduced both a new corporate governance code and an investor stewardship to increase shareholder profitability and power, while seeking to unravel much of the corporate cross-shareholding that characterized Japan’s *keiretsu* system since the end of the Second World War.575
These reforms look set to continue under the administration of current Japanese Prime Minister, Yoshihide Suga. In a document entitled, “JFSA priorities for July 2020-June 2021”, the Japan Financial Services Agency (JFSA) set out its current priorities. Overcoming the challenges of COVID is of course high on the list. But the remainder of the JFSA’s priorities emphasize continued structural reform. p. 167

This includes efforts to reform the JFSA itself.\(^{576}\) To promote innovation within the agency, the JFSA is observing tests the government is conducting on the potential for AI systems in the monitoring of AML/CFT risks, and the JFSA plans to encourage the use of these systems if the results are positive.\(^{577}\) For example, the JFSA is close to completing work on a system which uses AI to monitor new account openings and money transfers for unusual activity, flagging people who are suspected of criminal activity.\(^{578}\)

The JFSA is also prioritizing the “digitalization” of Japanese financial markets, as the Suga administration looks to do likewise across a wide range of government administrative activities that regularly touch Japanese citizens and consumers. In this direction, the JFSA plans to enhance its FinTech Innovation Hub (FIH) to address regulatory and technological issues.

Reflecting the priorities of Abe’s “third arrow,” the JFSA updated its Stewardship Code – an advisory code for institutional investors – in March 2020.\(^{579}\) The JFSA and the Tokyo Stock Exchange (TSE) established a council of experts to improve upon Japan’s corporate governance and stewardship codes. Formally proposed in April 2021, these reforms seek to enhance board independence, promote diversity through the adoption of voluntary targets, and encourage a focus on sustainability and ESG.\(^{580}\) The corporate governance changes will also call on companies to treat human rights as a board-level concern.\(^{581}\)

The council will work to encourage enhanced climate related disclosures in line with TCFD standards, among other goals.\(^{582}\) This will be welcome news to the many Japanese investors who are seeking more consistent ESG data for the companies in which they invest.\(^{583}\)

**ACTIVIST INVESTING ON THE RISE**

In February 2021, Mitsubishi Corporation became one of the first major Japanese companies to adopt the new corporate governance code, leading the way for other companies to do the same.\(^{584}\)

With the loosening of Japan’s corporate governance constraints, activist investing has grown rapidly in the country.\(^{585}\) Some say that inflows of investment money from large institutional investors, like Berkshire Hathaway, show that Abenomics has paid off.\(^{586}\) There has also been significant growth of sustainable investment in Japan. The sustainable investment assets under management grew to $3.1 trillion in 2019, jumping 45 percent from the previous year.\(^{587}\)

In July 2020, a sustainability measure proposed by a shareholder of Mizuho Financial Group was voted down at the company’s annual general meeting. This measure would have required that the bank, which is heavily invested in fossil fuels, disclose climate risks of its business activities. While it is not particularly surprising that this measure failed, many found it striking that the proposal won a third of the votes. This is taken as a sign that Japanese investors are beginning to take sustainability and climate risks more seriously.\(^{588}\)

Though the number of companies that faced activist demands in the first six months of 2020 dropped to 42 from 53 over the same period in 2019, some believe that this is likely because of the pandemic and the difficult financial situations companies faced. For example, activist investor Oasis said it had backed
down from its campaign to remove the president of a company in which it was invested because of the coronavirus pandemic.589

JAPAN’S DIGITALIZATION

In early 2020, the situation for many Japanese regional banks seemed dire, with extremely low interest rates and stagnant local economies. In regions where the pandemic hit particularly hard, it presented a silver lining for the local regional banks. In 2018, less than a quarter of consumer transactions in Japan were conducted digitally. However, with the social distancing and remote operations mandated by the pandemic, Japan’s aging population was forced to embrace new technologies and digital operations that they had previously avoided.

In August 2020, Prime Minister Abe stepped down because of poor health. The following month, the new Prime Minister, Yoshihide Suga, announced his intention to create an agency to lead the digital transformation of Japan.390 “We need to make a digital agency as an organisation which will have a function of strong command power with personnel of high ability from public and private sectors, and lead digitalisation in the overall society,” Suga proclaimed.

Digital Transformation Minister Takuya Hirai is in charge of preparations for the creation of the new Digital Agency.391 In an interview, Hirai said that the new agency will have the authority to drive change, and will likely work with the private sector to do so. Hirai added, “Digital transformation is endless. There is no finish line. That makes it sound really hard, but the truth is it’s the same for the private sector—they are constantly reacting swiftly to new technologies, working out what they can adopt and how they can adapt. The government has to do that too. That’s a habit we need to form.”392

In a survey of 300 executives, McKinsey found that, while 80 percent of respondents agreed that “digital is a promising opportunity,” only 34 percent believed their company was ready to go digital.593 Many believe the biggest hurdle will be changing mindsets towards innovation in Japan’s relatively risk-averse culture. Notably, in Japan today, less than 12% of government administrative work is completed online.594

In February 2021, Prime Minister Suga announced that Japan would be forming a $100 billion university endowment to fund innovation, with the goal of growing the pool of researchers in the country. The Japanese government is thus building on earlier moves in this direction taken by private sector actors. In October 2020, for instance, Tata Consultancy Services and the University of Tokyo announced that they would be partnering on a project to support business innovation and technological collaboration, talent exchange, ideation, and start-up engagement.595

INTERNATIONALIZATION

Despite easing of financial regulations and tax pressures to encourage foreign entrepreneurs and companies to enter the Japanese market, the required regulatory filings necessary make it difficult to do so. In an effort to lift such obstacles to the growth of the country’s talent pool, the JFSA announced it would encourage foreign firms to apply for licences to operate in Japan, allowing them to submit applications and receive approvals in English, while also speeding up application and approval processes. This is especially timely, as geopolitical tensions in Hong Kong are leading some firms to consider diversifying their operations and risks across the region.596

In April 2021, the JFSA announced it had registered the first overseas affiliated asset management company in Japan’s capital market through its new ‘Financial Market Entry Office’ - the Japanese subsidiary of a UK asset management company Affirmative Investment Management Partners.597
In Focus
APRA’s evolving approach to transforming risk culture in Australia

By MARK ROE

The supervision of risk culture has been an elevated area of strategic focus for APRA (Australian Prudential Regulation Authority) in recent years and is a key part of APRA’s ‘transforming governance, risk culture, remuneration and accountability’ community outcome outlined in its Corporate Plan.

As supervising risk culture requires different skill-sets and approaches compared to traditional areas of prudential regulatory focus, APRA has established a specialist Risk Culture team which has enabled APRA to enhance its focus on risk culture through a broad range of activities. These activities include: the development of a risk culture framework, the roll-out of a risk culture benchmarking survey, the completion of a number of deep dive reviews of entities, and the up-skilling of supervisors in how to assess an entity’s risk culture. The team has also harnessed a range of innovative tools such as natural language processing and developed a risk culture transformation toolkit to help embed risk culture change in the long-term.

APRA’s risk culture focus

Focusing on an entity’s attitude to risk management enables APRA, as a regulator, to assess the influence of culture on how risks are managed. Risk culture, more broadly, refers to the norms of behaviour for individuals and groups that shape the ability to identify, understand, openly discuss, escalate and act on an entity’s current and future challenges and risks.

APRA’s new Supervision Risk and Intensity (SRI) model

In 2020, APRA introduced a new model to assess risk and determine supervisory intensity, called the Supervision Risk and Intensity (SRI) model. The SRI Model is the new common platform by which all APRA-regulated entities are assessed, and their level of supervision intensity determined. Risk culture is included as part of the SRI model, making APRA one of the first regulators to embed this area in our supervisory framework.

Risk Culture 10 Dimensions (RC10D)

To support APRA’s supervisors form a view of risk culture of the entities they supervise, APRA’s Risk Culture team developed the Risk Culture 10 Dimensions (RC10D) in late 2019. Over 150 (around two-thirds) of APRA’s supervisors have now been trained in how to use the framework.
As well as supporting supervisors in their SRI assessments, the RC10D is used as part of all APRA’s risk culture initiatives, giving APRA a structured approach to help assess the risk culture of entities as well as to track and benchmark their progress over time.

**Supervisory toolkit**

APRA’s Risk Culture team has developed an enhanced supervisory toolkit through which to assess risk culture issues. The toolkit includes:

- **Industry-wide risk culture survey:** APRA is piloting an online survey of staff at a number of entities in order to develop a risk culture benchmark which can be mapped across the Risk Culture 10 Dimensions. Following the pilot, the expectation is that the project will be expanded to a broader set of entities on a regular basis. The approach is similar to that undertaken by the Banking Standards Board in the UK but with a focus on risk culture.

- **Risk culture deep dive reviews of entities:** The team is undertaking a number of risk culture deep dive reviews each year. Findings are made following a triangulation of data from interviews of members of the Board, senior management and staff, focus groups with staff, online surveys and document reviews. Following the reviews, actions undertaken by entities are tracked to ensure that appropriate changes are being made.

- **Risk culture transformation toolkit:** A toolkit has been developed that outlines the key drivers for embedding strong risk culture outcomes in the long-term. The toolkit has been tested as part of recent deep dive reviews and is included as part of our feedback to entities outlining the areas they need to focus on to enable long-term improvements to risk culture, rather than short-term fixes. It is planned that the toolkit will be rolled out more broadly during 2021.

- **RegTech and innovative approaches:** As the available methods and technologies used to assess risk culture are rapidly evolving, APRA is trialling a
number of approaches including the use of natural language processing which is used as part of risk culture reviews.

Issues such as psychological safety, role-modelling of leaders, how managers ‘listen up and act’, incentives and remuneration, accountability, governance effectiveness and how Covid-19 has impacted entities are some of the many factors the team has recently examined.

Transforming risk culture - next steps

To achieve its goal of transforming risk culture practices, APRA will continue to effect change across the industry from multiple angles. APRA intends to achieve this through ongoing engagement with individual entities, consultants, peer regulators and industry bodies and associations in order to further embed its approach to assessing risk culture.

Building on an Information Paper published in November 2019, which outlined a more intensive regulatory approach in these areas, APRA plans to publish an Information Paper on Risk Culture in 2021. Planned content includes the Risk Culture 10 Dimensions framework, what ‘good’ and ‘ineffective’ risk culture practices look like, examples of metrics that entities are using and findings from our activities so far.

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Australia

REGULATORY BACKGROUND

Australia has avoided almost all of the most significant global economic slumps experienced in the course of the past three decades. This strength has underpinned the financial sector’s performance and, some would argue, led to a dulling of the senses of the importance of culture, conduct, and customer outcomes.598

This streak of relative stability ended in 2020, with the worst downturn the country had seen since 1959, when relevant data collection began. Despite the myriad of customer support initiatives deployed throughout the pandemic-driven upheaval of 2020, according to a survey conducted by Accenture, the percentage of Australians who trust their banks to have consumer best interests at heart has fallen to 29 percent (14 percent lower than in 2018).599

Alex Trott, Accenture’s banking lead for Australia and New Zealand, warned, “Australian banks have made progress rebuilding consumer trust since the royal commission into banking misconduct. But these efforts are facing another major test, as the rapid and abrupt shift to digital banking interaction during the pandemic is threatening the relationship and trust banks have worked to rebuild.”600 (The royal commission into banking misconduct is discussed later in this section.)

Former Australian Securities and Investments Commission (ASIC) Chairman Greg Medcraft argued that, in the wake of the royal commission into banking misconduct, banks still have a lot of work to do to regain public trust. Medcraft, who now runs the OECD’s Directorate for Financial and Enterprise Affairs, said, “It is all about trust. It is up to the banks to rebuild the trust from the community.”601 P. 212

Given the demands of the coronavirus pandemic that were faced by regulators in the last year, many of their planned regulatory change initiatives were largely put on hold in 2020. Much of this intended change is now set to come to fruition – and on an accelerated timeline – in the course of 2021 and 2022. As such, firms will face a huge program of work over the next two years, much of it focused on culture, conduct, and regulatory technology.

In response to Starling’s Survey on Culture and Conduct Regulation and Supervision, APRA wrote that, to handle COVID-19:

APRA prioritised maintaining financial system resilience by: protecting the safety and soundness of APRA’s regulated institutions; fostering their operational resilience during a period of significant disruption; and enhancing contingency plans for adverse events. This prioritisation is expected to last 12-18 months, but in 2021 APRA is already starting to find some increase in capacity for its other priorities.

The pandemic has also forced banks to work together, and with the government, to help financially vulnerable customers. As Anna Bligh, CEO of the Australian Banking Association, said: “What the public needed was for the banks and the government to be able to operate as trusted partners.”602

CONDUCT LEGISLATION AND REGULATION

Bligh believes that sound culture is as important to operational resilience as any other measure of financial stability: “Culture is a new element of operational risk and it is just as critical for prudential stability as bank capital requirements. The Global Financial Crisis showed uncontained cultural risk has a significant impact on the stability of the banking system. It is rightly elevated as a board-level consideration.”603 It is perhaps noteworthy that Ms. Bligh points to events that took place in the context
of the GFC as having drawn attention to culture as a systemic risk factor. In so doing, she echoes the sentiments of former Bank of England Governor Mark Carney, who said, “Global banks’ misconduct costs have now reached over $320 billion—capital that could otherwise have been used to support up to $5 trillion of lending to households and businesses.”

The more recent misconduct events in Australia, outlined in the course of the Hayne Commission work, demonstrate that the systemic risks posed by culture concerns remain unabated.

Australia’s Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry (the Hayne Commission), continues to drive much of the regulatory agenda. The Commission’s final report, issued in 2019, made 76 recommendations for reform, including 54 for government, 12 for regulators, and 10 for industry participants themselves.

The Commission’s key question was how the industry might serve customers more efficiently, honestly, and fairly—a legal duty for providers stipulated under Section 912A of the 2001 Corporations Act. Commissioner Hayne gave his interpretation of the six-part definition of Section 912A within the Final Report, which an Australian Federal Court judgment summarized in one brief principle of conduct — “be fair.”

After reforms were delayed to deal with the coronavirus pandemic, Treasurer Josh Frydenberg introduced a bill to legislate the government’s response to 20 Hayne recommendations in November 2020. Frydenberg said that this bill was another “major step forward in completing the implementation of the Hayne Royal Commission.”

Yet some have criticized Frydenberg, and the government, for how slowly they have carried out called-for reforms. As of January 2020, only 27 of the 76 recommendations had been implemented, and four had been abandoned entirely. A year later, in January 2021, 44 recommendations had still yet to be implemented. Some have come to fear that the scandals which led to the Commission’s inquiry are being wholly forgotten as regulators, firms and the public attend to the more immediate imperatives of Covid-response needs.

In a speech to the Committee for the Economic Development of Australia, Australian Prudential Regulation Authority (APRA) Chair Wayne Byres stated that, while public attention on governance, culture, remuneration and accountability (GCRA) issues may have waned since the Hayne Commission, they are still a focal point of APRA’s work: “Our GCRA initiatives, however, didn’t stop, and we remain of the view that systemic weaknesses in GCRA are often the root cause of problems that crystallise into significant, unexpected and damaging financial losses.”

Signs of tensions between the desire for greater regulatory oversight and supporting a healthy business environment are starting to show. The first recommendation appearing in the Commission’s final report was that responsible lending laws should not be changed or eased.

However, Treasurer Frydenberg announced in September 2020 that the government would scrap those laws, originally introduced in 2009 in response to the global financial crisis – ostensibly to place continued focus on stimulating credit creation to support the economy. Critics argue that this move is driven by political opportunism, using the coronavirus pandemic to justify a more business-friendly posture at the expense of consumers.

Ms. Bligh responds to such criticism: “One of the unfortunate things in the debate ... is this emerging view that if you take out of the provision [of responsible lending] ... that somehow the industry is about to be completely and utterly deregulated in this area.” Bligh added that, while the penalty regime will change, APRA will retain its teeth and continue to be well placed to ensure that banks treat consumers fairly.
The Australian banking industry maintains that the stricter lending rules, lifted by Frydenberg, would have restricted necessary business activity during a significant downturn, and argue that banks are already subject to sufficient oversight.618

With these new changes, bank and most non-bank lenders will be overseen by APRA, under its less strict lending rules. ASIC will continue to oversee payday lenders, with some bolstered rules to protect vulnerable borrowers.619

This situation exemplifies a predicament in which Australian regulators often find themselves. On one hand, the regulators are criticized for not being tough enough. The Hayne Commission, for example, accused ASIC of being reluctant to enforce regulations, thus enabling an excessively risk-seeking culture in the industry, however inadvertently.620 ASIC has also been criticized for its lax oversight of the derivatives sector.621 But when ASIC took these observation to heart, and sought to build out a more comprehensive regulatory framework, they were then accused of regulatory overreach that was stifling economic recovery.622 These criticisms were amplified by multiple failures to litigate conduct cases, such as the directors’ duties case against CommBank.623

The Morrison government is also working to establish a Financial Regulator Assessment Authority, an organization with the goal of assessing the effectiveness of ASIC and APRA.625 While this new body would not have any authority to assess the regulator’s specific actions, it will have the ability to judge how they are discharging their mandates.

COMPLIANCE FAILURES

In spite of this tension, regulators brought forward a number of significant punitive actions in 2020. Westpac Banking Corp, Australia’s second-largest bank, settled with the Australian Transaction Reports and Analysis Centre (AUSTRAC), agreeing to pay a $920 million fine in 2020 for their failings to properly report 19.5 million international transactions, breaching money-laundering and anti-terrorist financing laws.626 This fine came just two years after the Commonwealth Bank of Australia, the country’s largest bank, was fined $532 million, the largest civil settlement ever at the time, for breaking anti-money-laundering and counter-terrorism laws.627 APRA dropped its own investigation into these allegations in March 2021.628

At its penalty hearing, Westpac was criticized by regulators for its compliance failures. At this hearing, AUSTRAC lawyer Wendy Harris said, “if your risk assessment processes are not robust ... if your due diligence assessments are not adequate, then you are failing in your role in a pretty major way.”629 Some have argued that the fine marked a turning point: AUSTRAC was able to levy a fine large enough to cut into Westpac’s profits and hurt shareholders, and so the executives are being held accountable and some have already been forced out.630

Another of the major Australian banks, National Australia Bank (NAB), confessed to breaking the law thousands of times in a “fees for no service” case which leaves them exposed to a financial penalty of more than $100 million. The bank admitted to several thousand of the 10,000 allegations initially laid out by AUSTRAC. In a related statement, ASIC said that “NAB’s systems and controls were defective and not reasonably adequate to prevent the FFNS Conduct, the No FDS Conduct or the Prohibited Charging.”631 This admission came a few months after NAB announced it was hiring FINSIA to professionalize all 34,000 of its employees p. 185.632 Notably, this is the second fees-for-no-service charge brought against NAB in the past year. In September, Australia’s federal court fined NAB $41 million for charging fees with no service to thousands of retirees in the course of its pension fund management activities.633

In 2018, following a series of highly public misconduct scandals at Australia’s largest bank, Commonwealth Bank of Australia (CBA), APRA found deficiencies in
In Focus
Professionalism in Australia’s banking & finance industry

By CHRIS WHITEHEAD and DENNIS GENTILIN

For a variety of reasons, professionalism has never been formally instituted in the Australian banking industry. This is not to suggest that bankers over the years have not viewed themselves as professionals. Rather, the formal structures that underpin and support professionalism have never been put in place. When they have, the approach has been piecemeal. Without these structures, the full benefits that professionalism can deliver are never realised.

And the benefits associated with professionalism can be significant. Properly instituted it can reduce the burden of regulation and government oversight, improve consumer outcomes, and enhance the reputation of the industry and its practitioners. Over time, the trust this elicits drives enormous benefits, both economic and social.

For obvious reasons, conduct has become a prominent issue for the banking and finance industry in Australia. It is our belief that professionalism has a role to play in helping address this issue. But for this to happen, all of the formal structures associated with professionalism must be instituted. To understand what these structures are and what the banking industry needs to do, a brief history of professionalism in Australia is required to provide the necessary context.

A brief history

In Australia, a statutory scheme has been developed that enables professions to be accredited. The genesis for the scheme can be traced back to the 1960s when a precedent was established that enabled statements containing advice, information, or opinions to be deemed negligent. Although this did not cause too many concerns initially, as the size of the damages awarded grew, so too did the cost of insurance and the viability of many practitioners.

New South Wales (NSW) was the first state to pass legislation to address this potential crisis. The Professional Standards Act (1994) was passed in late 1994 and came into force in May 1995. The Act created the Professional Standards Council (PSC), an independent statutory body whose role it is to work with professional associations to ensure they have the processes and systems in place required to be recognised as a profession.

These requirements are documented in a Professional Standards Scheme, “legal instruments that bind associations to monitor, enforce and improve the professional standards of their members, and protect consumers of professional services.” By abiding to
the tenets of the scheme, a professional association can limit the amount of damages its members might be liable for.

At the turn of the century the Commonwealth Government passed legislation that established a PSC in each state. Their role is to administer the legislation and work with approved professional associations (of which there are currently 17) to ensure they adhere to their Professional Standard Schemes. The PSC has developed a model for professionalism that provides professional associations with guidance on what is required to do this successfully.

What is required to be a profession?

According to Australia’s PSC, “a good profession has demonstrated a capacity for self-regulation and consumer protection.” For this to occur, a range of formal processes, practices, and structures must be in place to support these outcomes. To capture these, the PSC has developed a reference model that describes a total of 40 elements that need to be in place if a body of practitioners would like to declare themselves to be a profession.

For industries and practitioners on a journey towards professionalism (or considering embarking on one), the PSC has also developed a simpler, less prescriptive model. Known as the “5Es” model (for reasons that shall become obvious), the model provides a high-level description of the five core elements that must be in place to support professionalism. These are:

**Ethics**: The declared professional and ethical standards to which practitioners in the industry commit to holding themselves accountable to.

**Education**: The technical and professional requirements an individual must have to be a practitioner in the industry (both entry-level qualifications and continuing education).

**Experience**: The personal capabilities, competencies and expectations of experience required to practice as a professional in the industry.

**Examination**: The methods employed to ensure practitioners adhere to the ethical, education and experience standards (above), and are held accountable when they fail to do so.

**Entity**: A central entity that registers practitioners, administers a disciplinary scheme, and provides the community with confidence that individuals in the industry are committed to a higher duty of care and conduct themselves with the utmost level of probity.

The overarching point of the models developed by the PSC is that professionalism is not just about standards. Nor is it just about education. Or registration to an entity. Rather, it is a combination of processes, practices and structures that come together to create a system that promotes ethical conduct and adherence to higher standards.

An industry or group of practitioners cannot claim to be a profession if only a subset of the elements are in place. By putting them in place, it is possible to create an environment where the professionals within an industry are accountable to themselves and their peers. They become a community of practitioners who take pride in their profession and work hard collectively to safeguard its reputation. As we like to say, you do not have professional firms, you have firms of professionals.
Professionalism in Australia’s banking industry

For the banking and finance industry in Australia, the preceding sections provide important background and context. As mentioned in the introduction, professionalism can deliver significant benefits to the industry. And even if accreditation with the PSC is not the end goal, the models the PSC have developed provide a blueprint for what is required if the industry wishes to embark on a journey towards professionalism.

FINSIA, the not-for-profit professional membership body for financial services with which we are associated, is proud to be playing an important role in this journey. Indeed, professionalism is core to FINSIA’s heritage. Its roots can be traced back to 1886 when the Bankers Institute of Victoria was founded. One of the key objectives of that association was to drive improvements in professional practice within the industry. We have been going at it for a long time!

Unfortunately, for organisations like FINSIA, professionalism has been deprioritised over the past 30 years. Industry and market trends have resulted in automation, efficiency and short-term returns taking precedence over good stewardship. However, recent conduct failures have caused the pendulum to swing, and an appetite for professionalism has returned to the fore. True to its origins, FINSIA has been playing an important role in aiding this momentum shift.

To illustrate, FINSIA recently developed a series of professional qualifications that target bankers at different levels of experience. One of these, Professional Banking Fundamentals, provides baseline knowledge for anyone working in or entering the industry. Another, Certified Professional Banker, deepens knowledge in specific domains of banking and helps practitioners enhance their strategic and ethical judgement.

We are pleased to say that take up of these education opportunities has been promising. A number of institutions have committed to putting all of their staff through the Professional Banking Fundamentals course, including one of the four major banks. As at March 2021, 5,046 practitioners across Australia have enrolled in this baseline course.

Recently, FINSIA has kicked off a project to develop draft professional standards for practitioners working in the retail and business banking sector of the industry. The draft standards were made public in March 2020 and, after a period of consultation with practitioners and other interested stakeholders, they will be formalised by the end of the 2021 calendar year.

Over time, there is the potential for these initiatives to form part of a group of baseline prerequisites required to work in the industry. If they are complimented with some form of probationary employment period, a formal registration system, and mechanisms that recognise the benefits that different levels of experience bring to the industry, combined these measures will go a long way towards covering the education, ethics, and experience components of the 5Es model.

This leaves examination and entity. These are arguably the most difficult elements of professionalism to implement. Nobody enjoys being subject to scrutiny and accountability. And establishing an entity that administers and overseeing all of the work associated with professionalism requires significant investment. However, for reasons highlighted above, an industry can’t claim to be truly...
professional (or reap the benefits that come with professionalism) without putting these building blocks in place.

The case might be that FINSIA is not the most appropriate body to deliver all of the benefits associated with professionalism. For example, it might best act as an entity through which practitioners are registered and provided with continuing education. Examination and ongoing maintenance of professional standards would require a degree of independence that, without appropriate safeguards, FINSIA is unable to provide. Whatever the case, we stand prepared to play a role – our purpose demands that we do so.

**Conclusion**

Professionalism has the potential to deliver enormous benefits to the banking and finance industry. Among other things, it can ease legislative and regulatory burdens, contribute to improved customer outcomes, enhance the industry’s reputation, and create a sense of pride and belonging among practitioners. It is when a community of professionals is successfully established and committed to higher standards that greater self-regulation becomes a real possibility.

To obtain these benefits an industry cannot pretend to strive for professionalism by applying band aid solutions – it must be instituted properly. For this to occur, all the elements associated with professionalism must be put in place to create a system that promotes ethical conduct and a culture that sustains it. FINSIA is proud to be playing a role in this work and, with the industry’s support, continuing to do so.

*Chris Whitehead is the CEO of FINSIA*

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CBA’s non-financial risk management. To rectify this, the regulator imposed a A$1 billion add-on to CBA’s operational risk capital requirement and approved a Remedial Action Plan for CBA to carry out and report on its progress. As of November 2020, CBA was found to have made strides in improving its non-financial risk management, but still had a ways to go in order to have the add-on removed fully. APRA halved the capital requirement, keeping the remaining $500 million add-on in place until CBA has fully implemented its Remedial Action Plan and adequately addresses all of the recommendations APRA set forth in 2018.

Though, in April 2021, CBA was sued for overcharging customers $55 million. ASIC announced the action against CBA, saying it had wrongly charged groups including pensioners and full-time students. In the announcement, ASIC wrote, “ASIC commenced this proceeding because financial institutions need to have robust compliance systems to meet their obligations to customers. Financial institutions need to put customers first, and customers should have confidence that the banks they deal with charge fees correctly.”

As of the end of 2020, Australian banks had paid A$1.22 billion in compensation to clients for advice-related misconduct, such as non-compliant advice and charging fees for no service, according to ASIC.

ANZ senior executive Richard Moscati was charged with forming a cartel to manipulate the bank’s share price in February 2021, alongside six other bankers. ANZ is now facing criminal charges for aiding and abetting the violation of these laws. Citigroup and Deutsche Bank are also facing charges for their own alleged involvement in the scheme.

In addition to issuing sanctions for rule violations, regulators in Australia have been pressing firms to implement more robust culture and conduct frameworks in an effort to mitigate potential future harm. APRA called Westpac’s non-financial risk culture “immature and reactive” after a culture reassessment demanded by the regulator identified ongoing issues, many of which had not changed since APRA’s first culture assessment exercise, in 2018. With this, Westpac was forced to launch a program to fix its risk culture and improve its management of non-financial risk.

APRA hit Westpac with an additional penalty in late 2020, requiring that it hold an additional 10% cash on hand until it has completed an independent review of its liquidity risk management. The regulator also agreed to a court-enforceable undertaking from Westpac, which pledged to improve its risk governance framework. Announcing this action, APRA wrote, “Westpac has failed to deliver the expected risk governance improvements despite almost two years of remediation. This has undermined APRA’s confidence in Westpac’s ability to remediate these weaknesses in a timely manner.” Some have said that this demonstrates a new strategy for APRA, favoring public disclosure over formal enforcement actions as a means of driving desired outcomes.

In the announcement of this undertaking, APRA Deputy Chair John Lonsdale commented, “As one of the country’s largest and most important financial institutions, Westpac should be a leader in risk management. Although the bank has made progress in some areas over the past year, it is not good enough. We continue to observe new prudential issues arising while long-standing weaknesses persist, and we believe Westpac’s governance, culture and accountability frameworks and practices are still in need of a substantial uplift.”

An investigation into the money laundering operations of cartels found that 16 financial institutions in Australia were unknowingly used to launder A$500 million from 2014 to 2017. This seemed to demonstrate an industry-wide deficiency in AML/CTF operations, and is potentially an opportunity for the country to integrate new regtech and AI/ML applications.
The Hayne Commission has also led to a number of investigations and regulatory actions since its completion. In total, ASIC’s royal commission-related investigations have resulted in nearly $78 million in fines.  

**AUDIT REFORMS**

Regulators and legislators in Australia have also worked in the past year to hold external auditors more accountable for the quality of their work. A parliamentary committee has recommended a change that would require companies to justify long-standing relationships with their auditors. A 10-year audit tendering rule is designed to limit the long-term relationships auditors and companies tend to form, which some see to be overly “cozy.” The committee made a few other recommendations aimed at improved audit quality, such as requiring companies to disclose audit firm tenure in financial reports, and revising the ASIC’s audit inspection regime, discussed in detail in the ASIC subsection that follows below.

The Institute of Internal Auditors (IIA) in Australia published a Better Practice Guide for internal auditors of financial institutions, sometimes referred to as the “Fourth Line of Defense.” In this guide, the IIA laid out 32 recommendations surrounding the following six principles: position internal audit for success, ensure adequate resourcing and seniority, provide assurance which adds value, employ appropriate methods and tools, report to influence positive change, and adopt appropriate risk culture auditing methodologies.

In the past year, some have suggested that Australia is facing a culture crisis, evidenced by overly frequent misconduct scandals and the removal of major company CEOs in recent history. Many note that, while there are standards for reporting all sorts of financial data, there are no such standards for reporting on culture, which has a proven history of impacting the material outcomes of firms.

**REMOTE WORK AND REGTECH**

The Reserve Bank of Australia (RBA) warned companies that they must take care to monitor culture as their staff worked with customers facing financial difficulties during the recession. In its Annual Financial Stability Report, the RBA wrote, “Appropriate culture will be especially important as banks face the challenging task of dealing with customers’ loan repayment deferrals and responding more broadly to the economic contraction.”

As is seen throughout this report, the coronavirus pandemic has increased conduct risks for firms in every industry. Remote working, burnout, and unmonitored communication channels have all presented new or increased challenges for firms to deal with. This increased risk exposure is made even more complicated by the decrease in supervisory activity while regulators dealt with the pandemic and the recessionary pressures it caused. This lull in regulatory activity may have inadvertently facilitated complacency at some firms, leaving them exposed to significant potential future action.

Standing Committee on Economics Chair Tim Wilson argued that the risks introduced by the coronavirus pandemic necessitate stronger regulation: “Now, more than ever, it is essential to maintain strong prudential regulation; promote competition; and ensure fair and transparent dealings to safeguard financial stability and consumer trust in the financial sector.”

The Australian government has begun to embrace new Regtech innovations as a means to improve consumer outcomes and risk management in the financial sector. The Productivity Commission, an advisory body under Australia’s Treasury that provides independent analysis and advice to governments, released a report that described the potential benefits that Regtech solutions could bring to the economy more broadly, and made the case for additional support from regulators and policymakers to encourage adoption.
The report lists four key areas where regtech solutions may be especially beneficial: where technology can unlock more data for regulatory compliance, where it can help companies respond more effectively to the current work-from-home environment, where risk-based regulation can be adopted, and where regulated entities face complex regulatory requirements.653

While these advanced regtech solutions may take a lot of time and resources to implement, the Productivity Commission believes they are worth the investment. The report suggests that regulators open up communication and collaboration between regulated entities, regtech providers, and the regulators themselves to facilitate development. These efforts will create a safe environment to develop and test regtech solutions like those in the report.654

Many regtech companies have said that this paper, and the Productivity Commission’s focus on regulatory technology, will help accelerate the adoption of new approaches. The system outlined in the report would help to break down the silos between regulators, banks, and technology providers that have traditionally slowed adoption.655

Bain Consulting Group, alongside the RegTech Association, released a report detailing the regulatory technology landscape in Australia, in October 2020. The first finding of the report was that Australia is the third-largest hub for regtech in the world, housing over 10 percent of all regtech companies. The report also found that, while local, risk-averse markets may be impeding funding for regtech companies, there are still opportunities to grow.656

Increased conduct and cybersecurity risks presented by the work-from-home environment and digital operations have created the impetus for companies to more quickly adopt regtech. This increased demand is coupled with governmental support for regtech which will create a prime environment for the sector to grow.657

In order to see this growth through, the report laid out four pillars to help close the funding gap for local regtech companies. These four pillars are: driving demand for regtech services, facilitating access to funding, enhancing regulatory frameworks to support innovation, and promoting development of regtech skills to improve the talent pool.658

And the Australian Senate has also gotten into the act, forming a senate committee on fintech and regtech in November 2019.659 In September 2020, the committee released its interim report making 32 recommendations which Senator Andrew Bragg, the committee’s chair, termed “a series of quick wins.”660 The committee announced two months later that it would be delving even deeper into its probe, and would deliver a final report on the subject in April 2021.661

Some believe that Australia is well-poised to become a fintech and regtech center in the Asian-Pacific. Senator Bragg has argued that Australia must continue to embrace technology and create jobs to remain globally competitive: “Australia should continue developing as a leading Asia-Pacific fintech nation, especially as Hong Kong declines as a financial centre.”

### Australian Securities and Investments Commission

#### REGULATOR UNDER SCRUTINY

In an August 2020 speech entitled “Regulation, Trust and Social License”, ASIC Chair James Shipton stated that regulators must be concerned with catalyzing trust in financial institutions while building confidence in their regulatory institutions.662 Shipton explained that the current trust
levels in government and business in Australia are low, 41% and 50% respectively, which inhibits the institutions’ ability to operate.

Two months after Shipton gave the above speech, an investigation began into $180,000 in payments made by ASIC to cover the cost of managing Shipton’s tax affairs and rental fees for his deputy chair Daniel Crennan. In both instances, the costs were related to their relocation to Sydney to take up their ASIC roles, and though both felt that they had acted consistently with ASIC’s expectations, both have nevertheless opted to repay the monies personally.

When the payments issue became a public matter, provoking outcry among some, Crennan resigned immediately and has since set up his own consulting firm. ASIC Commissioner Karen Chester admitted that ASIC acted at a ‘glacial pace’ in dealing with the rent payments for Daniel Crennan, after questions had been raised by the Australian National Audit Office in 2019.

Shipton opted to step aside, pending the outcome of an internal investigation, and though the inquiry established that neither Shipton and Crennan had done wrong, Treasurer Frydenberg nevertheless accepted Shipton’s resignation, which would take effect after three months during which Shipton would work to facilitate transition to a suitable successor.

Shipton has since done his best to make the transition a smooth one, but the road ahead for ASIC is quite uncertain. Treasurer Frydenberg is planning to reorganize the regulator, hoping to set it on a path to chasing misconduct, rather than “straying” into policymaking. Meanwhile, ASIC has come under further criticism for paying more than A$1.5 million for psychological assessments and leadership gurus in the last two years.

CALLS FOR RESTRUCTURING

Former Australian Competition and Consumer Commission Chairman Graeme Samuel has called for the regulator to be restructured, suggesting that the role of chairman and chief executive be split rather than one position covering both responsibility sets. Others have called for even larger changes, such as splitting the agency into three discrete divisions, all of which would report to a single ASIC head who, in turn, would report to a board of governors.

No matter how the government decides to restructure the regulator, the first step was to determine who will run it when Shipton steps down, and this is not an easy role for which to recruit. Not only does the ASIC leader have to understand the law, s/he also must have strong management skills, and be able to stand up to the banks and government when necessary and appropriate.

In April 2021, ASIC announced that Joseph Longo, a corporate lawyer, would replace Shipton as head of the regulatory agency, with a new deputy chair, Australian Competition and Consumer Commission commissioner Sarah Court. Treasurer Frydenberg said, “ASIC will benefit from their understanding of regulatory settings, insight into business and their strong leadership.”

MOVING FORWARD

In a keynote address at the Australian Financial Review Banking & Wealth Summit, Commissioner Chester said, “At ASIC we recognise that this is a time of a potential ‘new better’ for regulators and for business – where boards step in early and step up decisively to manage both financial and non-financial risk. And with that ‘step in and step up’ by business, ASIC can step back. To only intervene when the data (early warning signs) of harm and misconduct require us to do so.” This outline seems to imply that ASIC is putting more responsibility on regulated entities to step up and handle all sorts of risk in their businesses.
ASIC has taken the lead in facilitating innovation in fintech and regtech in recent years. In 2019, it implemented a new policy requiring banks to explain why they have not adopted these latest technologies in an effort to improve compliance and risk governance, when they are slow to do so, rather than just conveying vague plans to do so in some undefined future.675

In a presentation titled “ASIC’s regtech initiatives 2019–20,” ASIC summarized its activity in supporting regtech and suptech innovation in the 2019-2020 financial year and laid out its plans to continue to do so in the 2020-2021 financial year.676 After their initiatives in 2020, ASIC concluded that regtech has a vital role to play in the financial services industry because of the monetary, time, and manpower efficiencies it provides. However, laws must be modernised to recognize differences in outcomes in a digital and remote environment.

In its 2020-2024 corporate plan, ASIC lays out the actions it plans to take over the next few years. These plans include supporting regtech and suptech through its innovation hub, promoting regtech to improve compliance and customer outcomes, and conducting targeted reviews of companies’ governance to assess culture, governance, and risk management shortcomings, among many other activities.677

The conduct regulator has pinpointed underinvestment in data and technology as a key root cause of breaches in many cases. ASIC Commissioner Sean Hughes said, “Given the year that we have had, I do not say this lightly: investment in getting data and systems right is essential. And it is overdue.”678

With the discontinuation of the London Interbank Offered Rate (LIBOR) at the end of 2021, ASIC issued guidance on how firms can manage conduct risk during this transition period.679 This is potentially an area where regtech might have impact.

ASIC released its Audit Inspection Report in December 2020 in which it presented the results of its July 2019 to June 2020 review of audit firms. The review found that auditors failed to obtain “reasonable assurance” that the financial statements were free of “material misstatement.” The report also shows that, overall, the audit inspection uncovered more adverse findings than in the previous two review periods.680 Audit quality and the role of auditors in discovering fraud at firms are other areas where new technologies may be valuable.

Under ASIC’s new whistleblower rules, individuals who engage with others in financial crime, such as market fixing, insider trading, or other dishonest conduct, can receive immunity if they report the misconduct to ASIC before the regulator begins its own investigation. While this does not include immunity from administrative or monetary sanctions, ASIC will take the individual’s cooperation into account when considering those actions.681

Australian Prudential Regulation Authority

CULTURE AND CONDUCT SUPERVISION

During the 2020 Forum of the Risk Management Association, APRA Chair Wayne Byres said, “If ever there was a year when risk managers proved their worth, this was it.”682

Byres also remarked, “But the people-related risks from the extended period of disruption are very real. They will impact organisational performance, operational controls, and risk culture – all critical to good risk management and organisational resilience. So to perhaps state the obvious, as risk managers you need to very much have them in your sights.”683
APRA’s supervisory philosophy has been self-described as risk-based, forward-looking, and outcome-focused. These attributes are at the heart of APRA’s drive for “supervisory excellence.”\textsuperscript{684}

This is reflected in APRA’s 2020-2024 corporate plan which states that its long-term aspiration for community outcomes include: maintaining the resilience of the financial system; improving superannuation outcomes; transforming governance, culture, remuneration, and accountability (GCRA); and improving cyber resilience.\textsuperscript{685}

To improve GCRA across its regulated institutions, APRA plans to assess trends in risk culture across institutions. It will actively seek to drive improvement in GCRA at large institutions by undertaking culture “deep dives” and prudential engagements in the short term. In the long term, APRA plans to overhaul risk governance practices using the results of its assessments at the large institutions, and to inspect institutions for deficiencies in the management of GCRA risks.\textsuperscript{686}

In APRA’s policy and supervision priorities for 2021, the regulator stated that it plans on “updating prudential standards on operational risk, governance and risk management, and consulting with industry on guidance for climate change-related financial risk.” This includes plans to increase supervision of firms’ cybersecurity capabilities, to conduct a risk culture survey, and to work to close further identified risk governance issues.\textsuperscript{687}

APRA has launched a supervisory regime dedicated to non-financial risk for banks, insurers, and pension funds. This regime comes as an update to the regulator’s current risk-assessment model, which assigns a score to regulated entities based on a variety of financial and non-financial factors.\textsuperscript{688}

APRA revealed its new supervisory framework – the Supervision Risk and Intensity (SRI) model, for banks, insurers, and superannuation funds – in October 2020. This confidential rating system serves as a replacement for its previous, 15-year old supervisory framework.\textsuperscript{689} The SRI ranks participating firms by size and gives them a grade for risk, after which the firms will be designated as having achieved a “stage” in its maturity, ranging from 1 to 5, where 1 indicates adequate routine supervision of relevant risks while a stage 5 designation implies an entities position is not viable and resolution is called for, to include restructuring and dissolution. The new rating system expressly includes a focus on non-financial risk concerns, to include operational resilience, culture, and governance.\textsuperscript{690}

APRA also announced that it would engage more frequently with the Australian Competition and Consumer Commission (ACCC). This shows the regulators’ focus on how conduct drives customer outcomes, and how misconduct affects consumers.\textsuperscript{691}

**INDIVIDUAL ACCOUNTABILITY**

There have been a rash of corporate governance scandals in Australia in the past year. Rio Tinto, a major mining company, announced that its CEO and two other executives would be departing in the wake of the company’s decision to destroy a 46,000 year-old aboriginal site.\textsuperscript{692} Investment manager AMP saw A$2.1 billion in outflows after promoting an employee who had previously been fined for sexual harassment to lead the company.\textsuperscript{693} Insure Allianz Australia entered into an enforceable agreement with APRA to improve its culture, risk management, and compliance.\textsuperscript{694} All of these scandals, while in totally separate industries, have put wind behind relevant efforts in the banking industry.

As Dr. John Laker, former APRA Chairman, stated that “transforming culture is not a short-term project; it requires time, leadership, tenacity and ... courage.” He goes on to describe the task as “a journey, not a destination.” As reflected elsewhere in this report,
the task of reforming culture could be considered a “wicked problem” and addressing them effectively involves an “infinite game” ▷ P. 221.

APRA has taken steps in the previous year to address this wicked problem, and try to improve culture in financial services firms by encouraging individual accountability among executives and senior managers.

For example, APRA is requiring that firms place, “material weight” on non-financial performance metrics, such as diversity, risk, or conduct when considering an executive’s remuneration. While this is a more lenient policy than the initially proposed 50% cap on financial performance criteria for bonuses, it still requires that firms take more than just financial outcomes into account for executive compensation.\

APRA also continued efforts to hold senior executives individually accountable in 2020. The regulator released a paper detailing the conclusions of its review of the Banking Executive Accountability Regime (BEAR). This review was completed at three of Australia’s largest banks: ANZ, CBA, and NAB. While APRA found that all three banks had designed adequate frameworks for the implementation of BEAR, the report identifies several areas where improvements could be made.

The review found that the banks could benefit from improving their monitoring of accountable persons in fulfilling their accountability obligations. The report also lays out better practices that other banks might use to improve their own implementation of the BEAR, to more clearly define accountabilities and implementing new remuneration frameworks that serve to reinforce accountability decisions.

Research by Macquarie University has shown that the BEAR has been effective at improving bankers’ diligence. Macquarie professor Elizabeth Sheedy said, “The BEAR has undoubtedly brought a greater clarity about who is accountable for what. It is a big commitment, but if you are going to earn the big bucks and take on senior roles, most people in the country would say you have to have the skills and be able to handle the pressure.”

It is expected that the Financial Accountability Regime, discussed at some length in last year’s issue of this annual report, will be passed in 2021. This regime will absorb the BEAR and supplant it to expand the reach of the requirements. With APRA, ASIC will become co-regulator of the FAR.

AUSTRALIAN TRANSACTION REPORTS AND ANALYSIS CENTRE (AUSTRAC)

In its 2019-2020 Annual Report, Austrac writes that one of its primary objectives is to “build and maintain trust and integrity in Australia’s financial system as part of the global community.” It works to achieve this goal, along with its other objectives, using regulation and financial intelligence. These two pillars of its strategy are designed to work together so as to help improve the resilience of the financial sector.

One of the ways that Austrac encourages institutions to meet their obligations with regards to anti-money laundering and combating the financing of terrorism (AML/CFT) is to engage with regtech companies. The regulator has issued guidance both for how regtech firms should engage with financial institutions, and how financial institutions should work with regtechs.

Austrac expects regtech businesses to understand the requirements of Australia’s AML/CFT regulations, to analyze the gaps in their clients’ implementation of these guidelines, and be able to explain clearly how their solutions will help to fill those gaps. On the other hand, Austrac encourages institutions to be knowledgeable regarding their own systems,
to understand their AML/CFT obligations, and how newly trialed solutions may be implemented so as to meet them.\textsuperscript{705}

AUSTRAC announced in November 2020 that it was preparing as many as 10 risk assessments including some tailored to financial institutions.\textsuperscript{706}

**New Zealand**

**INDUSTRY AND REGULATORY BACKGROUND**

In November 2018, the Reserve Bank of New Zealand (RBNZ) and the country’s Financial Markets Authority (FMA) released a report titled “Bank Conduct and Culture.” In the wake of misconduct scandals brought to light by the Hayne Commission in neighboring Australia, the central bank and regulator reviewed New Zealand’s 11 largest banks in order to identify any culture or conduct related risks may be lurking in the sector locally.\textsuperscript{707} The results of that review are discussed in detail in the 2019 edition of this report.

In her remarks at the 16th Annual Financial Markets Law Conference in October 2020, RBNZ Assistant Governor Simone Robbers said, “We are pleased to see that banks are taking on board our recommendations from the Bank Conduct and Culture Review that we conducted with the FMA in 2018.”\textsuperscript{708}

Like most financial markets, New Zealand has seen serious cases of misconduct in the financial sector. In June 2020, the FMA filed court proceedings against ANZ New Zealand (ANZ) for misleading representations in supplying credit card repayment insurance to bank customers, in violation of the Financial Markets Conduct Act 2013.\textsuperscript{709} In February 2021, ANZ admitted to these charges.\textsuperscript{710}

After admitting fault, ANZ was ordered to pay AUD $260 thousand by the High Court in Auckland. In response to the fine, FMA Head of Enforcement Karen Chang said, “We have talked consistently about the risks of consumer harm when firms fail to maintain appropriate systems to manage conduct risk.”\textsuperscript{711} This is not the first time that ANZ has faced penalties for employee misconduct in recent years.

Indeed, in May 2019, the RBNZ revoked ANZ’s accreditation to model its own operational risk capital requirement due persistent failures in its controls and attestation process.\textsuperscript{712} In a separate controversy, the firm’s New Zealand CEO was forced to resign over large expense claims, of which the board had not been made aware, and the sale of a bank property to his wife for a below-market price.\textsuperscript{713}

In order to hold financial institutions accountable for their employees’ conduct more effectively, New Zealand is looking to amend the Financial Markets Conduct Act 2013. The proposed amendment would require banks, insurers and non-bank deposit takers to be licensed in their general conduct toward retail customers and prohibits incentives based on value and volume of sales. The FMA would monitor and enforce this regime.\textsuperscript{714} Some have criticized this law, stating that it does not go far enough, citing that the bill still allows institutions to offer remuneration and incentives which are not linked to sales.\textsuperscript{715}

The RBNZ also established a standalone enforcement department in April 2021. The department, which will now be separate from the supervision department, will establish a framework to oversee enforcement actions taken for serious or repeated violations. BNZ Deputy Governor Geoff Bascand said, “The Enforcement Department will support the bank’s more intensive supervisory and enforcement approach and help the bank promote a sound and efficient financial system built on integrity, innovation and inclusion.”\textsuperscript{716}

As in most countries, over the last year New Zealand has emphasized ESG considerations as they may touch on the financial sector. For instance, the Sustainable Finance Forum (SFF), an association of prominent financial industry figures and firms,
In Focus
Addressing the Blind Spots: Raising Conduct Risk Maturity in New Zealand

By CLARE BOLINGFORD

New Zealand banking regulation has been focussed largely on prudential standards and has lagged other jurisdictions on conduct legislation, until now.

For instance, the main focus of the Financial Markets Conduct Act 2013 (FMCA) was on the effective operation of capital markets and on investment-related activity. The FMCA was recently amended to introduce a modernised financial advice regime, and further amendments are passing through Parliament to establish a conduct regime for banks, insurers and non-bank deposit takers. The Financial Markets Authority (FMA) will be responsible for the implementation of these regimes.

We see this as an opportunity to work with the industry to build trust and confidence in New Zealand financial services.

Although this legislation itself has not yet passed, the FMA has been proactively influencing good conduct management practices for many years. In early 2017, we published our guide to the FMA’s view of conduct, describing why good conduct matters and how high standards of conduct support fair and efficient financial services.

As more sectors come within our culture and conduct framework, we have been reflecting on how ‘blind spots’ may have contributed to the resistance of some parts of industry to embrace good conduct practices.

BLIND SPOT #1: We don’t need conduct regulation – we already do the right thing

Within a jurisdiction more accustomed to rules-based regulation, we initially received feedback that our conduct guidance could be overstepping our legislative remit. And although the debate in New Zealand has moved on significantly from then, there are still some who do not agree that new conduct regulation is required.

Late in 2017, the Australian Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was established. As the biggest New Zealand banks are Australian-owned, questions were asked about whether similar misconduct was occurring here. There were calls for a similar commission to be established to investigate activities in New Zealand.

In response, the FMA and the Reserve Bank of New Zealand (RBNZ - the prudential supervisor and licensing agency for banks and insurers) agreed with the Government that a more proportionate response would be to conduct a joint review of culture and conduct within the retail banks and life insurers. The findings from this review were published at the end of 2018 and did not find egregious misconduct. They did, however, identify significant weaknesses in the governance and management of conduct risks which could have led to widespread harms over
time. Banks lacked proactivity and had been slow to address culture and conduct issues. The report made a number of recommendations, including the introduction of a direct legislative mandate for regulating the conduct of providers of core retail banking and insurance services.

At the same time, the FMA conducted a review on how banks incentivise frontline salespeople and their managers. It identified that incentives were highly sales focused, creating a high risk of inappropriate sales practices occurring. The review also found that the controls to mitigate the risk of inappropriate sales appeared to be ineffective. The FMA and RBNZ told banks they expected them to remove incentives linked to sales measures for salespeople and their managers and, in 2019, those banks committed to doing so.

Thus we have demonstrated that progress can be made to promote good conduct before final regulations pass. The FMA has not been restrained in pushing for improvements, and we will continue to maintain the momentum of good progress made.

**BLIND SPOT #2: We invest in our business strategy – our systems and processes will keep up**

The FMA and RBNZ have continued to monitor the progress banks are making to embed improved conduct risk management. Banks’ own reviews of the performance of their products and services have shown that often their systems and processes were not well established to identify and manage post-sales risks over the full lifetime of products. As an example, firms were marketing products with discounted benefits and then not applying those discounts to a number of customer accounts due to manual processing errors. Investment was provided for product development and marketing, but underlying technology and processes have not always kept up.

This is a pattern we have seen repeated, and it is a risk we see increasing in a sector with accelerated digitisation, legacy technology challenges and squeezed margins.

Banks are now more proactive in reviewing their systems, processes and controls, including legacy product sets to determine whether they remain fit for purpose. We have better engagement with firms on their remediation plans where issues have been identified, but more still needs to be done. Inadvertent harm is still harm and banks have some way to go to demonstrate they have minimised risks and will respond quickly to reduce harm when issues are identified.

We were pleased to see many banks increase their customer outreach and support services during the pandemic. Although New Zealand has faced credit risk challenges similar to other jurisdictions, our banks have generally responded very well to significant increases in customer communication and servicing needs, with many increasing their focus on vulnerable customers. Following rapid engagement and feedback from the industry, the members of the New Zealand Council of Financial Regulators delayed some regulatory implementation and relaxed requirements to enable banks to deploy their resources to key areas of customer need.

**BLIND SPOT #3: Our vision is focussed on the customer and we have implemented our compliance programme – we’re finished**

Since our reviews, we have spoken to many firms which have strengthened their vision and purposes statements to drive a more customer-centric culture. This is a good starting point but clear vision statements can only have a limited impact on the
lived culture of the firm. We are concerned when we see leaders with an almost evangelical belief in their customer-focused mission statements who have not invested in sound controls and reporting to manage and understand the actual customer experience.

As regulators we obviously need to ensure that firms comply with the law. But good conduct risk management will not be achieved by a compliance implementation programme alone, because it is about how leaders and employees behave over time. For an industry within a jurisdiction that has been used to a more legalistic approach, this requires a change of mindset and a move from the compliance-led programmes that have been implemented in the past to conduct-led programmes that are better able to monitor the real outcomes of actions.

The sector is in the process of developing new metrics and ways to receive feedback; exploring the role of improved data focused on the customer journey and experience, rather than quantification of financial risks and customer satisfaction scores alone.

The focus of bank leaders should be on identifying and acting on behaviours that produce poor customer outcomes over time – and the implementation of this approach is ultimately an exercise in change management. Unfortunately we have seen firms spending a lot of time and money developing voluminous compliance manuals and processes that fail to deliver much value for their business or their customers. We want to avoid this happening again and our industry engagement programme is being designed to address this shift in focus.

We must also change ourselves. Many of the regulatory tools and processes we use now remain more suitable to a compliance-led regime and we are seeking new ways to monitor good culture and conduct risk management.

Raising conduct risk maturity

One of the benefits of being late to the party on conduct legislation (at least for banking and insurance) is that both the New Zealand banking industry and its regulators can learn from what has worked well in other places. The FMA has begun to signal intentions for how it will approach the implementation of the new regime and what areas we will focus on over time.

We have learned from the UK FCA’s approach – focussing on good customer outcomes, culture, and vulnerable customers – and we would like, in time, to see the introduction of a senior manager’s regime in New Zealand. We have spoken to ASIC in Australia to understand their use of behavioural insights in conduct regulation. And we are watching with interest the progress that MAS in Singapore is making as they incorporate RegTech and SupTech into their approach.

The sector we regulate is changing and will continue to change fundamentally over the course of the next five years. We believe the introduction of a new regime for banking conduct, and the improvements we have seen since our initial review, bring the opportunity to build greater trust and confidence in banks among New Zealanders.

If done well, it is a real opportunity to embed benefits for customers and benefits for the industry at the same time. Our goal is to achieve this through the full suite of regulatory tools available to us, from early and constructive engagement and co-design of solutions, to investigating and enforcing against breaches of the regime.

Clare Bolingford is the Director of Banking and Insurance at the Financial Markets Authority.
released a road map aimed at creating a more sustainable financial system by 2030. The three key themes of this road map are changing mindsets, transforming the financial system, and financing the transformation. In November 2020 it was announced that former Reserve Bank director Bridget Coates would join the SFF’s board as co-chair.

In order to change mindsets, the SFF recommends that institutions account for ESG risks and work to improve governance and accountability. To transform the financial system, the report recommends improving the quality and availability of relevant data, reporting, and disclosures. Lastly, to fund necessary change, the SFF states that prudential regulation should be used to build resilience in connection with environmental risks, and that standards should be developed to encourage ESG investment.

In April 2021, legislation was introduced to the New Zealand parliament which would require financial institutions to collect data on climate risks, and mandate that they report on that data. Commerce and Consumer Affairs Minister James Shaw said, “It is important that every part of New Zealand’s economy is helping us cut emissions and transition to a low carbon future. This legislation ensures that financial organisations disclose and ultimately take action against climate-related risks and opportunities.”

The Financial Markets Authority released its “Supervision Insights” report in September 2020, a review of the regulator’s supervision and monitoring activities from the previous twelve months.

The FMA found that few, if any, steps had been taken to evaluate internal culture and conduct risks at many of the entities which had not been included in the 2018 “Bank Conduct and Culture” review. Many of the weaknesses found among these organizations were similar to the issues found in the 2018 review, including weak culture governance and inadequate customer complaint management.

REFERENCES

In the press release issued at the time of this report, Mr. Everett said, “Trust and confidence in our financial institutions has been tested significantly over recent years and we have made conduct within financial services firms our first priority.” Everett also said, “Good conduct comes from the top. We expect boards and senior leadership to champion customers’ interests, and to demand the systems and processes required to deliver strong governance of these issues.”

Ms. Bolingford has argued that banks and insurers must focus on customer outcomes, internal culture, and internal processes to prove that they are putting customers first:

> What we quite often find is not that there’s an intent to drive poor customer outcomes within firms, but that actually, the systems or processes aren’t there to achieve them. So if you’re thinking about launching a new product or digitalisation, you’ve got to have the systems behind that to ensure the customer outcomes that you expect are actually achieved.

South Africa

REGULATORY BACKGROUND

South Africa’s Financial Sector Conduct Authority (FSCA) received an explicit mandate to regulate culture and conduct under the Financial Sector Regulation Act of 2017, with a specific focus on banking set out in a 2019 statement supporting a new banking Conduct Standard.

The FSCA’s approach to culture and conduct aims at pre-empting emerging risks, within banks and other financial institutions, as well as related risks at an industry level. Such risks will be relayed to the FSCA through a new reporting framework, permitting supervisors to gather and analyze information that reveals conduct risks and identifies related trends at any particular bank. This framework may develop into a more comprehensive market conduct framework over time.

The core of the new conduct standard for banks is a set of ‘Treating Customers Fairly’ outcomes. As part of its consultative approach, the FSCA requested the industry to identify any risks and benefits about which industry participants are especially interested, and to solicit comment on the potential costs of implementing the new standards, before it was made effective.

The pandemic has accelerated the digitalization of financial services as banks were forced in response to early lockdown restrictions to close physical branches and conduct their business digitally. New digital services may expose customers to scams and fraud, especially financially vulnerable customers: The increased scams and fraud incidents can be attributed to the pandemic and its economic impacts. This has created the need for regulators to be agile. The FSCA has prioritized identifying technology solutions that emphasize inclusion and consumer protection, as well as advancing consumer education on the new digital offerings within banks.

CULTURE AND CONDUCT STANDARDS

After the draft Standard was published for consultation purposes, the final “new banking conduct standard” was published in July 2020 and is scheduled to come into full effect by July 2021. The FSCA Head of Supervision for Banks and Payment Providers Sindsiswa Makhubalo stated that the conduct standard is an essential step to improve customer outcomes in the sector:

This is a new regulation that requires all banking institutions to comply with the requirement that their business is conducted in a manner that promotes the fair treatment of customers. What the standard will help us with is that it will assist us, as the FCSA,
to monitor the conduct of banks by ensuring that their customers are central to the development of products, and to the provision of services. Obviously, as I indicated, this is a first step to what we call the Conduct of Financial Institutions Bill, which we are working on at this present moment.729

The Conduct of Financial Institutions Bill, also known as the CoFi Bill, is a piece of legislation initially introduced for comment in 2019 to provide an overarching framework by which the FSCA can regulate the conduct of all financial institutions.730

In the Culture and Governance section of the banking conduct standard, the FSCA requires that banks must conduct their business with integrity, act reasonably, manage their affairs responsibly, avoid conflicts of interest, and conduct business with transparency, among other requirements. Business should also be monitored by systems, processes, and internal controls that focus on compliance and fair customer treatment.731

The standards also include various requirements for product design, governance, advertisements, and fair treatment of customers. In the statement supporting the conduct standard for banks, the FSCA states that they will monitor compliance with the standard using proactive supervision, covering emerging risks within the institutions and systemic risks in the sector.

As we go to print with this year’s report, the incoming FSCA Commissioner, Unathi Kamlana, said that he plans for the regulator to develop better ways to deal with conduct risk and protect consumers more effectively: “Given the sheer number of financial institutions, you need to have a well-designed risk-based framework, which will be informed by market surveillance.”732

Dubai

DUBAI FINANCIAL SERVICES AUTHORITY

The Dubai Financial Services Authority (DFSA) supervises various financial institutions, including entities from the banking, insurance, and wealth management sectors. All firms, including banks, are subject to periodic on-site risk assessments, the frequency of which is determined by the risk profile of the entity. Such inspections will generally include evaluation of the following areas:

- Corporate governance;
- Strategy and business models;
- Financial and operational risks;
- Conduct of business risks to clients and markets; and
- Financial crime risks

CULTURE AND CONDUCT REGULATION

The DFSA has an express mandate to regulate culture and conduct risks for entities providing financial services in or from the Dubai International Financial Centre (DIFC), and conduct risk is one of the three key regulatory priorities set out for 2021 and beyond in DFSA’s 2021-2022 Business Plan.733

In response to Starling’s Survey on Culture and Conduct Regulation and Supervision, Peter Smith, the DFSA’s Managing Director, Head of Strategy, Policy and Risk, explained the regulator’s plans surrounding culture and conduct for the coming year, “We will be introducing new conduct rules on the sale of highly leveraged products to retail customers (e.g., CFD trading). We will be consulting publicly on proposals for a whistleblowing regime; for rules on digital assets (crypto-currencies, etc.); and on the handling of client assets. We also plan to issue a discussion paper...
In Focus
Conduct regulation in a developing country: the case for change

By KATHERINE GIBSON

South Africa is known globally for having an efficiently run, well-regulated and stable financial sector. The enterprise earlier tasked with regulating this robust sector, the Financial Services Board – a non-bank regulator that oversaw both the prudential and market conduct regulation of non-bank financial institutions – was largely successful. This therefore begs the question: why was the Financial Sector Conduct Authority (FSCA) formed in 2018?

The 2008 global financial crisis resulted in a sea-change in financial sector regulation across the world, with a particular focus on conduct regulation. South Africa experienced the crisis from a slightly different perspective, as its financial sector weathered the stability crisis well, reflecting the strong prudential and stability framework already in place. Nevertheless, the role of the financial sector in supporting the South African economy and the country’s citizens was put under review, in particular looking at the conduct and culture of financial institutions.

South Africa is a dichotomous country, characterised by high levels of inequality between the rich and the poor, which has resulted in a sophisticated and modern financial sector existing alongside high levels of economic exclusion among many South Africans.

The South African financial industry is dominated by large and sophisticated financial groups, leading to a highly concentrated formal market sector. Given the country’s history of legislated inequality (through apartheid), there remains relatively low participation in the financial sector among black South Africans. For this and a variety of other reasons, many South Africans remain excluded from the formal sector, giving rise to a large informal financial sector.

In this particular context, the financial sector could and should be doing more to drive better outcomes for South Africa’s citizens and economy. High-profile cases of outright fraud and misconduct have been endemic, alongside poor practices such as opaque pricing structures, ineffective disclosures, poor claims and complaints practices, and complicated product offerings. This has resulted in high levels of mistrust among financial customers.

More active participation in the sector was required in order to drive improved outcomes for customers, and to ensure that the financial sector plays its facilitative role in the economy well: channeling savings productively; insuring risks; facilitating productive lending; and enabling the buying and selling of goods and services through the payment system.

Despite the successes of the Financial Services Board, these challenges presented a clear need for South Africa to reform its regulatory architecture, and to improve the conduct oversight of its financial institutions. South Africa required two regulators...
to make financial services safer, to reduce potential threats to financial stability, and to ensure that the sector is working in the interest of all South Africans.

This was implemented through a Twin Peaks regulatory model – the FSCA being one of the two regulating bodies, with the Prudential Authority (PA) being the other. The FSCA supervises how financial institutions conduct their business and treat their customers, and empowers customers to make better financial decisions through financial literacy initiatives, while the PA supervises the safety and soundness of all financial institutions.

The FSCA’s core mandate is to:

- promote fair customer outcomes;
- provide financial education;
- enhance the efficiency and integrity of financial markets; and
- assist in maintaining financial stability in South Africa.

The creation of the new FSCA involved a significant change management process, shifting from the organisational, regulatory and supervisory approach of the Financial Services Board to an entirely new institution, focused on a relatively new area of financial sector regulatory interests, i.e. conduct and financial sector outcomes. The FSCA has oversight of financial products and services not previously overseen by its predecessor: banking services related to credit, debt collection, payment services, and the buying and selling of foreign exchange.

A further shift in approach was necessary, away from the traditional compliance-driven model to one that is proactive, pre-emptive, risk-based and outcomes-focused.

Fintech industry: promoting responsible innovation

Financial technology (fintech) has grown exponentially, and advancements in areas such as blockchain, cryptocurrencies, artificial intelligence (AI), machine learning and open banking, among others, have unlocked valuable opportunities to identify and address the most critical issues facing the sector and its regulators, including the promotion of growth and widespread financial inclusion.

The FSCA has partnered with key South African financial sector regulators, namely: the South African Reserve Bank and Prudential Authority, Financial Intelligence Center, National Credit Regulator and South African Revenue Services. Under an Intergovernmental Fintech Working Group (IFWG) we have established an Innovation Hub to ensure that fintech activity in South Africa is regulated effectively.

The Innovation Hub was launched in February 2020, to enable regulators to continually promote and support responsible innovation and to drive further financial inclusion in the financial services sector. We have already witnessed how upstart fintech firms, consumers and financial regulators stand to benefit collectively from the Innovation Hub, which is providing a space for safe experimentation, collaboration, and for market innovators to resolve specific questions regarding the policy landscape and regulatory requirements of relevance to their business models. Through this ‘sandbox,’ six innovators are testing their offerings as part of Cohort-1, including: a crowdfunding platform, a bank reporting on cross-border foreign exchange transactions to the central bank using a blockchain platform, and a custody service for crypto assets.

The IFWG also recently published a position paper, making recommendations pertaining to the regulation of crypto assets. As a stepping-stone towards implementing these recommendations, the FSCA is declaring crypto assets as a financial product under
existing conduct law. The Declaration would have the effect that any person furnishing advice or rendering intermediary services in relation to crypto assets must be authorised as a financial services provider and comply with relevant requirements.

This provides a timely example of the need for flexible activity-based law that can be adapted to respond to a rapidly changing financial sector, reducing potential for regulatory arbitrage and consumer harm – matters that are all the more important where non-financial institutions, like retailers and fintechs, increasingly provide financial products and services.

Recognising the need to ‘disrupt’ ourselves as well – particularly in the post Covid-19 era – we are leveraging our proximity and access to emerging fintech firms to identify suitable technologies that can fast-track our own internal digital transformation efforts and improve supervisory capabilities.

The FSCA will host several hackathons, bringing together key players in the fintech ecosystem, to share ideas, develop financial products that address pressing problems, and drive the formulation of policy. As a regulator, the FSCA ultimately wants to see innovations that are beneficial to customers and the market, resulting in lower prices, increased competition, improved access and financial inclusion, lower costs, increased efficiency and improved regulatory compliance. Hackathons being explored by South African regulators for 2021 are given in the table below.

<table>
<thead>
<tr>
<th>Use case</th>
<th>Problem Statement</th>
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<tbody>
<tr>
<td>Automated data collection</td>
<td>How might we help Regulators to use innovative technology to collect, validate and store quantitative and qualitative data (e.g. data reported from regulated entities) to enable thematic reviews such as on-site visits, research on risks/issues identified, and collaboration work with financial industry professionals?</td>
</tr>
<tr>
<td>AI for fraud detection including Anti Money Laundering (AML) / Combating the Financing of Terrorism (CFT)</td>
<td>How might we help Regulators to use AI to conduct risk scoring, detection of networks, compliance with AML requirements and assessment of the likelihood of AML and fraud?</td>
</tr>
<tr>
<td>Forecasting and predictive analytics</td>
<td>How might we help Regulators to use innovative technology to transition from descriptive analytics, to diagnostic, predictive and prescriptive analytics in order to better understand and proactively respond to financial sector risks?</td>
</tr>
<tr>
<td>Crypto currency risk management</td>
<td>How might we help Regulators to use innovative technology to de-anonymize crypto asset transactions and help regulators evaluate and monitor the trustworthiness of virtual asset businesses?</td>
</tr>
<tr>
<td>Financial crime surveillance</td>
<td>How might we help Regulators to use innovative technologies to monitor (entities and individuals) behavioural patterns in order to create transparency, enable more effective transaction monitoring, enhance Know Your Customer (KYC) reviews and drive early fraud detection?</td>
</tr>
</tbody>
</table>
In the face of Covid-related developments that are leading to greater degrees of digital adoption and accelerated change, our desire is to ensure that we promote responsible financial sector innovation that generates economic benefits for individuals and businesses in South Africa.

**Our role in harnessing AI**

Our main role is to ensure that customers and the broader industry thrive by defining controls that protect all South Africans and prevent and pre-empt unfair treatment of customers. We also have a critical role to play in ensuring that advances in technology do not exacerbate or create new areas of exclusion or negative ethical, legal, social or political consequences associated with these technologies.

On our part, we are taking steps to provide the correct technology solutions – such as AI – to do business with financial services providers and drive the growth of the wider sector. This is well illustrated by the use cases given above for the envisaged hackathons.

Ultimately, technology will continue to gather pace, and devices, objects, people and organisations will become increasingly interconnected. Machines will become more ‘intelligent’ as they start drawing on past experiences to inform future decisions – although the true impact on humans remain unknown. But, with the right governance and guidelines in place, there is potential to leverage technology to improve business operations and lives across the continent significantly, by facilitating much-needed growth across rural as well as urban communities.

**A focus on customer outcomes**

A focus on outcomes, and in particular customer outcomes produced in the financial sector, is a significant focus for the FSCA. Under the previous regulatory regime, the then-Financial Services Board introduced the Treating Customers Fairly initiative, which highlighted six key outcomes that customers should expect from financial institutions:

1. Customers can be confident they are dealing with firms where Treating Customers Fairly is central to the corporate culture
2. Products & services marketed and sold in the retail market are designed to meet the needs of identified customer groups and are targeted accordingly
3. Customers are provided with clear information and kept appropriately informed before, during and after point of sale
4. Where advice is given, it is suitable and takes account of customer circumstance
5. Products perform as firms have led customers to expect, and service is of an acceptable standard and as they have been led to expect
6. Customers do not face unreasonable post-sale barriers imposed by firms to change product, switch providers, submit a claim or make a complaint.

In support of Treating Customers Fairly, the FSCA also has a robust Consumer Education programme that targets all persons living in South Africa, addressing various financial topics but mainly focused on providing unbiased information on personal financial management. Our Consumer Education activities also serve to strengthen the strategic objective of informed financial customers and aims to integrate our regulatory functions with consumer education. All activities are supported by an interactive website.³

The FSCA is further entrenching the Treating Customers Fairly principles in its regulatory and supervisory work. However, a key consideration that both regulators and regulated entities continue to grapple with is how to measure the extent to which these outcomes are achieved in the sector.
To this end, in 2019 the FSCA engaged with the Consultative Group to Assist the Poor (CGAP) on their Customer Protection & Value Project, which aims to develop a Customer-Outcomes Indicator Framework that can be applied by regulators, and financial service providers, so as to achieve better outcomes for poor customers and contribute to their well-being.

The project explores how we might establish new approaches to consumer protection that incentivize business models which, in turn, better protect and create value for low-income customers. We are also working to identify opportunities and challenges that may flow from “prescriptive” consumer protection regulation, focused primarily on “doing no harm” tests and achieved through process-oriented tick-box exercises. The project seeks to demonstrate how this approach can be complemented with a new one that strives for positive customer outcomes that are documented, measured and based on a constructive dialogue between regulator and financial services providers.

The project complements work underway within the FSCA to develop a comprehensive Conduct of Business Return for financial institutions – a report submitted by regulated entities as part of their statutory obligations, that aims to gather quantitative information about the market conduct outcomes they are achieving.

In this connection, regulated entities should submit information providing insight into the customer-centricity of their business: for example, by identifying the volume and value of products sold to targeted customer segments over the review period, with detail about product features, distribution channels, product usage and cancellation rates, complaints received and responded to, etc.

These returns will inform the conduct risk-assessments done by the supervision team, to complement other sources of information about

Social Media Sentiment Analysis – supervision of the banking sector

The FSCA has onboarded a service provider (BrandsEye) – an online platform that analyses in-depth and real time qualitative and quantitative social media data. This data is gathered and verified by the ‘crowd’ from current, former and potential customers to gauge sentiments on various social media platforms. It is being used to assist the FSCA in identifying patterns of behavior at an individual bank and at a sector wide level.

The FSCA at times observes a disconnect between the culture and values espoused publicly by banks and on-the-ground realities in terms of customer treatment and service. In short, professed cultural norms and values do not always align with the actual customer experience. The trends identified from BrandsEye support this – in fact, recent information shows that 90.7% of customer complaints tracked by the social monitoring tool were related to Treating Customer Fairly outcomes, and 56.6% of these complaints went without response from the relevant banks.

The FSCA’s data driven strategy will support our ability to understand fully the extent and nature of customer sentiment regarding its regulated entities.
supervised entities, like ombudsman complaints, thematic mystery shopping and social media sentiment analysis.

While the Treating Customer Fairly principles focus on the retail customer segment, the FSCA has a mandate to protect all financial customers. To this end, we are considering suitable conduct requirements for the wholesale sector as well, in line with recommendations regarding misconduct promulgated by international standard setting bodies like the Financial Stability Board.

**Legislative reforms to support the new regulator**

South Africa’s market conduct regulatory reform process entails more than the creation of a new regulator. Another key focus is to streamline and harmonise the legal landscape within which financial institutions, and their regulator, will operate. This entails a comprehensive review of existing financial sector laws, with the aim of developing a single, holistic legal framework for market conduct regulation that is consistently applied to all financial institutions in South Africa.

The draft Conduct of Financial Institutions (COFI) Bill represents this new legal framework. It is expected to be finalised and implemented by the FSCA in the next two years. The FSCA has simultaneously undertaken a review of subordinate legislation to harmonise regulatory requirements that apply to different financial entities. These legislative reforms will better equip the FSCA to fulfil its mandate.

The COFI Bill also puts in place a market conduct framework that is more principles-based, allowing for regulation that is flexible, proportionate, and focused on the achievement of outcomes rather than the mere compliance box-ticking that characterized the previous regulatory regime. The revised approach will foster financial inclusion and greater participation by black South Africans in the ownership and management of financial institutions, with a focus on supporting increased competition in the sector and improved value for customers.

The FSCA exercises a gate-keeper function through licensing, to stop persons prone to misconduct from entering the sector. Licensing and regulatory requirements in the COFI Bill will be based on the activity being performed, rather than on the type of financial institution, to ensure a level regulatory playing field and reduce the risk of regulatory arbitrage.

This is especially important as financial products and services are increasingly offered by non-financial institutions like retailers, car dealers and fintechs. Examples of the activities among these non-traditional financial players include, for instance: providing a financial product (like insurance or a transaction account), intermediary services, giving advice, discretionary investment management, custody and administration, and providing a payment service.

Banking conduct regulation, and particularly appropriate governance practices and culture outcomes, remains a key focus area of the FSCA and a crucial success indicator of the newly adopted Twin Peaks regulatory framework. While the law reform process is underway, subordinate regulation is being introduced by the FSCA that applies the new approach to conduct regulation and supervision on a wider range of financial institutions.
The FSCA has promulgated Conduct Standard 3 of 2020 ("Conduct Standard"), the underlying regulatory instrument for the conduct of banks. This Conduct Standard will become effective in a phased approach from March 2021 onwards. Amongst its key requirements and provisions is the obligation for banks to have in place proper governance and culture-focused structures, and related policies conducive to good customer outcomes. Having engaged with firms in this regard, the FSCA is of the view that South African banks have a fairly good understanding of what conduct risk entails, with some already having established and adopted the requisite conduct structures, frameworks, metrics and supporting policies.

*Katherine Gibson is a member of the FSCA Transitional Management Committee*

REFERENCES

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1. Improvements to the prudential and financial stability framework were also identified, for example relating to oversight of financial groups, monitoring of interconnectedness amongst financial institutions as well as other non-financial businesses like in retail, and resolution of financial institutions, especially those identified as systemic.

2. For more information, see Intergovernmental Fintech Working Group, "Regulatory Sandbox." [www.ifwg.co.za/regulatory-sandbox](http://www.ifwg.co.za/regulatory-sandbox)


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on the most effective way to allocate compliance responsibilities within regulated firms and who should be held accountable for compliance failures."

The DFSA took five enforcement actions in 2020, according to its “DFSA in Action” report. In this report, the DFSA wrote, “In taking such action, the DFSA seeks to deter wrongdoers by demonstrating that the risks of engaging in misconduct outweigh the rewards; discouraging non-compliant attitudes and behaviours.”

We are embracing FinTech and RegTech as part of the future of finance, while being mindful of our role as a regulator in protecting clients and markets. Encouraging and supporting innovation in the Centre goes hand-in-hand with employing the next generation of regulators and bringing a fresh mind-set to financial regulation."

The DFSA is also looking to improve its own use of technology to supervise and monitor regulated institutions. DFSA Associate Director of Conduct Supervision Tim Younger wrote in his response to Starling’s survey, “[W]e are looking at SupTech solutions that can improve monitoring by ourselves of regulated firm compliance. Some of these are simple automation and information aggregation/identification tools, but would still be a step forward compared to our existing processes in some areas.”

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**DRIVING INNOVATION**

DFSA has also been a driver of innovation in fintech and regtech in recent years. For example, in DFSA’s 2019 Annual Report, DFSA Chief Executive Bryan Stirewalt wrote:
In June 2019, the Bank for International Settlements (BIS) launched the BIS Innovation Hub, “to identify and develop in-depth insights into critical trends in technology affecting central banking; develop public goods in the technology space geared towards improving the functioning of the global financial system; and serve as a focal point for a network of central bank experts on innovation.”

As a part of the initial phase, the BIS established Hub centers in Hong Kong, Singapore, and Switzerland. After its first year of operation, the Innovation Hub announced new hubs to be launched in Toronto, London, Frankfurt and Paris, and Stockholm. They also announced a strategic partnership with the Federal Reserve Bank of New York.

The Innovation Hub is just one example of BIS attempting to harness the potential and mitigate the risks associated with the digitalization of finance, by supporting innovation among central banks and regulators. The BIS has a broad research program on innovation and the digital economy. BIS economists have shed light on fintech and big tech credit, cyber risk in the financial sector, the risks of viral transmission through cash, stablecoins, and central bank digital currencies. This work also shows that the COVID-19 pandemic has accelerated demand for new technologies, and digital financial services have seen record utilization.

As a further example of research to encourage innovation in central banking, BIS staff published a paper called, “From data reporting to data-sharing: how far can suptech and other innovations challenge the status quo of regulatory reporting?” in November 2020. This paper states that regulatory data, specifically data shared with financial regulators by supervised institutions are essential to efficient monitoring, especially during the COVID-19 pandemic, when work-from-home demands make traditional on-site monitoring difficult, if possible at all. However, the authors emphasized that heterogeneity of data across financial institutions, and the limitations of traditional regulatory reports, present obstacles to the use of data. If central banks focus efforts on improving input data standardization, as well as data transmission, they might make much more efficient use of the data they collect from regulated entities. In the paper, the authors list five preconditions to the success of new regulatory reporting initiatives:

1. Strong commitment and support from top management at both financial authorities and financial institutions;
2. Alignment of vision by engaging transparently, collaboratively and openly with key stakeholders;
3. A culture of innovation that relies on data-driven decision-making, openness to experimentation and questioning “legacy thinking” within financial authorities;
4. A well defined centralised data strategy and data governance framework within financial authorities;
5. Effective management of the transition to the new regulatory reporting processes, particularly by taking a step-wise approach.

The BIS has hosted multiple conferences and workshops on fintech, digital innovation, central bank digital currencies and related topics. The BIS also hosts central bank committees like the Committee on Payments and Market Infrastructures (CPMI), and bodies like the Basel Committee on Banking Supervision (BCBS), Financial Stability Board (FSB), International Association of Insurance Supervisors (IAIS) and International Association of Deposit Insurers. Each of these bodies have work programs that include issues of fintech and digital innovation.
In an October 2020 letter from Financial Stability Board (FSB) Chair Randal K. Quarles to the G20, Quarles wrote, “[T]he FSB has not lost sight of important ongoing work in financial innovation, payments systems, cyber resilience, and market fragmentation.” One such example is the ongoing assessment of how suptech and regtech may help both regulators and regulated entities worldwide.

Alongside this letter, the FSB provided a report entitled, “The Use of Supervisory and Regulatory Technology by Authorities and Regulated Institutions.” This report explains that suptech and regtech could have significant benefits for financial stability. They could help regulators improve oversight and surveillance while helping regulated institutions improve compliance outcomes and enhance risk management systems. In the report, the FSB writes: “The opportunities offered by SuT ech and RegT ech have been created by the substantial increase in availability and granularity of data, and new infrastructure such as cloud computing and application programming interfaces (APIs) which allow large data sets to be collected, stored and analysed more efficiently.”

In a survey of FSB members, the majority of the regulatory institutions that responded had suptech, innovation, or data strategies in place, and had seen these strategies grow significantly since 2016. In the FSB’s list of priorities for 2021, it states that it will continue its work on regtech and suptech given their importance for financial stability.

At the BCBS annual International Conference of Banking Supervisors, in October 2020, much of the focus was on the increased digitalization of finance and the current work-from-home protocols resultant of the coronavirus pandemic. While speaking on the digitalization of finance at the conference, the BCBS Chair and Governor of the Bank of Spain, Pablo Hernández de Cos said, “The ongoing digitalization of finance also presents risks and challenges to the banking system, which COVID-19 has further magnified. This includes the evolving nature of cyber-attacks to banks and the growing reliance on third-party service providers.”

The BCBS published its “Principles for Operational Resilience” in early April 2021. The principles focus on governance, operational risk management, cyber security and more. The BCBS also revised its Principles for the Sound Management of Operational Risk (PSMOR) to reflect the relationship between operational resilience and operational risk.

Later that same month, the BCBS published its “Basel Committee work programme and strategic priorities for 2021/2022.” The three key themes the BCBS will focus on in the coming year are COVID-19 recovery and resilience, analysis of structural trends and mitigating risks, and strengthening supervisory coordination and practices.

The BCBS’s work on supervision will include a focus on suptech, specifically AI/ML, data governance, supervisory approaches to operational resilience, and leveraged lending.
The International Association of Insurance Supervisors (IAIS) is a voluntary membership organization made up of insurance supervisors and regulators from over 200 jurisdictions worldwide. In recent years, the IAIS has emphasized the importance of culture and conduct in the insurance industry. In its 2020-2024 strategic plan, the organization writes, “A holistic approach to market conduct and prudential supervision is called for, recognising that conduct and culture issues could lead to financial soundness and stability concerns.” Conduct and culture are listed as part of the organizations’ top priorities over the four years.

In 2020, the IAIS planned several initiatives to promote Conduct and Culture supervision to its members. These initiatives continued to be advanced during the pandemic, including an additional focus by the IAIS to consider how conduct and culture issues may have been impacted by heightened consumer risks as a result of COVID-19. Taking into account these considerations, in 2021 the IAIS plans to publish an Issue Paper on Insurer Culture to “explore the importance of insurer culture as a key intersection point for the supervision of prudential and conduct issues.” It also plans to develop an Application Paper on the use of key indicators to assess conduct-related outcomes.

In the OECD’s “Business and Finance Outlook 2020” report, Greg Medcraft, Director of the Financial and Enterprise Affairs Directorate, argued that in order to maintain their social license to operate it will be essential for companies to focus on ESG related activities. Medcraft urged that this should be a policy priority for governments.

The OECD also calls for global standards of ESG scoring and reporting to allow for investors to understand the management and resilience of their investments in this report, and while the OECD has emphasized the E piece of ESG, its recent analytical papers have also covered the entire ESG ecosystem.

In remarks offered to Starling for inclusion herein, Mr. Medcraft wrote:

As ESG grows in importance companies will need to consider how best to gather, analyze and report a host of non-traditional, non-financial data. Emerging technologies, particularly AI, could play a critical role in collecting, securing and interpreting this wealth of information and turning into something markets and investors can use.

In May 2020, the Financial Action Task Force (FATF) released guidance on managing AML risks associated with the coronavirus pandemic resulting from the increase in fraud, cyber crime, and exploitation of relief funds.

The FATF announced in October 2020 that it will seek to drive digital transformations of AML/CFT systems. While its may guidance is still viable, it says,
the coronavirus pandemic has impacted every country differently, and so the risks faced in each country will vary widely.\textsuperscript{768}

The task force, referencing the FinCEN files and the millions of suspicious transactions contained therein, called for all countries to fully implement FATF standards for managing AML/CFT risks.\textsuperscript{769}

\section*{IOSCO}

In December 2020, the International Organization of Securities Commissions’s (IOSCO) Retail Market Conduct Taskforce (RMCTF) released its “Initial Findings and Observations About the Impact of COVID-19 on Retail Market Conduct.” The report, among other things, discusses the increased conduct risk due to the remote working environments at regulated firms. IOSCO states that, due to the remote working environment, “control managers may no longer have direct lines of sight over some key functions, as observed in certain jurisdictions.”\textsuperscript{770}

In April 2021, IOSCO published its “Work Program 2021-2022”. The organization plans to focus on risks created or exacerbated by the coronavirus pandemic: “The COVID-19 pandemic has created economic and social situations, such as job losses, financial strains, physical and social isolation, and active online engagement, which can increase conduct risk and magnify retail investors’ susceptibility to scams and frauds.”\textsuperscript{771}

The RMCTF will lead the work on developing impact COVID-19 impact reports on misconduct risks and fraud, while IOSCO itself will develop an impact report on operational and cybersecurity risks. \textsuperscript{772}

\section*{The World Bank}

The World Bank launched a data portal platform for users in relation to Environmental, Social, and Governance Data in 2019.\textsuperscript{773} The aim of the utility is to help investors align their analyses with sustainable development policy indicators, as well as to increase transparency in private sector investments in emerging markets. Data points included under its Governance Pillar include estimates for regulatory quality, government effectiveness, and rule of law. (However, none specifically address governance in the private sector.)

In March 2021 the World Bank published a paper titled, “The Next Wave of Suptech Innovation.” In this report, the World Bank writes, “Suptech solutions are increasingly critical given the digital transformation of the financial services industry in recent years. Supervisors have often lagged behind in their capacity to monitor these growing and increasingly complex markets.”\textsuperscript{774}

In order to accelerate the rates of suptech adoption and innovation, the World Bank has made various recommendations, including: creating a formal suptech and data strategy and creating an innovation office.\textsuperscript{775}

As ESG grows in importance companies will need to consider how best to gather, analyze and report a host of non-traditional, non-financial data. Emerging technologies, particularly AI, could play a critical role in collecting, securing and interpreting this wealth of information and turning into something markets and investors can use.

\textbf{Greg Medcraft}, Director of the Directorate for Financial and Enterprise Affairs of the OECD and former Chairman of the Australian Securities & Investment Commission

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\caption{Greg Medcraft}
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As discussed in the earlier issues of this annual report, in 2019 the United Nations Environment Programme Finance Initiative (UNEP-FI) published its “Principles for Responsible Banking,” listing Governance & Culture as one such. The Principles aim to align the business strategies of banks with societies’ goals, to provide a framework for a sustainable banking system, and to demonstrate how this contributes positively to society.776

The Principles were launched with the participation of 130 banks from 49 countries, collectively representing $47 trillion in assets. Signatories, now numbering some 220, agree to complete a self-assessment and to report to the UN annually.777

In June 2020, the UNEP-FI announced that its members and signatories to the Principles had voted for a new governance structure for reviewing the progress of signatories and holding them accountable where they fail to meet commitments. This new structure includes the formation of a governance body, the Banking Board, to oversee implementation of the Principles.778

The UNEP-FI has also published a “Principles for Sustainable Insurance,” which also focuses on corporate governance. The first of the four principles is: “We will embed in our decision-making environmental, social and governance issues relevant to our insurance business.” This includes treating customers fairly and integrating ESG issues into risk management processes.779

In 2018, the UK FCA and a dozen other regulators and related organizations formed the Global Financial Innovation Network (GFIN) to improve cross border knowledge sharing among participants. The organization has now grown to more than 60 members, adding more than 10 members just since the beginning of 2020.780

An early stated aim was to, “enhance regulatory clarity and understanding ... and promote early identification of emerging regulatory opportunities, challenges and risks”781 by fostering cooperation among financial authorities on a variety of innovation topics, regulatory approaches, and lessons learned.782

Members hoped to create efficiencies for innovative firms that might wish to interact with regulators by creating a vehicle that permitted them to do so across several different jurisdictions simultaneously.

The GFIN also serves as a hub for the innovation services provided by its member regulators and observer organizations, publishing its “GFIN Regulatory Compendium” to serve as a central location to view these services.783
Deeper Dive
The Normalization of Deviance

Under the banner “Black Lives Matter,” 2020 saw worldwide demonstrations against perceived police brutality with racist roots. A seeming pattern in the shooting of black Americans by white police officers suggested that policing in the United States was corrupted by systemic racism. And a systemic problem demands a systemic solution: for protestors, the answer was to be found in a broad defunding of police forces, triggering ascerbic and on-going political debate.

How might behavioral science inform this discourse?

Northwestern University sociologist Andrew Papachristos finds social network structures to be intimately involved in police misconduct. “Explanations of police misconduct are generally divided into two theories: ‘bad apples’ and ‘bad institutions’,” he writes. “From this perspective, misconduct happens because specific individuals violate the primary function of policing itself; such officers are seen as ‘deviants’ and believed to represent a small fraction of police.” But, Papachristos finds, “As with other deviant behavior, police misconduct is most likely a learned behavior acquired from others while ‘on the job’.”

“Between the microlevel theories of atomized individuals and the macrolevel theories of organizational culture lies a ‘mesolevel’ explanation of police misconduct: an officer learns to engage in misconduct from other officers in his or her social network.”
Such findings might inform those looking to improve culture and conduct risk governance in the financial sector. It appears a prevailing assumption, among firms and regulators alike, that misconduct problems can be discovered only after they occur (ex post). This ‘detect and correct’ mindset suggests that we should invest in systems of surveillance and monitoring to detect misconduct as it takes place, and that we must rely on whistleblowers to call out misconduct that goes undetected by these systems. For leading indicators of likely misconduct (ex ante), industry opinion leaders argue in this year’s report that firms must encourage psychologically safe workplace cultures, perhaps to be had through improved diversity, inclusion, and the relevant ‘tone from the top.’

What does experience suggest in this context?

The UK Banking Standards Board (now renamed the Financial Services Conduct Board) conducts an annual survey of employees across the UK’s banking industry. In past such studies, the BSB inquired into the reasons why employees had elected not to speak up. As we covered in last year’s Compendium, there are two principle motives to remain silent: firstly, employees fear retaliation from the executives above them, and ostracism from peers alongside them; secondly, they have concluded, based upon past observation, that management would take no remedial action even if they did speak up. Speaking up to call out conduct concerns results in high downside risk and no upside opportunity. So why bother? Better to just ‘go along to get along’ and to rationalize that choice by persuading one’s self that ‘it’s not my job’ to buck the system, or that ‘I have no choice’ but to conform to ‘how things are done around here.’
In her landmark study of the 1986 space shuttle Challenger disaster, sociologist Diane Vaughan confesses that, as she began her research, she expected to find amoral and calculating managers and engineers who violated organizational rules. Instead, she found that the disastrous launch decision was arrived at through conformity – “conformity to cultural beliefs, organizational rules and norms, and NASA’s bureaucratic, political and technical culture.”

Vaughn’s conclusions contradicted much of the established public scholarship and the findings of a Presidential Commission. For Vaughn, previous inquiries into the failure in NASA’s decision process were themselves subject to two key challenges to change in most organizations: “thinking in terms of individual causes rather than organizational system causes, and considering how to change a complex system where change in one part has consequences for another.”

By contrast, Vaughan’s analysis emphasized the “social construction of risk.” As is true for any organization, she found that the perceptions of and beliefs about operational risk at NASA were “shaped by social forces and environmental contingencies that impinged on and changed organizational structures and culture, routinely affecting the worldview that decision makers throughout the organization brought to their interpretation of technical information.”

Vaughn coined the phrase “the normalization of deviance” to explain what she found to have taken place at NASA.

Deviance is of course socially defined: what is considered orthodox in one social context may be deemed anathema in another. By ‘normalized’ Vaughan meant that decision making processes and action choices that were technically ‘deviant’ from the established rules for such had been “reinterpreted,” through informal work group consensus, such that decisions and actions were found to sit within the bounds of formally established performance norms. “They redefined evidence that deviated from an acceptable standard so that it became the standard.” And seven astronauts lost their lives.

**BOEING**

Shortly after take off, on October 29th 2018, a Boeing 737 Max-8 jetliner operated by Indonesia’s Lion Air plummeted into the Java Sea killing all 189 people on board. After investigating the incident, a February 2019 draft “Oversight Report” by the U.S. Federal Aviation Administration (FAA) “did not reveal any noncompliance” at Boeing: the company was found to have followed federal safety regulations even though the result was a flawed plane. About a month later, on March 10th, 2019, a 737 Max aircraft operated by Ethiopian Airlines crashed shortly after taking off from the Addis Ababa airport, killing 157 people.

A September 2020 report by investigators with U.S. House of Representatives Transportation Committee concluded that the 737 Max crashes represented, “the horrific culmination of a series of faulty technical assumptions by Boeing’s engineers, a lack of transparency on the part of Boeing’s management, and grossly insufficient oversight by the FAA.” “It was ‘compliant.’ But the problem is it was compliant and not safe. And people died,” said Transportation Committee Chairman Peter A. DeFazio. A civil lawsuit filed by shareholder accused Boeing’s board of “lax oversight.” Earlier this year, Boeing agreed to pay $2.5 billion to settle criminal charges and entered into a Deferred Prosecution Agreement with the U.S. Department of Justice. In the last several weeks, the FAA has issued new “Airworthiness Directives” further questioning the safety of the 737 Max.

**RIO TINTO**

Despite generating handsome returns for them in the course of his four-year tenure as CEO, investors forced Rio Tinto’s Jean-Sébastien Jacques to step down late last year. Australia’s Juukan Gorge is known for a cave that reveals continuous human occupation for over
46,000 years. Analysis of genetic material found at the site shows a direct lineage between the ancient peoples residing in the cave some 4,000 years ago and the Puutu Kunti Kurrama and Pinikura (PKKP) people alive today. Rio Tinto destroyed the sacred aboriginal site on May 23rd last year, in the course of iron mining activities. A subsequent internal board review found no single individual, or operational error, to be responsible. In response to an Australian Senate inquiry, Rio Tinto admitted that the mine manager at Juukan Gorge had been made aware that the site’s cave was one of the “top five” areas of archeological and cultural significance in the region – months before it was drilled and detonated.

“Systems and processes designed to provide layered governance and oversight did not work effectively,” Rio Tinto explained in its Senate submission. “The root causes of events that led to the destruction of the Juukan 1 and Juukan 2 rockshelters in May 2020 highlight the need for change in Rio Tinto’s cultural heritage management,” it concluded. That is, the risk management failure was a consequence of faulty processes and systems, not people. A report from the Joint Standing Committee on Northern Australia concluded otherwise. “Rio Tinto’s conduct reflects a corporate culture which prioritised commercial gain over the kind of meaningful engagement with Traditional Owners that should form a critical part of their social licence to operate,” the interim report argued.

Perhaps. But it is not clear that Diane Vaughn would agree with either conclusion. Rather, she directs our attention to “the structure of power and the power of structure and culture – factors that are difficult to identify and untangle yet have great impact on decision making in organizations.” She points us to our social networks and the manner in which the cultural norms they espouse inform organizational realities at the individual and group levels.

The U.S. SEC’s whistleblower program, implemented following the 2010 Dodd-Frank Act, has received more than 40,000 tips, according to a Wall Street Journal analysis of SEC data. In the fiscal year ending September 30th, 2020, the SEC’s whistleblower office had received more than 6,900 tips – a single-year record. And in the first seven months of fiscal 2021, over $250 million was awarded to whistleblowers under the agency’s ‘bounty’ program. Outgoing head of the whistleblower office, Jane Norberg believes that the program shows the value of creating a work environment that encourages employees to speak up when they have concerns regarding potential wrongdoing.

But are we to expect people to blow the whistle on deviant behavior that has been normalized? While whistleblowing programs and bounty schemes may help to generate notice of something especially egregious – within the cultural context of a given organization – Diane Vaughan’s work suggests that undesirable behavior which has become routine will not be viewed by employees as ‘wrong’ and will therefore likely go unreported — until catastrophic events unfold.
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Our View
‘Wicked Problems’ & ‘Infinite Games’

By JOHN SEELY BROWN and ANN M. PENDLETON-JULLIAN

In 1973, design theorists Horst Rittel and Melvin Webber articulated the concept of ‘wicked problems.’ What makes wicked problems wicked is that they are not ‘solvable’ in the traditional sense of the term. They do not yield to simple linear solutions, nor even to multifaceted solutions. A wicked problem is one for which each attempt to create a solution changes the nature and understanding of the problem itself, such that the definition of the problem evolves as new possible solutions are considered and/or trialed.

As such, wicked problems offer no explicit basis for the termination of problem-solving activity. Any proposed solution can be further developed, and because numerous plausible alternative solutions can always be provided, proposed solutions can be neither necessarily correct nor incorrect.

In his 1986 *Finite and Infinite Games: A Vision of Life as Play and Possibility*, James Carse – a professor of history, literature and religion – proposed a means by which we may sidle up to wicked problems. For Carse, ‘finite games’ are recognizable as having specific beginnings and ends. Think chess, for instance. The sale of a product or a trade in stock would also fall into this category. But ‘infinite games’ are more challenging, as they never really end. Instead, they evolve perpetually to present themselves anew, persistently demanding – and re-demanding – that we offer new responses.

“A finite game is played for the purpose of winning,” Carse writes, “an infinite game for the purpose of continuing the play.” Moreover, where the rules of a finite game can generally be discovered over time, in an infinite game the rules themselves continually adapt to the maneuvers of the responsive players. Think of ‘winning’ in the war for market-share, for instance. Or, for a particularly timely example, consider the way in which governments worldwide have sought to respond to the Covid-19 pandemic.

Modeling and predicting the projected progression of the coronavirus has proven fiendishly difficult. Early models, released in the Spring of 2020, predicted deaths worldwide in the millions. Fortunately, the worst projections were not realized. In fact, even infection rates fell well below initial projections and, as spring turned to summer, there was cause for hope that the pandemic might prove manageable. Projections from the US CDC showed a relative ‘flattening of the curve’ and a feared ‘summer surge’ never quite materialized. But then winter arrived, and with it, the virus was back with renewed ferocity.

Long after the immediate threat has diminished, and life resumes some version of normalcy, scholars will pick through the countless pandemic-inspired social experiments that took place as we struggled to contend with this evolving threat. In the face of difficult trade-offs, between potential loss of life and massive economic dislocation, governments and societies around the world reacted in at times radically different
ways. Many will claim that their adopted approach proved most successful in navigating the crisis, but we may never reach agreement as to which claims have merit – if any.

The pandemic is a wicked problem and, in our efforts to address it, we are caught in an infinite game. For wicked problems there is no ‘endgame’. Rather, such challenges are better seen as presenting us with problem environments or problem ecologies. Their complex, interrelated, and systemic nature demands equally complex, interrelated, and systemic responsive action – the results of which will only become clear over time, as the shape of the problem, and the trialed solutions, shift in an endlessly recursive loop.

**Culture and Conduct Risk as Ecosystem Design Challenges**

Such thinking holds lessons for those aspiring to manage complex organizations in a ‘whitewater world’ grown increasingly volatile, uncertain, complex, and ambiguous (or ‘VUCA’, to borrow from the military). This is perhaps especially true for those charged with managing culture and conduct related ‘soft risks’ in any organization, be it a business, government or social enterprise.

The need for such a shift in management thinking around culture and the conduct it espouses is amply evident in the banking sector, which has struggled perpetually despite hundreds of billions in aggregate annual investment in risk governance processes, systems and personnel. These risk management tasks may be approached, with some degree of success, only by viewing them as eco-systemic in nature. This demands a reformulation of the risk and compliance function, and the adoption of new tools.

Current management methods in this context have failed, to a large extent, perhaps because bankers and regulators alike have operated on the presumption that culture and conduct problems can be ‘solved’ in the first place. So long as the problem is seen as methodological – better systems, processes and people – rather than conceptual, these efforts will continue to produce suboptimal outcomes.

Prevalent management concepts leave us wedded to unsuccessful management methods. Believing that bad behavior is driven by bad actors, the task of managing organizational culture and the behavior it promotes has been cast as one that involves methods of oversight which aim to identify malefactors so that ‘bad apples’ won’t be permitted to spoil the barrel. But the problem lies with the barrel, not the apples: it is the organizational ecosystem that sets the conditions for spoilage.

Management theory often starts from the view that behavior is shaped most powerfully by financial incentives dangled before ‘rational actors.’ In any organization, however, management is confronted not by independently incentivized individuals, but by dynamic, complex, and adaptive collectives of individuals – groups of employees with their own values, norms, and rules for behavior.

Achieving good standing among respective peers is a critical concern for those who make up such groups – perhaps the critical concern – and that standing is won and maintained through what the sociologist calls “normative compliance.” The imperative to conform to peer expectations is indeed so strong that it almost invariably overwhelms ‘tone from the top’ and the policies, surveillance measures and other methods of control that management may deploy in an effort to implement its intent.

Just as socially reinforced reactions to the spread of the coronavirus undermined our modeling efforts, so too for social networks among groups of collaborative peers within an organization: these networks react
to management efforts and may work to counter-act those efforts. As surveillance and monitoring increase, for instance, employees have adopted the use of code words, alternative communications channels, or have simply gone off-line in an attempt to ‘game the system’.

Controls designed to restrict behavior instead promote workarounds. Such is the nature of wicked problems and infinite games, which differ from other types of problems in several significant ways. Wicked problems are, as Pendleton-Jullian characterizes them, polyarchic, polycentric, polymorphic and polylemmic and, as such, they require an extreme form of adaptability in behavior and agility in decision-making.

Firstly, they are *polyarchic*. They tend to have multiple centers of power. Operational reality in any organization involves a complex web of relationships between leaders, with stated authority and accountability, and staff at work across various business units, corporate functions, and geographies. Some of these interactions are collaborative, others competitive, and performance outcomes depend on their ebb and flow.

Second, they are *polycentric*. Wicked problem spaces do not have a single focal point, nor do infinite games afford a ‘winning move’. Rarely is there a single ‘bad actor’ or ‘malicious insider’ to occupy our attention when tackling culture and conduct related risks. Research has shown that behavior is a social construct; people take their behavioral cues from peers with whom identify – their ‘reference network’ – and particularly from those whom they trust most deeply. Because people operate within any number of reference networks within an organization, we are confronted by multiple and overlapping focal points of relevance.

Third, they are *polymorphic*. The multiple and overlapping focal points of relevance are constantly shifting as new alliances and behaviors adapt. The shape of the connections and network is constantly changing.

Fourth, they are *polylemmic*. One often must choose between multiple unsatisfactory, or even undesirable, options just to keep the problem moving. As outlined above, the effectiveness of interventions is constantly changing form in the context of wicked problems and infinite games. Wicked problems may have many potential solutions – none of which may be optimal. Managers must actively seek out solutions that will regularly lay far beyond their own limited expertise and this demands the highest form of coordinated action, agile enough to course correct as needed, while engaging all relevant staff – itself a fluid consideration.

In sum, wicked problems and infinite games are contextually-bound and dealing with them effectively demands that management possess the instinct and courage to try lots of things; to create and invent partial and provisional responses that affect the web of relationships and exchanges that characterize operations; to probe and study employee responses to management efforts while adapting perception of the ‘problem space’ until the gap between the wickedness of the problem and the effectiveness of response is sufficiently narrowed. This requires us to think in terms of ecosystem-design.

These risk management tasks may be approached, with some degree of success, only by viewing them as eco-systemic in nature.
Where to from Here?

During the industrial revolution Marx argued that, in a commodity-obsessed society, we focus on the relationship between people and things. But in so doing, we ignore the underlying and crucial social relations that connect people to one another and allow for them to make such things. He called this “commodity-fetishism.” Today, management appears to be enthralled by “process fetishism.”

Process thinking focuses on the way things work when everything goes according to plan. It assumes that people follow the ‘proper’ steps as intended and that all people do so in the same way. But people aren’t like that. The understandings and beliefs that shape their decisions and actions do not reduce to a set of rules that structure their experience. Rather, their practices emerge from their experience and, most of all, from their experience of one another in the workplace context.

Processes are an abstraction from the real work of a business – the work done by real people. Process thinking must yield to practice thinking, which takes as its starting point the observation of that great management theorist, heavyweight boxing champ Mike Tyson: “everyone has a plan until they get punched in the mouth.”

Management is an infinite game, and people present managers with ceaselessly wicked problems. Contending with this may seem overwhelming, but the challenge is a common one, and well known to boxers and battlefield commanders, emergency room triage teams and jazz ensembles, technology innovators and celebrity chefs. All must strive to be masters of the moment.

Designing for an emergent future requires understanding that action is not driven by plans that one implements but, rather, by norms of practice within an ecosystem of actors – a network – that one seeks to orchestrate. Computational social science technologies today afford us the ability to obtain a real-time appreciation of such networks as they operate, in vivo.

Such capabilities equip us with a means to master the moment with tools designed for the wickedness of ecosystem design work. And, in time, we may hope that such tools help to restore a sense of play to the infinite game of management.

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Deeper Dive
All Together Now

London’s Millennium Bridge is one of the most beautiful to cross the Thames. After a 1996 competition held by the Southwark Council, with the involvement of the Financial Times and the Royal Institute of British Architects, the “Blade of Light” design submitted by renowned architects Sir Norman Foster and Partners, engineering firm Over Arup & Partners, and sculptor Sir Anthony Caro was selected for the first new bridge to be built across the river in over 100 years. The 1,082 foot bridge would connect the Tate Modern Gallery, on the river’s south bank, with the neighborhood surrounding St. Paul’s Cathedral on the north. On June 10th, 2000, Queen Elizabeth II presiding, some 100,000 people turned out for the opening of the Millennium Bridge to be first among those to cross it.

Shortly after they began to cross the bridge, however, the pedestrians felt it begin to wobble from side to side gently. As they continued to cross, the wobbling became more and more obvious, and soon, the bridge began to sway and twist in regular oscillations, forcing people to cling to the banisters to avoid falling. As the oscillations grew increasingly extreme, pedestrians feared the bridge might collapse under them. The bridge was closed to the public on June 12th and remained closed for two years while engineers designed a fix. What went wrong?

In a 2005 Nature article, “Crowd synchrony on the Millennium Bridge,” Cornell University professor of theoretical and applied mechanics, Steve Strogatz explained the source of the oscillations.\(^1\) Walking one foot at a time, humans exert some amount of lateral force with each step, for balancing purposes. The bridge engineers understood this but expected that the randomness of pedestrians’ footfalls would offset this lateral force.
But as the bridge-crossers altered their gait so as to compensate for the bridge’s lateral sway, the rhythm of that sway led the pedestrians to alter their gait in unison. Their collectively adjusted footsteps magnified the bridge’s lateral motion: the more the bridge wobbled, the more people adjusted their gait to maintain balance, creating ever greater lateral force, and the worse things got.

“I’m not a civil engineer. I know nothing about bridges,” says Strogatz. “What I do know is group behavior.” It wasn’t some design failure that led to trouble upon the Millennium Bridge, it was the unexpected and spontaneous synchrony in the behavior of the crossing pedestrians.

Throughout natural and physical systems, researchers have found countless instances of such self-organized groups, interacting in accordance with a few simple rules, to produce often surprising collective outcomes. Scientists call these outcomes ‘emergent properties’. We witnessed a dramatic example of such spontaneous synchrony in the financial markets earlier this year, when day-traders self-organized on chat-site Reddit and began to trade in unison, driving the market capitalization of the otherwise languishing GameStop from a 2020 low of $250 million to over $25 billion.

Scientists are learning that many organisms are organized into social ecologies, if this is often non-obvious at initial glance. Trees in forests, for instance, have been found to coordinate spontaneously through a communications network of threadlike fungi, mycorrhizas, that connect individual trees at their roots – the forest’s own version of Reddit – to form a superorganism. Ian Couzin, director of the Max Planck Institute of Behavior at the University of Konstanz in Germany, studies swarming behavior in animals. His research has bearing on the behavior of the human animal, with lessons for those searching for a predictive ‘science’ behind seemingly spontaneous mass protest movements. Todd Haugh, a professor of business law and ethics, finds similar examples of “behavioral contagion” at work in corporate misconduct and compliance.

In a pioneering study, the Bank of England’s Andy Haldane and the late Chief Scientific Adviser to the UK Government and President of the Royal Society, Robert May, drew analogies between financial markets and the dynamics of ecological food webs and the networks within which infectious diseases spread. “There has been a spectacular rise in the size and concentration of the financial system over the past two decades,” Haldane and May wrote in 2011, “with the rapid emergence of ‘super-spreader institutions’ too big, connected or important to fail.” The banking system must therefore be regarded as a banking “ecosystem,” they argued, demanding appreciation for the interconnectedness between firms and how those might facilitate “propogations” – that is, emergent outcomes – across the financial system. “Looking at financial risk through a network lens indicates a fundamentally different rationale for prudential regulation,” Haldane and May concluded.

What is true at the macro-systemic level of the banking system is true at the micro-systemic level of individual firms, which might be examined for their own eco-systemic health. This approach may inform efforts to study how culture (rules of interaction) drive conduct and misconduct (emergent outcomes).
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What is the secret to organizational change? How do innovative technologies and new organizational cultures take hold? The answer is not what you think. Most people think that the key to change is identifying “influencers” who can advocate for an initiative. But, change is not about finding the right people. It’s about having the right contagion infrastructure.

I’m sure you have heard that behaviors are contagious, but what does that mean? Does organizational change really spread like a virus, cascading from person to person? Of course not. Anyone who has ever tried to initiate change within their organization will quickly appreciate that getting people to adopt a new management practice or business technology is not as simple as just telling them about it. Changing people’s workplace practices and their cultural norms is difficult precisely because these behaviors encounter resistance – which prevents them spreading virally.

But that does not mean that change is not contagious. It is. But, just not in the same way that a virus is. Over the last decade, my work has been dedicated to mapping the contours of social and organizational change to understand the role of social networks in transforming people’s acceptance of new technological practices and new cultural trends. From the explosive growth of Black Lives Matter, to the shifting culture of gender expectations within Fortune 500 firms, to open innovation and new corporate governance practices, the spread of cultural and normative change does in fact follow identifiable rules. But they are not the rules of viral contagion.

Viral contagions, like COVID-19, spread easily from person to person. Each social connection is a pathway for the disease. Information often works the same way – rumors and gossip spread easily, as each new contact spreads the word to dozens more. Highly connected social “stars” – so-called “influencers” – accelerate the growth of these viral contagions. An influencer’s large circle of social contacts enables them to rapidly spread a viral contagion to the farthest corners of the social network. Why doesn’t it work the same way for change initiatives?

Because change does not spread like a virus – a single exposure to an innovative idea or behavior is not typically sufficient to convince you to adopt it. Instead, spreading change is more like spreading acceptance for a vaccine: people need to be convinced that a new behavior is safe and legitimate – and there are lots of reasons, both personal and social, why people may resist. So, how do we get people to accept change?

My research shows that, as people consider whether to adopt a new belief or behavior, they are guided – much more than anyone realizes – by their social networks. Through the hidden power of social influence, the network around us shapes how we respond to an innovation, causing us either to ignore it or to adopt it. This much-deeper process of social
spreading is called complex contagion, and it has given rise to a new science for understanding how change happens — and how we can help make it happen.

As I explain in my new book, Change: How to Make Big Things Happen, the new science of complex contagions offers powerful insights into how to build an organizational network that supports change. There are three steps to building a successful contagion infrastructure: 1

1) WIDE BRIDGES:

The connections between people located in different social clusters are called bridges. Early network scientists often gauged the value of bridges by their length, meaning the social distance they spanned — what I call reach. Even today, the prevailing assumption — among not just social scientists but most people in industry and advocacy — is that reach is the key to success.

But there is another way to think about bridges, and that is in terms not of length but of width — by which I mean the number of ties they contain. A weak tie is a narrow bridge. Within an organization, a narrow bridge might consist of a single tie between a person in one division, such as the engineering group, and someone in another part of the organization, such as sales. In a company where the members of the engineering group almost never meet the members of the sales group, a weak tie between, say, Isabella the engineer and Celine the sales manager establishes a narrow bridge across the organizational network. It offers a rare opportunity for useful information to spread between the two groups.

A wide bridge, by contrast, reflects strong ties that enable true collaboration: it involves a group of people, from one division, engaging with individuals and teams, from another, through multiple overlapping connections. Wide bridges are not about reach but redundancy. They allow people on both sides of the bridge to hear the opinions and recommendations of multiple peers and colleagues, and to discuss and debate ideas with them. Wide bridges mean stronger ties.

To spread a new behavior from one group to another, wide bridges are essential for establishing the necessary trust, credibility, and legitimacy. Any attempt to coordinate a large and diverse population should be based on establishing wide bridges that both engender and reflect trust between different subgroups — among different divisions within an organization, across different communities and regions, and between different political constituencies.

2) RELEVANCE:

The important idea for building a successful contagion infrastructure is not similarity, but relevance. There are some situations in which the diversity of adopters, rather than their similarity, is actually more important for determining their relevance. There is no magic bullet for creating relevance, no single defining trait that is always influential. However, a few general principles are helpful for understanding how relevance gets established from one context to another:

**Principle 1:** When behavior change requires that people be given social proof that a particular innovation will be useful for them, similarity with the adopters is a key factor for creating relevance.
**Principle 2:** When behavior change requires a degree of emotional excitement or feelings of loyalty and solidarity, then, once again, similarity among the sources of reinforcement will help to inspire behavior change.

**Principle 3:** When behavior change is based on legitimacy — that is, believing that the behavior is widely accepted — then the opposite is true: diversity among reinforcing sources of adoption is key for spreading the innovation.

When it comes to creating relevance, context is king. Deciding whether the key factor is diversity or similarity (and what kind of similarity) depends upon the barriers to adoption — the kind of resistance that your desired behavior change will be most likely to encounter. Is it an issue of credibility, legitimacy, or excitement? Once you identify the kind of resistance, you will also know how to create relevance.

3) **DE-BIASING NETWORKS:**

Networks are not neutral. They either foster innovation or they hamper it. They either promote knowledge transfer across groups or they reduce it. The right contagion infrastructure spurs teams to be more creative, and groups to be more cooperative; the wrong one can thwart creativity and cooperation.

Familiar ideas and biased opinions are viral contagions. They are easy to understand and easy to follow. They will spread if you let them. Influencers are particularly effective for spreading these simple contagions.

But information-based change campaigns often fail because of social networks.

Networks are prisms that color and shape what people see and what they believe. Networks can either reinforce bias, stabilizing the status quo, or champion new ideas that overturn the status quo. True innovation requires protecting people from influences that reinforce the status quo.

Breaking free of old ideas and discovering new common ground requires a contagion infrastructure that preserves diversity and stimulates the discovery of new knowledge. Untapped knowledge is often hidden in the outer edges of the social network. The right contagion infrastructure can bring that knowledge to everyone — and reduce a group’s unconscious bias in the process.

Leaders concerned with managing conduct-related risks must first understand the contagion infrastructure that shapes the day-to-day experience of individuals and teams within their organization. Are those networks composed of narrow bridges, sufficient only for transmitting information? Or are they built with wide bridges, essential for real behavioral change?

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1 The text below is excerpted from “Change: How to Make Big Things Happen” (Little, Brown Spark, 2021).
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Non-financial risk management in the financial services sector is managed according to a Three Lines of Defense (‘3LoD’) model. This model seeks to manage risk through restrictive policies, processes, systems, and record-keeping, and to apportion accountability for such among front office business leaders (1st Line), supported and overseen by risk and compliance staff (2nd Line), with assurance coming from the internal audit function (3rd Line). Following on the heels of risk management failures, most post-mortems conclude that the 3LoD model was insufficiently well ‘embedded’ within a firm. Call-outs typically include: inadequate clarity regarding roles and responsibilities, coordination challenges within and between the lines, broken processes, inapt systems, and inaccurate risk reporting. Collectively, these challenges lead to an enfeebled ‘voice of risk’ in the organization.

Why does this pattern of failure persist?

As discussed herein, perhaps traditional risk management underweights our profoundly social nature. In all spheres of life, humans operate within fundamentally social constructs, with informally defined expectations of behavior guiding how we must act if we are to ‘fit in.’ Formal processes, systems and structures (including financial incentives) hold far less sway than does the social imperative of compliance with cultural norms – ‘going along to get along.’ Looking at risk governance problems through a structural lens, however, one perceives structural solutions.
And this is characteristic of current approaches to non-financial risk management: we emphasize process and system solutions.

But if there are other factors at play—namely, social factors that system and process tweaks fail to contemplate—then perhaps we should not be surprised when structural solutions result in regular risk management failures.

When misconduct crises erupt, and particularly those that appear to have issues of corporate culture at their roots, remedial responsibilities often reside within a firm's human resources function. A principal tool in the HR toolkit is the annual employee engagement survey, which aims to take the pulse of the organization by asking employees about their perceptions of things like company culture and purpose, values and tone from the top, perceptions of psychological safety, workplace inclusiveness and diversity, and job satisfaction. While perhaps representing “good hygiene,” such survey efforts have not been demonstrably successful in reducing misconduct risk.

“The annual employment survey needs to be retired,” writes Peter Cappelli, a professor of management at the University of Pennsylvania’s Wharton School and director of its Center for Human Resources.1 “The reason companies do these surveys—to find out what is going on in their workplace and with employees—remains as important as ever, Cappelli allows. “But workers don’t like the surveys and often won’t respond to them, and most companies don’t do anything with the results anyway.” Most often, Cappelli argues, companies fail to act on survey results because the concerns employees raise are too big or expensive to be easily addressed.

Or perhaps it is because they’re not sure what else to do?

“Many executives are rightly frustrated about paying immense and growing compliance costs without seeing clear benefits,” writes Harvard Business School professor Eugene Soltes and Hui Chen, a former DOJ compliance expert, “And yet they continue to invest—not because they think it’s necessarily productive but because they fear exposing their organizations to greater liability should they fail to spend enough,” they maintain.2

This typifies thinking about ubiquitous and *de rigeur* ‘ethics training’ programs. For many company leaders, such programs are akin to an expensive insurance policy – when problems erupt, they can point to their training investment in hopes that this may placate regulators and prosecutors. But employees most usually resent these exercises, seeing them as a series of mindless box-checking routines. For many,
it is like being required to read a book on *Judo* and expecting that to be sufficient training should they run into trouble.

One of the main reasons that companies keep investing in such training is that they do not have the right measures and thus cannot tell what works and what doesn’t, Soltes and Chen claim. They find that many firms therefore rely on training program completion rates as a proxy for the program efficacy. “Completion rates may be relevant for a firm to track for other purposes,” Soltes and Chen allow, “but a meaningful measure of effectiveness must be directly tied to a clearly articulated outcome—for example, employees’ demonstrated understanding of policies and procedures, their acquisition of useful skills for confronting anticipated scenarios, or a change in their behavior.”

The persistence of misconduct scandals suggests that these training programs are failing to deliver the desired return on investment.

The Basel Committee on Banking Supervision (BCBS) defines Operational Risk as the risk of loss resulting from inadequate or failed processes, systems, and people (emphasis added), or by external events. To a large extent, firms have focused attention and resources on processes, systems and guards against external threats (e.g., cybersecurity). They have been far less successful at addressing the people element, though perhaps not for lack of trying.

Firms have long relied on enterprise risk management (ERM) tools to gauge levels of operational, reputational and strategic risks. But a study into the effects of such ERM systems on business performance outcomes in the wake of the 2008-09 financial crisis, by researchers at Canada’s Telfer School of Management, found that the information produced by ERM systems, in the years prior to the crisis, had no appreciable effect on firms’ ability to predict imminent risk outcomes or subsequent firm performance.³ Improvement in financial risk monitoring, assessment and management were the priorities following the financial crisis, for regulators and firms alike.

Experience in the course of the COVID-pandemic suggests that macroprudential guardrails put in place following the financial crisis have adequately tamed financial risk. But such systems have not shown similar efficacy in the realm of non-financial risks. Redressing this is now a priority for supervisors and policymakers, out of concern for misconduct scandals, operational risks that flow from changes in technology, mounting cybersecurity challenges, the accelerated entrance of non-bank firms into the financial sector and, in the wake of the pandemic, broad concern for ‘resiliency.’

Reflecting this, the BCBS released a consultation paper in November 2020, ‘Principles for operational resilience’. ⁴ “While it may not be possible to avoid certain operational risks, such as a pandemic, it is possible to improve the resilience of a bank’s operations to such events,” the paper reads. Essential in this regard is that firms develop a comprehensive mapping of all “the people, technology, processes, information, facilities, and the interconnections and interdependencies among them needed to deliver the bank’s critical operations.” In an earlier (August 2020) consultation paper entitled, ‘Revisions to the principles for the sound management of operational risk’, a first principle spelled out by the BCBS asserts that, “The board of directors and senior management should establish a corporate culture guided by strong risk management, set standards and incentives for professional and responsible behaviour, and ensure that staff receives appropriate risk management and ethics training.”⁵
But how is such a culture to be established and what training will support a change in regularly witnessed outcomes?

“We need to think about infrastructure and controls very differently,” said outgoing Citigroup CEO Mike Corbat in a memo to employees last August. “We can’t think of them as just something that is important to our regulators. It’s not about getting remediation projects done or checking boxes.”6 In describing the business value of effective risk controls, Corbat referenced race car driver Mario Andretti: brakes allow drivers to go faster, safe in the knowledge that they can slow and stop the car when necessary. Corbat went on to call for changed thinking about risk management in the financial industry, giving voice to much of the thinking expressed by contributors to this report.

All of us have a role to play in changing our mindset. This is not the job of just some of our colleagues. It is all of our jobs, across businesses, regions and functions. Siloed thinking that prioritizes one individual’s or group’s task rather than the best outcome for the firm is not acceptable. Our approach to risk and controls needs to be proactive, consistent across the firm, deeply embedded in how we do business and prioritized by every person who works at Citi. We will be measured, as a firm and individually, by how well we accomplish this change, and I encourage you to see it as an opportunity.

REFERENCES

Ground Breakers
"The Healthiest Human System"

An Interview with JOHN FLINT

Q: While CEO at HSBC, you prioritized something that you referred to as “the healthiest human system.” Can you say a bit about what that means?

A: The ambition to build the Healthiest Human System in Financial Services was an ambition communicated on my first day as CEO. I wanted to signal to everyone within HSBC that I believed that my most significant responsibility was to create an environment in which everyone could be at their best, and in which everyone could work towards fulfilling their own potential.

Q: How did you come to form these views?

This ambition was appropriate for the context in which I assumed leadership of the Group. We had just navigated a very demanding Deferred Prosecution Agreement with the US Department of Justice, and the impact of this episode upon the people working inside HSBC had been profound. I had the opportunity to hit the “reset” button and to work towards improving the confidence and outlook of the Bank. It was time for the Bank to become less inward looking and to be less afraid. It was time to “look up and to look out”.

Q: What did you hope to achieve, in very practical terms?

A: In practical terms I wanted to achieve two simple things. The first was to give leaders at all levels permission to lead, and not just to wait for the instructions from head office. The second was to reduce fear in the organization. Fear had permeated the organization and, as a consequence, decision making was less effective than it should have been.

Q: Bank regulators have long emphasized the importance of ‘Tone from the Top’ in terms of shaping behavioral norms among employees. Given your long personal experience in the industry, do you agree that ‘Tone from the Top’ is paramount?

“Tone from the Top” is critical, yes. But the actions and behaviors of leaders are even more important than what they say. Pretty much all leaders know what the right thing to say is. But not all lead and behave in a way which is consistent with this. Leaders are increasingly visible and if there is a gap between their words and their actions they will be exposed.

Q: How did this leadership example shape your own career?

The behavior of leaders had a significant impact on my development as a leader. I was fortunate to grow up in an organization with terrific leaders and role models and I was a keen observer of the attributes and behaviors that made them successful. I was also fortunate that the organization was full of stories – so that the best examples of leadership were passed down (and possibly embellished over time!) from generation to generation.
Q: Did that leadership action and ‘tone’ conflict with what you may have heard from more immediate peers?

No, I don’t recall ever experiencing conflict in this regard in my time at HSBC. There was plenty of disagreement and debate – but it was generally healthy. And, looking back, my honest reflection is that the Bank was very good at making sound choices about the way forward, even with incomplete information, and the complexities of multiple stakeholders. The organization I grew up in, and that I had the privilege to lead, possessed a culture fit for the task of banking.

Q: Many of the misconduct scandals that have bedeviled the industry appear to have caught firm leaders by surprise, damaging firm value as well as individual careers. Despite such materiality, many still consider things like culture to be ‘soft stuff’. Why is that?

A: Because it is harder to measure than profits. And because it is harder to measure it is harder to incentivize. Incentives (pay) is typically at the core of all challenges in financial services. Sadly the explanation is that simple.

Q: How do you think we ought to think about these issues at the level of the board and c-suite?

A: Boards typically recognize that they are responsible for the strategy of the firm, but too often they are passive when it comes to their responsibilities for holding the executive accountable for creating the appropriate environment for staff to deliver on their strategy. And the C-suite is often too risk averse. They prefer the path of least resistance and choose the route with the highest probability of objective (i.e., measurable) success, failing to remember that, as a leader, the only thing you lead is people. You can’t “lead” working capital, buildings, inventory etc. Leaders lead people – that’s all.

Q: The UK’s Financial Conduct Authority argues that things like ‘bullying’ or challenges with diversity, equity and inclusion (‘DE&I’) represent ‘cultural’ challenges at a firm, that likely indicate heightened conduct risk that warrants closer supervisory scrutiny. Do you agree?

A: I agree whole-heartedly with that view. You have to join the dots and look for potential vulnerabilities. If the culture of a firm is a happy host of bullying, or harmful unconscious biases, then it is reasonable to assume that the same culture also facilitates other behaviors which can lead to increased conduct risk.

Q: How might institutional investors consider such risks as they relate to their ‘ESG’ interests?

A: It is hard for institutional investors to engage with firms on these issues, but they need to make much more of an effort. Too often, ESG issues are the preserve of a small ESG team which is not necessarily aligned with fund managers. This alignment needs to be tightened up. And, of course, if institutional investors are to become more actively involved in the ESG issues of their investee firms, they need to make sure that management at those firms is practicing what they preach.
Q: Given your views here, what counsel would you offer a newly installed bank CEO?

A: As a new CEO you should focus on two immediate tasks.

Firstly, ensure that you have broad agreement with relevant stakeholders on your business strategy. Where will you compete? How will you allocate resources? How will you ensure a fair exchange of value between customers and shareholders? etc.

Once this has been agreed and communicated you can focus your energies on your second task – the task of creating the best possible environment for the people you lead to deliver on your strategy. Many leaders stop after the first task. But the real magic of leadership though lies in the second task.

*John Flint is Former Chief Executive of HSBC.*
When I was growing up, my aspirations did not revolve around the finance industry. At different points in time, I wanted to be a doctor, or a lawyer, or a teacher. Life sometimes takes us to places we had never imagined. Little did I know that I would be a banker one day. After reading Economics and Philosophy at the National University of Singapore, I was drawn to a career in banking, as Singapore was an emerging financial hub in the 1990s and the industry was becoming a vibrant and attractive sector.

Like many of my peers who wanted a foot in the door, I applied and was Fortunately selected to be a management trainee in Standard Chartered Bank. I spent the next 22 years in various roles that spanned corporate banking, trade finance, technology, and operations. I also had the privilege of working in and travelling across Asia, the Middle East, Africa, and Europe before joining DBS in 2016. At every step of my journey, I often asked myself – What is my purpose in banking?

Banking dates back to 2000 BCE. As civilizations developed, activities between parties depositing their wealth, storing and keeping records of such wealth, lending, and borrowing started to emerge. This wealth took various forms, including grain, cattle and gold, and transactions involved palaces, temples, merchants, traders and farmers.

As we trace the development of civilisations, we discover that the underlying function and purpose of banking remains highly relevant and critical today. Banking promotes a trusted system and framework that enable the smooth functioning of commercial activities and the economic development of societies. At the macro level, banks facilitate safe and convenient payments between parties that allow trade and commerce to function both domestically and internationally. Banks also play the intermediary role between depositors with excess funds and borrowers who need access to loans. This role facilitates the efficient deployment of financial resources to businesses that need working capital. Banks are also key facilitators in the capital markets that help institutions access longer term capital needed for development, expansion and growth. At the individual level, banks serve financial needs by providing a trusted and safe facility where people can deposit their financial assets, grow their wealth, transact for their everyday activities and access personal credit.

As I continue to be engaged with the industry, I am even more convinced that banking remains an essential and purposeful service for society as it promotes the healthy functioning and development of economies, which in turn improve the lives of people.

Being guided by this purpose, I have seen how we can make a meaningful difference in the lives of our customers, business owners and companies. I am constantly learning new things from interactions with clients across all walks of life, who operate in various industries and countries, developing and deploying solutions to address their needs. I have also been exposed to many different cultures as I have worked with people across the globe.

While my journey in banking has been gratifying, it is not without its ups and downs. Those challenging times included the Asian Financial Crisis in the 1990s, Severe Acute Respiratory Syndrome (SARS) epidemic in 2003 and the Global Financial Crisis (GFC) in 2008. Throughout those tough times, some
banks remained resilient and emerged stronger, while others failed. During the GFC, there were also banks that introduced systemic risks into the industry, thereby exacerbating the crisis. Many lives were impacted as result, with some banks failing and some others bailed out with public finances. Therefore, it was unsurprising to see public trust in banks being eroded in the aftermath as some perceived bankers as villains who are in the profession just for money. Post the GFC, several other banking scandals, albeit less systemic, peppered around several countries in the last decade further tainted the industry.

I remain convinced that the fundamental purpose of banking is noble. It is therefore paramount for all leaders in the industry to constantly steer their organisations to stay true to the original core, or soul, of banking. While it is key for banks to remain profitable to ensure the soundness of the financial system, we must never forget that banks exist to serve real people, support real businesses, develop real economies and contribute to real communities. Beyond the external façade of branches and financial products, banks must constantly engage in soul searching to determine if the core values that define banking remain true. Banks should consider if they continue to deserve or enjoy the trust of their stakeholders, which is a vital foundation to the success of the industry. Banks must spare no effort to earn, build and guard the trust that stakeholders place in them.

The recent Covid-19 pandemic is a clarion call for the banking industry to reach into the soul of banking again, to connect with that original purpose. This is an opportunity for banks to make a real impact, to enable the smooth functioning of the economy, support real people, businesses and the community. At a personal level, despite the challenges faced in 2020, it was an incredibly fulfilling year for me and my colleagues. At DBS, we worked with the industry and various agencies to support both individual customers and small medium enterprises (SME) by offering a suite of credit programs. This provided the necessary cashflow to help them navigate through the crisis, which kept businesses afloat and sustained livelihoods. We leveraged our digital capabilities to help customers overcome the disruption to their businesses arising from the lockdown. We worked with our insurance partner to offer free Covid-19 insurance coverage to our customers. While DBS was already banking for the vast majority of migrant workers, we went the extra mile to open accounts for the remaining unbanked ones during the lockdown. This allowed them to continue being paid by their employers and to access our digital remittance services to send money home. Apart from making a corporate donation, we also galvanised our staff, customers and the public to raise additional funds to provide meals and care packs to vulnerable individuals impacted by the pandemic.

If one truly embraces the soul of banking, it is indeed a fulfilling profession in which one can do well and do good at the same time. I have been very blessed to have started my career at an institution which had made immense contribution to the development of many countries in the emerging markets of Asia, Africa and the Middle East for over a century. The years I spent there had given me the opportunity to witness the positive impact banking can have on the lives of ordinary people and development of nations. As I transitioned into DBS, the current institution I serve in, I was further inspired by the strong sense of purpose that makes up the DNA of the bank.

The story of DBS is probably a good illustration of the soul in banking. DBS began as the Development Bank of Singapore, established to support the development, industrialisation, and modernisation of the nation. Singapore’s rapid progress from third world to a first world city and financial hub is a testimony of the positive impact that DBS and the industry have made in the last few decades, alongside good governance from the government and regulators. Therefore, it was within expectations that independent surveys have indicated a high public trust in both the government and the banking industry in Singapore. But where do we go from here?
Today, DBS continues to offer a full suite of financial services, serving the full spectrum of customers, including customers that might be unserved or underserved. True to DBS’ DNA, we continue to collaborate closely with various agencies in the ongoing digitisation and transformation efforts of the nation. I think it is vital that banks do not become complacent. We must endeavour to guard and build on the public trust placed on us. Even as we seek to build a vibrant and profitable business which is necessary for a sound economy, we must never compromise on upholding the highest standards of ethics, and in relentlessly fulfilling the purpose of banking, serving real people, supporting real business and communities.

Shee Tse Koon is Group Executive and Country Head for DBS and chair of the Culture and Conduct Steering Group in Singapore, which comprises representatives from 14 banks, the Monetary Authority of Singapore, and the Association of Banks in Singapore.
Ground Breakers 'From Policy to Practice'

An Interview with MIREA RAAIJMAKERS

Q: The DNB was the first central bank to bring an organizational psychologist on board to help think about behavioral science in the context of supervising culture and conduct risks in the industry. How did that come about?

A: One of the lessons that could be drawn from the financial crisis and major incidents in the financial sector is that employee behaviour and culture greatly affect the soundness, risk profile and integrity of financial institutions. Answers had to be sought in employee behaviour, going beyond organizational structure and processes. Behavioural problems often already exist before problems in the performance of the organization come to light. Therefore, by identifying and tackling ineffective behaviour and an unhealthy culture at an early stage, major financial and nonfinancial risks can be prevented. The basis for understanding human behaviour draws on evolutionary, cognitive and social psychology. These fields are increasingly considered in combination with economic concepts to understand what drives, and what prevents, behavioural change. So, what can I say? It’s a clever decision DNB made back then...

Q: What are some of the key lessons you took away your time in this policy-oriented role?

A: That it adds a lot of value to financial institutions and supervision to include this behavioural lens in risk management. It requires both supervisors and financial institutions to focus on root causes of performance, and how integrity elicits conversations more focused on sustainable impact and behavioural change. I have seen an increasing awareness of the importance of culture and behaviour, and a shift from ‘why is this important to address’ to ‘how can we address this effectively.’ Willingness to change has increased over time as well. There’s still a lot to do, but nobody doubts that these topics are here to stay.

Q: Many have embraced the approach to supervising culture and conduct issues that you pioneered at the DNB. Others, however, find the behavioral science approach a bit too academic, and not terribly practical in a day-to-day context. What do you say to them?

A: Behavioural Risk Management uncovers structural behavioural patterns at work within an organization that might lead to financial as well as non-financial risks. By thoroughly analysing behavioural patterns in the organization, we develop tailor-made interventions that mitigate and – eventually - prevent behavioural risks. This approach to risk management is new to organizations. Introducing a new approach and way of working, one that most people in the organization are unfamiliar with, naturally leads to internal debate. People stick to certain patterns and ways of thinking about the ‘effective’ way to work in an organization. It is not easy to break through these habits, these fixed ways of thinking, but real change takes place through discussion and debate. It’s a matter of talking the same language and approaching people in the right way. In the end, we all want the same outcome: reduced financial and nonfinancial risk and a healthy, high performing organization. If that requires insight drawn from behavioural science, most people are actually quite keen to explore how this adds value.
**Q:** How would you describe your journey in Behavioral Risk Management at ING?

**A:** The receptiveness within ING has been significant ever since we started building our Behavioural Risk Management team. When we presented our findings for the first time to the top 200 executives, there was mainly recognition and appreciation for what we addressed and the way we did so. Of course, there was also scepticism and push back. Yet, I no longer need to convince my peers that behaviour matters and that addressing behavioural risk is part of being a safe and compliant bank. This now resonates, and that is shown in the fact that we work and impact strategic areas and that our expertise is taken on in bank-wide efforts on improving risk culture and KYC.

**Q:** Looking back how would you describe the impact of BRM on ING so far?

**A:** Behavioural Risk Management uses innovative ways to change behavioural patterns that have been identified as posing a potential risk. For example, we have introduced “Nudge Labs” to the organization as a means of steering people in the right direction and encouraging desired behaviours. In these Nudge Labs, employees engage in a mutual effort to reflect on uncovered challenges. Together with our team’s behavioural experts, employees investigate their behavioural biases and co-create simple, yet innovative solutions. We see that interventions such as these Nudge Labs result in greater collaboration and cohesiveness in teams, which in turn improves performance and the quality of work.

**Q:** What are you most proud of, thus far?

**A:** There are so many moments that leave me feeling grateful and proud. I am most proud when I hear senior leaders and employees talk about behavioural risks and use behavioural risk language. That they refer to us-them dynamics as something that needs to be addressed. That they think and talk about drivers of behaviour and refer to informal drivers. That they pick up behavioural challenges and change the way we do things at ING. That’s when you know the work we do resonates and that we add value.

**Q:** Culture and conduct risks are gaining increased attention in connection with environmental, social & governance concerns (ESG) and the diversity, equity & inclusion (DE&I) agenda. Can you share some of your own views in that regard?

**A:** Being a safe and compliant bank means we stand as a gatekeeper for our customers, employees, regulators and society. We’re committed to certain principles to take care of the world we live in, including our environment and society. The trust of our customers and employees is extremely important to us. In order to truly understand and be connected to our environment, we need diversity. For diversity to thrive and add value, we need to include everybody who is willing to live up to the principles and promises we make.

**Q:** Work-from-Home protocols have challenged us all in the past year, and the line between our work and personal life is more blurred than ever. How does this impact management of behavioral risks?

**A:** In the beginning of the crisis you saw people adjust very quickly. Clear priorities were set and there was hope that things would resolve. Right now, more than a year later, that new energy has faded away. People might feel alone or isolated, and there is no certainty when things “go back to normal”. People are social creatures that want to belong to and identify with a group. They look for “social cues” to determine which behaviour is appropriate and which is not. While
working from home, we miss the connection with our colleagues and the social cues that come with it. Research shows how this can negatively impact mental and physical health as well as performance. In addition, a decrease in motivation and engagement might lead to unethical behaviour - because rules and regulations seem so far away, and without social cues, we might struggle how to behave appropriately. Therefore, especially during times of a crisis like now, it is important to stimulate behaviours that keep people motivated, engaged and connected to work. Leaders play a crucial role in this: they should focus on building social connection and strengthening relationships, while taking into account personal differences. It is crucial to listen to your employees, to be empathic, discuss dilemmas, but also to celebrate successes together.

Q: Have you discovered opportunities and means by which to advance your work in new ways? Can you say a bit about that?

A: Honestly, we learn new things and see opportunities every day. Everywhere around us. There are many areas within the bank that can benefit from our perspective, and I see many opportunities in cooperating with other departments within the bank – to join forces and strengthen each other.

Q: You earlier described the discourse around culture as having moved on from, “Culture is important and here’s why,” to “Managing these issues is critical to firm performance outcomes, so how do we do manage well in this context?” Where are we headed next?

A: People will always be a significant part of organizations, which means that managing behavioural risks will always remain an explicit focus area. In my opinion, the next step would be to provide people with the right tools and resources such that they themselves are aware of their behaviour and can proactively engage in behavioural topics across the organization.

Q: Looking forward, how do you think we can accelerate the impact of managing behavioural risk across the financial industry? What is your vision on the use of data and AI to mitigate behavioural risk?

A: Big Data developments have given rise to new methodological tools to investigate behaviour beyond what is possible through traditional forms of analysis. We keep a close eye on emerging technologies in the field of behavioural science to see where it may impact our work. For instance, we see opportunities in exploring new technologies for identifying areas that are more prone to behavioural risks and which may thus benefit from a better understanding of underlying human behavioural tendencies within ING.

Q: We’re seeing a shift in regulatory priorities, away from reactive/corrective measures in the wake of misconduct event, and towards developing a more proactive/preventative capability. What are your own views in that regard?

A: In recent years it has become increasingly clear that studying behaviour has a predictive quality with regard to future performance. Early intervention can mitigate risks in a more timely way and help to prevent future problems. Where people used to look back more, nowadays, there is more value attached to looking ahead, and people are increasingly aware that the capacity to examine behavioural risk is an important asset in this respect.

Mirea Raaijmakers is Global Head of Behavioural Risk for ING.
Ground Breakers
Elevating Culture & Conduct Risk Management

By Loretta Yuen

Introduction

“Culture” has been a buzzword in recent years. However, this term is still a vague concept for many. At OCBC, we understand “organisation culture” to mean the corporate values, attitudes and conduct of an organisation.

A positive culture that encourages the right behaviours can effectively pre-empt potential misconduct. It is therefore imperative that banks get culture right. A strong and sound culture can help to reduce litigation and regulatory enforcement risk that may arise from conduct failings.

OCBC’s Culture and Conduct Journey

The knowledge that culture is a key driver of conduct is not new to OCBC Group. Two years ago, we embarked on a journey to strengthen our corporate culture and encourage our staff to adhere to the highest ethical standards in their day-to-day actions.

From our journey thus far, we have distilled the following learnings:

- Build a strong culture and conduct governance structure
- Help employees understand what “good” looks like
- Do not neglect areas of strength even as you work on areas that require improvement
- Industry collaboration and knowledge sharing is critical for success.

BUILD A STRONG CULTURE AND CONDUCT GOVERNANCE STRUCTURE

In the last decade, culture and conduct as a subject matter has grown in significance within the banking industry. As such, bank boards and senior executives are proactively steering and shaping desired culture within their respective organisations.

At OCBC, we have a dedicated Board Ethics and Conduct Committee to ensure culture and conduct discussions form part of the regular agenda at board forums. Comprised entirely of non-executive directors, our board committee oversees initiatives that help to ensure OCBC Group maintains a strong culture of responsible banking and fair dealing.

Culture-building is a shared responsibility that requires collaboration between different people and functions. At OCBC, our board committee is supported by two cross-functional and multi-disciplinary senior management committees. At OCBC, the General Counsel, together with the Heads of Human Resources, Communications and Risk Management, sit on both these committees. The powerful combination of our professional expertise ensures initiatives are holistically reviewed and implemented in a meaningful manner.
HELP EMPLOYEES UNDERSTAND WHAT “GOOD” LOOKS LIKE

To achieve desired culture, a common understanding of what “good” looks like should be consistently communicated to staff. At the minimum, corporate values must be clear and periodically reviewed to ensure they remain relevant to the organisation’s long-term goals. When coupled with internal policies that are easy to understand (e.g., a comprehensive and well-drafted Code of Conduct), clearly articulated corporate values will help guide employees to behave in a manner that is desired by the organisation.

That said, having good paperwork is no longer sufficient. Additional steps should be taken to translate corporate policies into everyday actions that are straightforward and easily understood by employees. At OCBC, we make a conscious effort to compile relatable “on-the-job” stories of how our employees across various bank roles have correctly applied our corporate values in their work. These acts are then shared with the rest of the bank through dedicated training programmes and in-house communication channels. Where these real-life examples are formally recognised through awards or commendations, such moments are celebrated. When employees realise that the organisation positively acknowledges and rewards the right behaviours, consistent displays of good conduct that align with such examples will follow soon after. Over time, banks that leverage positive recognition practices will eventually have an edge over their peers that do not.

The behaviours of senior management executives are also instrumental in shaping desired corporate culture. Change happens when leaders “walk-the-talk” and model the behaviours they want their subordinates to emulate. Top-down messaging from leaders and middle managers must be consistent with corporate policies. If employees receive mixed messages (e.g., sales teams get rewarded for selling unsuitable products to customers, or whistle-blowers get socially labelled as “troublemakers” at the workplace for speaking up), this causes confusion on the ground and can result in negative consequences for the organisation.

DO NOT NEGLECT AREAS OF STRENGTH EVEN AS YOU WORK ON AREAS THAT REQUIRE IMPROVEMENT

To achieve desired culture, banks must be willing to prioritise this subject matter on their corporate agenda. This means allocating appropriate resources to understand their “current state of culture” and describe their “desired future state”.

At OCBC, we invested significant resources to understand what our people felt about our current culture. Candid feedback from more than 4,500 individuals, which included board members, senior management executives and employees, was collated through a combination of interviews, focus group sessions and a culture survey. The data was thoroughly reviewed and digested into a set of findings which detailed our strengths, as well as potential areas for improvement.

It is important that equal emphasis be placed on areas of strength, as well as areas in which an organisation can do better. Too often, banks prioritise work on areas of weakness when trying to improve corporate culture. While practical, this “glass-half-empty” approach may unintentionally paint a skewed picture of the organisation. Complacency about areas of strength may also lull some organisations into a false sense of security, as they take the view that these areas require less attention. The consequential lack of priority may cause standards to drop overtime.
In contrast, if banks are willing to identify positive attributes and put in extra effort to keep them in view, it crystallises the need to invest continual resources to maintain or further uplift progress made in these areas, even as we work to address other aspects of culture.

At OCBC, we have designed a dashboard to monitor our culture and conduct status using similar principles. Our Dashboard focuses on attributes and outcomes that are important to us. This means we track areas in which we are already doing well, as well as areas in which we intend to further improve. Our Dashboard incorporates more than just misconduct-related metrics. We consciously include a wider range of metrics that measure customer compliments, public sentiment, the extent of corporate values adherence by our staff, our community contributions and our sustainability efforts. We analyse both qualitative and quantitative data so that we not only understand whether we are meeting targets, we also understand why this is the case.

Although the launch of our Dashboard marks a significant milestone in our culture and conduct journey, we are not done. Identifying the right metrics and putting in place monitoring mechanisms is just the beginning. We intend to further enhance the quality of our dashboard analysis by assessing whether meaningful connections that can be drawn across metrics. This can only be achieved through effective horizontal collaboration across bank functions and well-coordinated knowledge sharing efforts. Done right, it will enable us to provide an even more robust and comprehensive report of our organisation’s culture and conduct state to our Board.

**INDUSTRY COLLABORATION AND KNOWLEDGE SHARING IS CRITICAL FOR SUCCESS**

A positive culture movement cannot be achieved through individual bank effort; it requires industry consensus, cooperation, and collaboration. As a member of the Culture and Conduct Steering Group, a Singapore banking industry group set up to promote sound culture and raise conduct standards, OCBC has been greatly enriched by the generous sharing of best practices by our peers at this forum. More importantly, these sharing sessions compel us to constantly re-evaluate our existing internal practices and inspire us to further improve.

We are also extremely grateful to our regulator, the Monetary Authority of Singapore, for their continued guidance in this area. Over the years, the Monetary Authority of Singapore has been an active participant at industry dialogues, where they shared valuable insights and observations about emerging risks gathered through their supervisory lens. They have also invested significant time and resources to publish various information papers and guidelines on topics like accountability, incentive structures and observations of good culture and conduct industry practices. These contributions have helped to demystify culture and conduct as a subject matter, and crystallise the outcomes banks in Singapore should work towards to maintain a culture of trust and existing ethical business practices.

**Some Final Thoughts**

Real culture change is not a check box exercise that can be achieved single-handedly by one department or through a top-down mandate. The entire organisation must collectively work together in pursuit of this common purpose. Driving culture change and ensuring we stay on track is not easy. Along the way, organisational friction does happen and is inevitable. When this happens, it is best to view such “healthy tensions” optimistically. Just like diamonds, we all need a little friction to become our best. A seamless experience, in contrast, suggests little or no change is taking place.
The Covid-19 pandemic has demonstrated that a strong corporate culture is critical to guide banks to overcome challenging times and emerge stronger and more resilient. It is therefore imperative that banks build and maintain a culture anchored by their corporate values. This will enable them to continue creating sustainable value for their customers and other stakeholders in the long term.

Loretta Yuen is General Counsel for Oversea-Chinese Banking Corporation Limited.
Deeper Dive
Colaborating on RegTech

“So what is the future of supervision in this changing world, and what can we learn from the current crisis?” asked BCBS chairman Pablo Hernández de Cos, addressing the 21st International Conference of Banking Supervisors in an October 2020 speech.¹

The implications of these developments for supervisors are threefold. First, proactive supervision must be the primary response to these changes, as the traditional regulatory framework may not be sufficient. Second, greater consideration should be given to the regulatory perimeter to ensure that the oft-cited mantra of ‘same activities, same risks, same rules; is actually operationalised. And third, cooperation among different authorities – spanning both monetary and regulatory authorities – will be even more important.

As we observed in our report last year, regulators and central bankers are now working closely - through cross-border initiatives such as the Global Financial Innovation Network² and the Bank for International Settlements (BIS) Innovation Hub³ – so they might learn from one another’s experiences in bringing new technologies to bear amidst today’s manifold challenges. July saw the launch of a Digital Regulation Cooperation Forum in the UK, for instance.⁴ The BIS announced broad expansion of its Innovation Hub, with new centers planned for London, New York (in partnership with the NY Fed), Toronto, Stockholm, Frankfurt and Paris.⁵
The European Banking Authority (EBA) issued a Consultation Paper in August last year indicating that it is looking at “mapping and understanding existing RegTech solutions, identifying barriers and risks relating to the use of RegTech and analyzing how to facilitate the application of RegTech across the EU.”

“While fintech is an essential part of the UK financial ecosystem, it’s important to remember that RegTech companies have also played a crucial role in helping firms navigate the challenges posed by COVID-19,” said William Russell, Lord Mayor of London, in a speech last month. “Innovative technologies provided by the RegTech industry can help financial services to better meet their regulatory obligations, enabling real time surveillance of the financial markets and even predicting where risks and problems will emerge.”

“The benefits and opportunities of regtech and suptech for regulated entities and supervisory authorities to improve efficiency, reduce manual processes and make effective use of data are enormous,” said BIS Innovation Hub head Benoît Cœuré, during an August 2020 speech. “SupTech and RegTech tools could have important benefits for financial stability,” wrote the FSB in an October report. “For authorities, the use of SupTech could improve oversight, surveillance and analytical capabilities, and generate real-time indicators of risk to support forward looking, judgement based, supervision and policymaking,” the report noted, adding that “For regulated institutions, the use of RegTech could improve compliance outcomes, enhance risk management capabilities, and generate new insights into the business for improved decision-making. For both authorities and regulated institutions, the efficiency and effectiveness gains, and possible improvement in quality arising from automation of previously manual processes, is a significant consideration.”

Partly driven by strains arising from the COVID-pandemic, the past year has seen a continuation and expansion in these collaborative undertakings, giving a marked boost to the adoption of fintech offerings.

The leak of the FinCEN files triggered greater collaboration around anti-money laundering and other financial risks, and the collapse of Wirecard, may have boosted demand for technologies that address operational and other non-financial risks.

An Australian Senate Select Committee on Financial Technology and Regulatory Technology issued an Interim Report on learnings it has gained through more than 200 submissions from an array of industry participants. The Select Committee has shown interest in developing an informed appreciation of barriers to uptake of these new technologies and recently changed its name to the Select Committee on Australia as a Technology and Financial Centre. “This is the ideal time to widen our scope and explore new opportunities for Australia as a technology and finance centre arising from the COVID-19 pandemic,” proclaimed Senator Andrew Bragg, Committee chair. “I fully expect the committee to focus on removing more barriers to Australian growth as a technology and a finance centre,” he added.

Increasingly, regulators are acting to catalyze technology innovation. Australia’s ASIC has called upon the financial industry for greater collaboration towards achieving better regulation. “We consider that regulatory technology (regtech) has significant potential to help businesses enhance their risk management and compliance activities,” ASIC indicated in a report summarizing the regtech initiatives it undertook during the 2019–20 financial year. “We are committed to the continued promotion of regtech and its use by financial firms. We consider that it can deliver better consumer and market integrity outcomes.”

“The use of technologies that enhance efficiency and/or the effectiveness of risk management and regulatory compliance – presents opportunities to unlock significant benefits for banks, regulators and the wider economy,” the Hong Kong Monetary Authority observed in a report released in November. “The HKMA strongly believes that Hong Kong has
the right foundations to support a thriving Regtech ecosystem, and ultimately become a Regtech hub,” said HKMA Deputy Chief Executive Arthur Yuen in a speech coinciding with the report’s launch. “We want to accelerate the adoption of Regtech in Hong Kong. And this will involve us working hand-in-hand with banks and the Regtech community.” At the close of the year, the HKMA outlined a number of regtech use cases that might effectively respond to operational challenges presented by Covid-19 disruptions. And, in January this year, the HKMA issued a report on the use of regtech in connection with AML/CFT obligations. “Regtech adoption will not be an aspiration in 2021,” KPMG argued, “it will be a necessity.”

Banks have also drawn closer to the fintech and regtech ecosystems in the past year. “By using artificial intelligence, machine learning, and other advanced technologies and practices,” wrote BCG in an April 2020 report, “they can improve bank steering; deliver predictive, real-time insights; and execute faster and more efficiently.” In a September report, McKinsey offered, “Sub-sectors such as digital investments, digital payments, and regtech, which have had tailwinds from crisis-related changes in behavior, appear set to take a greater share of the funding pie.” When the U.S. SEC’s Strategic Hub for Innovation and Financial Technology announced a series of virtual meetups in June, RegTech was the first theme to be covered. The UK FCA asked if the pandemic had helped to usher in a “watershed moment” for the RegTech space.

“Should there be a greater prudential focus on bank conduct, ethics and incentives? Is there scope for greater collaboration among different types of authorities on cross-cutting issues?” asked BCBS chair Hernández de Cos at his October speech cited at the outset here.

The GFC exposed serious deficiencies in these areas. In some instances, misconduct by a few ‘rotten apples’ in the system threatened to undermine the robustness of the barrel. In response, international bodies and authorities in charge of conduct and market integrity have rightly led the efforts to address these fault lines.

Yet episodes of malpractice and related behaviours have clear prudential implications too. They may point towards broader deficiencies in banks’ governance and risk management standards. Conduct-related fines to banks over the past decade totalled hundreds of billions of euros, and proved to be a significant driver of provisions and at times a source of risk to banks’ capital strength. And, even more importantly, ongoing misconduct practices erodes trust between the banking system and the public. A moral ‘run on the bank’ would have significant prudential implications.

Since the financial crisis, regulators and firms alike have emphasized a ‘detect and correct’ approach to conduct risk governance and supervision. As we move forward, perhaps regtech will permit for a more proactive, ‘predict and prevent’ capability set.

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In Focus
Adapting and Connecting in the Digital world: how regulators can lead

By TIMOTHY D. ADAMS

The COVID-19 pandemic accelerated the digitalization trend, elevating customers’ expectations, blurring traditional sectoral boundaries, and adding further urgency to digital transformation journeys. For financial institutions, it is critical to keep pace with advancements in digital technologies and to support an adaptive and dynamic culture. This is also the case for regulators and supervisors.

However, it is more than just a shared challenge and shared journey, it also an opportunity for the financial industry and for regulators to lead. Digitalization, and the increased reliance on advanced data analytics, present significant new policy issues that span industries and national borders, and financial regulators are best positioned to tackle and lead on these issues.
KEEPING PACE IN A RAPIDLY EVOLVING ECOSYSTEM

In an increasingly interlinked, data-driven global financial ecosystem, regulators face the difficult task of evolving with the pace of technological progress, while supporting their statutory objectives to preserve the integrity and stability of the financial system and protect consumers. Banks and insurers are adopting transformative technologies such as Artificial Intelligence (AI) and Cloud and are increasingly engaging with other technology partners across the ecosystem.

The IIF-Deloitte Realizing the Digital Promise series explored this topic, interviewing 200+ industry leaders and officials, and the magnitude of this challenge was encapsulated by a senior official at a national central bank in Europe:

“Many banks still have legacy issues, and board members with four-year mandates who won’t touch the legacy in that time. On the other hand, we have Google who says they ‘refactor all their code every three years’, which is incomprehensible for most of the major and older banks. This presents a real challenge for us regulators to keep up with.”

This observation highlights three key issues.

1. The challenge for banks to keep pace with technological change is enormous given advancements made by firms that are potential competitors and/or potential partners. To that end, it also suggests the need for banks to partner with technology specialists;

2. The scale of the challenge for regulators regarding immediate upskilling and developing an adaptive culture that can keep pace and evolve going forward is vast.

3. There is a direction of travel for regulatory and ecosystem-wide collaboration. Historically, engagement among financial institutions, their technology partners and the regulators has been more bilaterally focused or sometimes at arms length. Today, there is increasing recognition that multilateral collaboration is needed.

It also underscores the emergence of new participants, services and dynamics in the ecosystem, such as Cloud Service Providers, and an increased focus on how data is stored, managed, processed, transferred and protected. The various national/regional regulations and restrictions on data are key considerations now, in addition to the traditional prudential views of safety, soundness and compliance.

FINANCE, DATA AND BLURRING LINES

The intersection of regulators’ mandates and overlaps among agencies make for an increasingly complicated labyrinth. The importance of data in the new economy means that the scope of a traditional banking, insurance or securities supervisor now intersects heavily with that of privacy and competition commissioners. Leading technology analyst Benedict Evans recently cited a major European competition regulator who said, “We tell a tech company to do X, and then that afternoon the privacy regulator tells them not to.”

This issue is amplified by the blurring of sectoral boundaries, for instance as BigTech firms increasingly move into financial services, with embedded finance and ‘banking as a service’ business models. Asymmetrical requirements such as ‘Open Banking’
have generated some competitive anomalies, and Bank of International Settlements General Manager Agustin Carstens highlighted the potential systemic importance of BigTech firms, with a potential need for additional supervisory oversight.3

These cross-sectoral issues arise in each jurisdiction and present an unenviable challenge for policymakers and supervisors. As each jurisdiction grapples with these under their own legal structures and political climates, this further complicates the ability to address these issues effectively at a global level. Nevertheless, it is critical that we face these difficult issues.

RENEWED URGENCY FOR GLOBAL COOPERATION

Internationally, digital divides are unfortunately deepening. Some governments limit market access for digital products and services, restrict data transfers and invoke protectionist barriers on digital designs. This further complicates efforts for international regulatory cooperation in an increasingly digitalized economy.

We are at an interesting juncture – perhaps an inflection point – for how we approach international coordination and cooperation in regulation of financial services and beyond. The digital age presents a renewed need for regulatory coordination and for refreshing regulatory mandates.

Monetary Authority of Singapore Managing Director Ravi Menon has highlighted the absence of a rulebook for the global digital economy, suggesting that some of the U.S.-China tech tensions were attributable to the lack of “rules of the game.”4 Menon has suggested the possible need for a ‘Digital Bretton Woods’, covering topics like data localization and digital services trade.

The adverse economic consequences of digital protectionism and data localization restrictions are well documented, and small businesses and gig economy workers may actually suffer some of the greatest impacts.5 For financial institutions, these can also undermine efforts at holistic risk management and combatting fraud and financial crime. This is especially relevant for cloud and enhanced security capabilities, where financial institutions and their customers need access to the best in data protection and analytics – services that are commonly provided by specialist firms across borders.

Menon cites Singapore’s successful bilateral Digital Economy Agreements (initially with Australia, New Zealand and Chile) as a helpful step, but we need to elevate these to major economies and hopefully multilateral approaches. This also needs to be complemented by further efforts to renew and modernize international regulatory frameworks for the digital era.

FINANCIAL REGULATORS CAN LEAD

Data and digitalization issues extend beyond financial services and beyond the traditional mandates of financial regulators. However, financial authorities are well placed to pick up the “free flow of data with trust” baton championed by Prime Minister Shinzo Abe during the G20 Leaders Summit in Osaka, and to include it in G7 and G20 arenas.

A consortium of major international companies (including IIF member firms Aflac, Citi, EY, Mastercard and Visa) have proposed that the G7 countries establish a ‘Data and Technology Forum’, which could mimic what the Financial Stability Board (FSB) did for financial services. Its proponents rightly highlight the need to modernize international regulatory structures to keep pace with digitalization and the blurring of sectoral boundaries.6 This imaginative solution
warrants consideration and the suggested use of the FSB as a template is significant. After all, while certain areas of regulatory fragmentation do persist, financial regulators have achieved a greater level of international cooperation and coordination than their peers in most other industries.

We also must be realistic and acknowledge that there is unlikely to be a singular data privacy and protection framework internationally, and that local values and attitudes can vary significantly. To this end, the objective should be for interoperability between national data regimes, as the APEC Business Council’s Financial Forum has backed – again, following many of the precedents set by financial regulators in their approach to cross-border supervision.

Like our regulatory counterparts, the financial services industry has a similar opportunity and obligation to lead within the private sector. International inconsistencies in data and digital services regulations also adversely impact telecommunications, medicine and logistics industries, and banks and insurers can similarly champion the cause of interoperable solutions that can benefit the wider economy.

The rapid digitalization of the global economy adds urgency to these issues. Economic recovery and growth, especially in the midst of the pandemic, demand that we realize the opportunities of digital trade and cross-border data connectivity. As industry and regulators upskill, transform and adapt for the digital world, we should lead the effort to ensure these economic gains are realized.

Timothy D. Adams is President & CEO of The Institute of International Finance.

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Our View
What Happens Next?

An Interview with GARY COHN, TOM CURRY, and RICK KETCHUM

Q: Managing culture and conduct related risks in the financial services sector was challenging, pre-COVID, and has become an order of magnitude more difficult since. Where are we headed next? What do you expect the ‘new normal’ to look like here?

COHN: I think that the ‘new normal’ is going to remain pretty fluid, at least in the short-term. I mean, it’s not yet clear what the ‘new normal’ will ultimately need to be. For instance, the once unthinkable notion of a highly regulated institution having its people work remotely or from home is now known to be possible. It may not be ideal, in all instances, but it seems pretty clear that some jobs will become permanently remote in nature. It looks like banks will fracture into a mix of remote and in-office work, and that the concept of the ‘central office’ may be less relevant as work becomes more distributed, geographically. We’re already seeing firms move into cities and other locales that are cheaper to operate in.

This has real implications for how we manage risk. The standard approach – the Three Lines of Defense – is predicated in part on the idea that people at work are sitting next to one another, talking through concerns, overhearing one another’s conversations, and watching each other at work. That context provides a check on misconduct. As does the idea of 2nd Line compliance officers ‘walking the beat’ and patrolling the office. Without that day-to-day interaction among employees being concentrated in one physical space, much is lost. Figuring out what to do about that is something all firms are now contending with. I think they’re doing the best they can, but the simple fact is that their processes and systems are not designed for this new work context. As a result, I think that we’re going to find a lot of dirty laundry when we do a post-COVID look-back.

KETCHUM: Gary’s right: in a remote or hybrid work environment, the great risk is that informal conversations among employees, and between the business line and supervision or compliance function, becomes stilted or simply disappears. That creates the risk that employees will make decisions without the level of guidance that they would otherwise normally access. And this increases the difficulty of regulatory supervision as well as internal compliance. Without being able to see where the puck is headed, we are all left playing catchup instead of offence.

So, regulators have the same challenges as those faced by firms in their efforts to address the ‘new normal.’ Of course, regulatory exams and monitoring today are extremely data-driven exercises, so some functions will change very little. But the risk of things being missed or dropped is real because of the limits of Zoom-type communications among the regulatory team, and between that team and financial firms. Regulators have been saying consistently that culture shapes conduct. The protections of a strong risk and compliance culture are clearly even more important in the supervisory context today. So, it just stands
to reason that, going forward, regulators will pay even more attention to these cultural issues in the current environment.

And what’s also significant is the rate of change occurring among financial firms and markets. To name just a few in the capital markets area, let’s start with the enormous growth of retail trading driven by the pandemic work environment and social media, resulting in the ‘meme stock’ phenomenon, intentional short squeezes and enormous individual stock volatility – all occurring outside a firm’s control. Second, there is the game-changing nature of the Solar Winds and Microsoft cyber events, and the increased concern with third-party provider controls. Third, look at the enormous increase of companies going public through SPAC mergers, bringing interesting new issues regarding diligence, forward-looking projections, and conflicts. Fourth, there are the issues posed for financial firms in dealing with less transparent and highly leveraged hedge funds and family foundations, as underlined by the recent Archegos fiasco.

That is a lot of change management to deal with – and don’t even get me started on the wealth of control issues arising out of crypto! With these and so many more significant issues confronting regulators at the same time, while they are operating in a suboptimal pandemic environment, not all risks will receive the level of regulatory attention that they deserve. One thing is certain, however: firms will not receive a free pass if a supervision problem emerges. So, we’re living through a time when an effective compliance and risk culture has never been more important!

COHN: Rick’s right on all of that. But, speaking from the perspective of someone who had these sorts of management challenges and obligations for a long time, to some extent this is not entirely unfamiliar terrain. When you run a global institution, you do a lot of work from home in order to engage with employees and clients in different time zones around the clock.

So, we have some experience here. But that experience tells me that more surveillance and monitoring isn’t going to solve the problem of bad actors. There are some few people in any firm who will be smart enough to take their illicit activities offline. As a result, this makes the informal monitoring I was speaking about earlier that much more critical. It helps to stop things from slipping through the inevitable cracks of any formal surveillance system. But you just can’t do this effectively when both risk-takers and control staff are working from home. This leaves us all the more dependent upon having confidence in our people to do the right thing in the first place, to question and surface perceived problems, and to act as a resource to one another. So, the culture element becomes that much more critical for firms as well as their overseers.

CURRY: I generally agree with Gary and Rick on the post-COVID outlook. Once regulators fully resume their normal onsite supervision and oversight programs, I think we will see the real scope of COVID-related internal control weaknesses emerge. It’s possible, but not probable, that the regulators will take the unique pressures of the pandemic into account as they fashion remedial measures.

I think Rick raises an interesting point about the recent high-profile failures in financial firms falling outside the current regulatory perimeter governing banks. This is an area to which the Yellen Financial Stability Oversight Council, and the Financial Stability Board, will devote increasing attention. Nonbanks – including money market funds, hedge funds, family offices, and internationally active mixed nonbank financial institutions – may face greater oversight, including reporting and leverage requirements. As
such, nonbanks would be wise to bolster their risk management capabilities in advance of any such increased regulation.

**Q:** What do you see as the implications of ‘hybrid’ work models in terms of how we apprentice the next generation of risk managers, bank supervisors / examiners, and both internal and external auditors?

**COHN:** This is a great example of what I was just saying. We’re not going back to pre-COVID work norms any time soon – if ever – so we simply have to figure this out. How do the regulators and regulated inculcate the right instincts and habits among new staff? How is ‘institutional memory’ regarding the way things are done around the organization shared across generations of staff? These are learnings, habits and skills that are obtained in the early years of one’s career, and historically they’ve been gained by watching senior leaders and seeing how they act. And it’s no different for a banker than it is for a junior regulator asking questions of a senior regulator about policies and procedures on the job.

In today’s changed circumstances we need to rethink organizational learning, and we’ll need to develop new management methods that will likely demand new management training methods and new tools by which to chart the course forward successfully. This goes to the point made by both Tom and Rick above: innovation and technology adoption is not optional. We simply have to develop new tools that are fit for purpose.

**KETCHUM:** Turnover is always a challenge for securities and banking examination and supervision programs, but the hybrid work environment makes the critical mentoring and training efforts of such programs even more challenging. As I said earlier, the greatest challenges lie in trying to keep up with the warp-speed level of change in the activities of financial firms and in the market environment. All of this leaves regulators operating in a “catch up” mode that will be made even more challenging as we go forward.

**CURRY:** The best financial sector regulators tend to be those who possess the requisite skills and who have gone through an economic downturn. You need experienced staff, who have seen what a real problem looks like, as it unfolds. Absent that type of experience, the agencies need to ensure there is a reliable process for knowledge transfer between senior and junior staff. Financial regulators will also

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What Are the Barriers to and Enablers of Innovation?

In a poll of 500 chief innovation officers, the following factors were found to be the biggest barriers to innovation.

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<th>Factor</th>
<th>Percentage</th>
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<tr>
<td>Politics/Turn Wars/No Alignment</td>
<td>45.3%</td>
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<tr>
<td>Cultural Issues</td>
<td>41.6%</td>
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<tr>
<td>Inability to act on signals critical to future business</td>
<td>40.8%</td>
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<tr>
<td>Lack budget</td>
<td>35.6%</td>
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<tr>
<td>Lack strategy, vision</td>
<td>28.1%</td>
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<tr>
<td>Not adopting emerging technologies</td>
<td>22.5%</td>
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<tr>
<td>Lack executive support</td>
<td>20.6%</td>
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<tr>
<td>Recruiting? Not enough of high demand skills</td>
<td>18.7%</td>
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<tr>
<td>Inability to pick up on signals critical to future business</td>
<td>17.6%</td>
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<tr>
<td>Lack CEO support</td>
<td>10.1%</td>
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*Note: Respondents were allowed to select all that apply. Source: Innovation Leader LLC and KPMG LLP (2018)*
be looking to technology to enhance their oversight programs, increasingly so. Artificial intelligence and machine learning tools adopted by financial institutions and regulators could radically change, and hopefully improve, financial regulation.

**Q:** We saw a spate of Consent Orders and Deferred Prosecution Agreements in recent months, nearly all insisting that firms must do a better job managing their non-financial risks. Yet while ‘more of the same’ seems insufficient, industry leaders express a consistent frustration when it comes to efforts to innovate in risk governance: they’re so busy trying to tick off the list of required measures that have been imposed by their regulators that they have no bandwidth to experiment with new tools. How do we get past this?

**CURRY:** I also wouldn’t underestimate the frustration felt by regulators, who are increasingly open to seeing RegTech solutions trialed, and especially where we have seen repeated risk management failures. Institutions need to move past this frustration and work on improving risk management through investing in innovative solutions to reduce the reputational and financial costs of noncompliance. Technology has a lot of potential to improve bank risk management in areas such as BSA/AML compliance, operational risk, and misconduct risk.

**KETCHUM:** Tom is absolutely correct: the simple answer from a regulator’s perspective is that, where there have been serious control failures, financial firms need to add the necessary resources to remediate their control weaknesses while, at the same time, maintaining their supervision and compliance capabilities across all their business activities. But I get that this is easier said than done!

The longer answer is that financial firms and regulators need to look towards new tools that help get it right. It is precisely because of this fact that regulators have been so focused on culture issues over the past ten years. You just can’t solve these contentious problems solely through better surveillance tools; you have to work to improve compliance and risk cultures to decrease the likelihood of bad outcomes.

Many firms have striven mightily to improve the clarity of ‘tone at the top’ and have deployed countless employee engagement surveys in an effort to measure their staff’s commitment to the firm’s stated values and to identify troubling subcultures. The frustration, however, has been that these activities haven’t really moved the needle very far. There remains a crying need for better data analytic tools that allow firms to focus in on exposures more quickly – before damage to clients has occurred.

Of course, regulators have to be careful of seeming too close to those they regulate. On the other hand, in some markets we are seeing encouraging examples of cooperation – of firms working with one another and with their regulators – so as to better address significant regulatory or systemic risks. U.S. regulators have stayed very informed about those efforts and have encouraged this sort of industry cooperation. If a number of firms stepped forward and proposed employing one or more culture diagnostic tools to determine better how to incorporate that into control environments, I think regulators would likely view that quite positively.

**COHN:** Look, this is difficult stuff, and it’s getting harder by the hour. It’s not like banks aren’t trying to get this right. At the better managed firms, at least, if a senior executive learns of some sort of potential misconduct, they act swiftly to put things right. The firms are throwing everything they have at this – and still too often coming up short. And this tells me that we clearly need to do new things. If you’re up at bat trying to hit a home run but you keep striking out, then you have to reevaluate your swing. That’s true when the sun is shining, and now we’re in the midst of a hurricane. So, banks are doing their best, but it’s clearly not working so they need to change their game. And this means engaging with their regulators.
in an appropriately collaborative context. Firms and regulators have to co-create the future here. We’re all in this together and need to develop solutions together. Firms and regulators have common cause in this – as does government.

**Q:** Given your histories, I can’t pass on asking how you see the politics around these questions playing out, given a Biden administration and Democrats now in charge of both the House and Senate?

**KETCHUM:** We could talk for hours if the subject was rulemaking or interpretive guidance, but the exam teams are far more focused on bad outcomes and emerging risks than ideology. The old focus on AML/CFT, conflicts of interest, operational resilience, cyber risk, and third-party governance is only likely to be heightened as we move forward, because serious problems keep arising. Combine those issues with the new risk areas that I discussed earlier, and this guarantees that oversight levels will increase – if anything, substantially. I’ve never changed the judgement I reached at Citi long ago: that it is way safer to regulate than to be regulated!

**CURRY:** I agree with Rick: front line supervisors are apolitical and are going to continue to focus on high-risk, high-impact areas. The emphasis may change but is usually attributable to industry structural changes, consumer or investor protection concerns, and major technological change.

**COHN:** Let me come back to what I said a moment ago: all these issues matter now for government and policy makers, not just regulators and firms. Despite everyone’s best efforts to manage these programs properly, look at all the fraud being uncovered in COVID-response government stimulus programs. Who is going to be held responsible for that?

In the current social climate, legislators will have little tolerance for more misconduct scandals, but it’s going to be interesting to see how fraud – into the billions – is dealt when the government itself is a principal actor. On both sides of the aisle, legislators and policy makers are going to come under heavy criticism for how various government programs themselves were run in the course of dealing with the pandemic.

Overall, the regulated banking industry has nowhere to run – both Republicans and Democrats alike are going to be all over them, with each trying to prove different political points. Furthermore – and unfortunately – in the time since the financial crisis, it seems that the regulatory appointee process has become more political, with every new administration bringing dramatic changes in agency leadership’s philosophy. Before the crisis, it didn’t really matter who ran the OCC or the CFTC – or many other agencies – in any political context. But in a world where the appointees are put in place more so for their political leanings and less so for their subject matter expertise, we will have a volatile regulatory environment.

For both staff within these regulatory agencies, and for firms, this volatility is going to make it much more difficult to develop a reliable line of sight towards whatever good oversight is supposed to look like.

Gary Cohn is Vice Chairman of IBM and Co-Chairman of Cohn Robbins Holding Corp. Prior to serving as Director of the U.S. National Economic Council (2017-18) he was President and Chief Operating Officer of Goldman Sachs.

Thomas Curry was US Comptroller of the Currency. As Comptroller, he also served as ex-officio member of the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) and the Financial Stability Oversight Council.

Richard Ketchum served as Chairman & CEO of FINRA, CEO of NYSE Regulation, Chief Regulatory Officer of the NYSE, President at both the NASDAQ and NASD, and Director of the Division of Market Regulation at the SEC.
“Ye live not for yourselves; ye cannot live for yourselves; a thousand fibres connect you with your fellow-men, and along those fibres, as along sympathetic threads, run your actions as causes, and return to you as effects.”

HENRY MELVILL, ‘PARTAKING IN OTHER MEN’S SINS’ (1855)
Conclusion: What’s next

Readers of our report last year may remember that we shared a graph, produced with Google’s nGram Viewer, reflecting trends in use of the phrases ‘freedom from’ and ‘freedom to.’ The chart is reproduced here, just below. It reflects a shift in priorities, beginning in about 1961 and accelerating thereafter, that emphasized the perhaps more individualistic interest in ‘freedom to’ (do, be, believe, have) over a more communalistic interests in ‘freedom from’ (fear, oppression, injustice, want).

Google’s nGram charts the frequency of word usage among millions of books printed since 1800. By dividing the number of appearances a word or phrase makes in a given year, by the total number of words in the entire corpus of work produced that year, Google calculates the frequency of single word ‘grams’ two-word bi-grams, and so on. Thus, the nGram tool serves as a rough guide to social trends.

This year, we again conducted some research with the nGram Viewer, tracking the usage over time of the bi-gram at the center of this report: ‘conduct risk.’ The results appear below. It is clear at a glance that, as an apparent prioritization of ‘freedoms to’ outpaced attention devoted to ‘freedoms from’, use of the phrase ‘conduct risk’ accelerated exponentially. It seems unlikely that this is coincidental.
PRICED IN?

As this report recounts, banks and other financial institutions invest tens if not hundreds of billions of dollars each year (in the global aggregate) on governance, risk and compliance systems, processes and personnel. At a certain point, the performance improvement gains from investment become inescapably incremental, while costs associated with such become increasingly exponential. At some point, it is not unreasonable to decide, ‘enough is enough.’ Where that point sits is a judgment call, and who can say if that call is correct, until a new scandal erupts and is taken as evidence that investment was insufficient?

Faced with that uncertainty, it is economically rational that a firm might ‘kick the can down the road’ and delay added investment until events and circumstances make it mandatory to do otherwise. As a precautionary accounting exercise, contingent budget for such potential future losses and costs is set aside. These reserves feature in financial disclosures and, thus, the potential financial impact of future conduct risk management failures is effectively ‘priced in’ by the market and reflected in share price.

Presence of the term ‘Conduct Risk’ over time

Source: Innovation Leader LLC and KPMG LLP, Google nGram
Rating agency Fitch notes that significant governance deficiencies have resulted in negative rating actions at financial institutions in the past. When the headlines filled with stories of a pending 1MDB settlement at Goldman Sachs, Fitch warned that further evidence of elevated conduct risk, governance weaknesses or risk management deficiencies could increase pressure on the firm’s ratings. “The estimated $5.1 billion in total direct financial impact to Goldman related to 1MDB has been substantially reserved,” Fitch noted when the firm’s settlement with the DOJ was ultimately announced. “The settlement is in line with Fitch Ratings’ prior expectations and has no immediate impact on Goldman’s ratings,” it concluded.784

Without reliable and established metrics by which to gauge the likelihood of some such operational risk management issue, firms are left exposed to ‘Black Swan’ events – as Credit Suisse, Boeing and Rio Tinto might attest. Risk models are used to establish what ought to provide sufficient financial cushion against such unlikely events. But there are no actuarial tables for #MeToo claims, the unintentional destruction of national heritage sites, or O-ring failures in space shuttle engines. So, while these unknowable risks may be priced in, it is not at all clear that the full materiality of such risks is accounted for reliably in financial reports to investors. As such, they are regularly caught off-guard when disaster strikes, and shareholder lawsuits are thus commonplace.

As discussed herein, the lack of reliable metrics for non-financial risk events makes it difficult to assess the G in ESG: what are the appropriate inputs for models that seek to calculate a ‘value at risk’ figure for governance lapses? This issue also bedevils efforts to gauge “Management Quality” with consistency when bank examiners decide upon a firm’s ‘CAMELS’ rating. Further compounding such troubles: the BIS finds a 2 to 4-year lag between the time when an operational risk management failure results in loss, and when the event is ‘recognized’ – both in the sense of when management and investors are made cognizant of the loss, and the time before such losses are accounted for in financial reports.785

In short, we are flying largely blind.

WHAT’S NEXT?

Similar circumstances prevailed just prior to the financial crisis: the risk models on which we relied to gauge financial risk did not anticipate a Black Swan event, like the meltdown of the housing markets, and we were equally blind to the systemic risks posed by ‘contagion effects’ across globally interlinked firms and markets. A decade of new rules and regulations ensued, aimed at solving the “too big to fail” problem through stress tests and capital buffers. It seems likely that, post-COVID, we will see a host of new rules and regulations aimed at the potentially systemic risks posed by the “too big to manage” problem. Firms should brace for an onslaught of new requirements in terms of their non-financial risk governance, the metrics by which they evidence risk awareness and commensurate safeguards, and the financial disclosure requirements that investors will demand so as to better assess governance risks.

Indeed, this series of reports reflects that this sea-change is already well underway: as has been said, “the future is already here, it’s just unevenly distributed.”

Most firms are now trying to develop forward-looking risk view capabilities, at the urging of regulators, investors, and others. Corporate governance and risk management are interrelated and interdependent, and many firms look to develop a sense of how they are doing in both regards through enterprise risk management (ERM) systems. Most typically, however, these serve as systems of record, better suited to assigning and ‘mapping’ accountability, capturing the details of risk events as they occur, and conducting forensic inquiries after risk management
failures become unmistakably evident. They do little to permit for proactive insight into the likelihood of such events.

The Basel Committee's 2011 Principles for the Sound Management of Operational Risk points to the importance of people, processes, and systems. At most firms, the emphasis is on processes and systems run by risk and compliance teams, while ‘people concerns’ are typically relegated to human resources departments where they are likely to receive less robust budget commitments and C-suite bandwidth. Behavioral risks can fall through the cracks between these functions, getting lost at the seams of a firm’s operational risk management framework.

Wells Fargo consultancy spend as a % of revenue

Source: SEC Filings
When HR and compliance toolkits fail to anticipate or prevent damaging operational risk events, firms look to consultants for guidance as to how they might do better.

To help draw up an assessment of its operational risk management capabilities, after previous failures of such were highlighted in the course of the Hayne Royal Commission, Commonwealth Bank of Australia (CBA) hired consultancy Oliver Wyman. The decision was later derided by an APRA capability review panelist, Graeme Samuel. “The vast expense of the CBA [assessment] was the hiring of some external consultants,” he complained. The Oliver Wyman review is reported to have cost CBA some $10 million. “I thought it was a waste of money, and it turned out that, in my view, it was,” Samuel said.

“The things that we rely on outside people to do is beyond anything that I’ve ever seen,” Wells Fargo CEO Charlie Scharf complained during a quarterly earnings call, as consultancy spend at Wells Fargo had grown to approach 10% of revenue. A majority of that spend was aimed at allaying concerns regarding conduct risk management capabilities, in hopes of winning release from an asset cap imposed by the Fed after the 2016 false accounts scandal.

“Stakeholder and wider public trust in the credibility of directors’ reporting and the statutory audit has been shaken by a succession of sudden and major corporate collapses which

### Topics addressed in periodic board-level risk management reporting packages

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Note: Percentages total to more than 100% because respondents could make multiple selections.
have caused serious economic and social damage,” asserts a UK government Policy Paper entitled, “Restoring trust in audit and corporate governance,” issued in March this year. “Problems with corporate reporting and audit are by no means exclusive to the UK, as the recent belated discovery of a major fraud at German payments processor Wirecard illustrates,” the report notes.  

Going forward, it is unlikely that regulators, investors or boards will be placated by after-the-fact outputs from company ERM systems, glossy power point decks produced by consultants, or audit reports that provide only a surface view of a firm’s underlying operational realities. The culture and conduct risk management solutions-market therefore looks set to face dramatic ‘disruption’ in the coming years. “The increasing pace of technological change means that, more and more, consultants’ recommendations are out of date nearly as soon as they’re made,” wrote market-trend analysts at CB Insights in October last year, in a report labelling consultancies inefficient, inflexible, and slow to adapt. “Any one of these weaknesses alone would suggest coming disruption,” CB Insights observed. “Possessing all of them points to a major fight ahead.”

“DIRECTING MIND AND WILL”

In February last year a jury acquitted three former Barclays executives of criminal fraud charges brought by the UK’s Serious Fraud Office (SFO). The three were alleged to have conspired to make secret payments to Qatar in exchange for its provision of financial assistance to Barclays during the 2008 financial crisis. Under UK law, to have succeeded in making its case, prosecutors needed to show that the executives represented the “directing mind and will” of the company – or, in other words, the executives’ actions need to be seen as constituting those of Barclays itself. Prosecutors failed to show that this was the case.

It is not immediately obvious (to us, at least) how the prosecutors might have done better. Lawyers have noted that the identification of a directing mind and will is “elusive.” Perhaps this is because the notion itself is faulty. Organizations are rarely directed from the top down through some imperious command and control apparatus. Complexity science teaches us the conceit of believing that a close study of the constituent parts of a system will permit us to grasp the whole. The whole emerges not from underlying constituent elements but, rather, from the interconnections and interplay between those elements. If we wish to appreciate, let alone direct, some collective body, then it is the relationships between its constituent parts that must occupy our study.

Instead, current predilection is to delve ever deeper into each constituent part as though they exist and operate in isolation from one another. Thus do we achieve a highly specialized ignorance, leaving us caught perpetually unawares when the whole produces outcomes we had never even contemplated, let alone planned for. Current circumstances amplify the challenge this implies for management.

“Our research makes clear that most managers today consider employees and other workers who create value for the enterprise — including contractors, service providers, gig workers, and even software bots — to be part of their workforce,” researchers at MIT and Deloitte report. Yet management practices, systems, and processes are designed for internal employees – and are highly ill-suited to conditions in which even they are working remotely. Wharton professor of management Rahul Kapoor urges that we broaden our sense of “the locus of value creation” within firms to encompass the full “ecosystem” of individuals whose collaboration produces company performance outcomes.

Network science theory may help to identify the individuals who most influence group performance within such ecosystems.
behavior finds that “only a small minority of informed individuals is needed to guide a large uninformed group.” If we are to seek anything approximating a ‘directing mind and will,’ it is to the contextually-situated actors within workplace social networks that we must look. “We shape our structures, and afterwards our structures shape us,” Winston Churchill once quipped. If we wish to examine how organizational behavior is shaped, then we must attend to underlying social structures to have any hope of identifying conduct proclivities proactively.

**DATA ‘WILDCATTERS’**

Oil prospectors who sink exploratory wells are called ‘wildcatters.’ If data is the new oil, as the saying goes, then ‘data-wildcatters’ look to machine learning algorithms to function as the new refineries. Crude oil is not immediately useful, and nor is crude data: value must be distilled, by refining raw information (data) into impactful intelligence (analytics).

In very recent years, advancements in such data technologies have allowed us to achieve heretofore unthinkable feats. IBM researchers have shown that when machine learning is applied to writing tests, we can predict the likely onset of Alzheimer’s and other neurological disorders. Deployed in the course of the pandemic, such tools have allowed us to detect asymptomatic COVID-infections through analysis of cellphone-recorded coughs. Machine processed blood tests have proven to be reliable predictors of a patient’s survival chances. Conversely, other AI tools have predicted who will likely die from COVID-19 with up to 90% accuracy, helping to predict respirator demand and to prioritize vaccinations.

Marrying complexity science to the analysis of social networks has permitted for essential advances in public health decisioning in the course of the pandemic. Because network effects may multiply viral threat, a failure to consider complex social networks led to critical flaws in early COVID-19 epidemic models. “If complex social networks are seriously considered,” researchers later concluded, “more sophisticated interventions can be explored that apply to specific categories or set of individuals with expected collective benefits.”

Prioritizing vaccination of so-called ‘super-spreaders’ for instance.

Applying these advances to the study of organizations, ‘computational social science’ methodologies are allowing us to discover hidden worlds within worlds. Enthusiasts announce that this has ushered in a ‘golden age’ of social science, “marked by the confluence of explosive growth in new data and analytic methods, interdisciplinary approaches, and a recognition that these ingredients are necessary to solve the more challenging problems facing our world.” Chess-master Gary Kasparov points to a future in which we will benefit from ‘augmented human intelligence’ – “the kind of intelligence that will allow for organizations to be more efficient and accurate, but at the same time also creative and pro-active.”

Deloitte envisions a ‘future of work’ in which man-machine collaboration becomes a management norm. “Rather than focusing primarily on the ability of computer technologies to automate tasks,” Deloitte argues, “we would do well to explore their abilities to augment human capabilities.” And rather than viewing AI solely as a cost-reduction tool, they suggest that we consider its potential to create more value for customers, and more meaning for employees. At Davos this year, it was argued that AI holds the promise of making organizations 40% more efficient by 2035, while unlocking an estimated $14 trillion in new economic value. The conventional view is that machines are good at rote calculus while the realm of ‘judgment’ is under exclusive human dominion. But London Business School professor, Sir Andrew Likierman, questions this. What we call good judgment may be rooted in the ability to spot certain environmental cues, much as a dog can catch a Frisbee in mid-air without knowing how to
calculate wind speed and air resistance. “In complex environments, decision rules based on one, or a few, good reasons can trump sophisticated alternatives,” Andy Haldane writes. “Less may be more.”

**AI ETHICS & PRIVACY**

The Covid-19 pandemic has sped us towards an era of heightened digital surveillance and has perhaps ushered in a rewiring of sensibilities regarding data privacy. A Harris Poll conducted late last March found that more than half of Americans backed anonymized government smartphone tracking. The 9-11 terrorist attacks led to new government surveillance powers in the name of protecting public safety. The coronavirus crisis could drive a similar readiness to accept increased surveillance powers, wielded now by firms as well as governments.

Firms thus face a quandary. On the one hand, they want to avoid accusations of Big Brother-like overweening staff surveillance. On the other, the U.S. Department of Justice has instructed prosecutors to examine the extent to which compliance teams have access to adequate data when considering penalty-levels for compliance breaches. If a balance is to be struck, firms will need to work with regulators and government to determine where legitimate concerns for privacy-rights must yield to the equally legitimate concern for the integrity of firms and the financial system. “Banks and the government have been in the trenches, trying to absorb the shock of this economic crisis,” said Anna Bligh, chief of the Australian Bankers Association. “In that process you learn a lot about each other - both as institutions and as individuals,” she added. “It changes the nature of the relationship.”

**PROGRESSING PUBLIC-PRIVATE PARTNERSHIP**

Why is it that we find technologies that observe and analyze our social connectivity and interactions to be ‘creepy’? Is this sensitivity itself not an excellent indicator that we believe our social dynamics to be incredibly important? And if it’s important, then how can we afford to ignore it? If these social dynamics are critical drivers of organizational outcomes — as all the evidence suggests — then are we not perhaps irresponsible in management if we fail to attend adequately to these dynamics in the workplace?

Perhaps the creepiness factor creeps in when we are unsure about who, specifically, will have access to this information, and for what purpose. What mediates most powerfully in the direction of creating comfort for us in this regard is whether or not we trust these people, and approve of their purposes. So, where employees find these technologies to be creepy, perhaps that is a sign in and of itself that there is a trust problem in the organization – which may actually make such technology all the more necessary.

“The level of trust that we feel towards our colleagues and our companies is likely to become more extreme—in both directions,” Wharton’s Adam Grant observes. “On the one hand, the teams and firms that stuck together during the crisis should be even tighter-knit on the other side of it,” he contends, with reference to WWII veterans who maintained decades-long bonds of amity. Conversely, however, many managers have responded to the challenges of the pandemic with heightened distrust, seeking to
micro-manage unreliable staff working from home, outside immediate supervision. Added surveillance not only undermines employee loyalty, but it can make such managers still more suspicious creating a vicious cycle. Creating and sustaining trust within an organization is difficult.\textsuperscript{818}

But consider a Superman metaphor. Everyone knows he has x-ray vision, of course. So, when he walks into a room, we are all laid bare before his unfettered gaze. Super invasive? Certainly. Yet Superman isn’t seen as creepy. Why not? Perhaps it is because we may trust him, intuitively. Not only do we not seem to mind that he leaves us utterly exposed, we don’t even think about it – it’s simply a non-issue.

Effective public-private partnerships might help to inspire this level of trust. Acting together, regulators can work to assure that privacy rights are respected, while firms work to assure that customer needs are met, and even anticipated, through the use of AI tools. Public sentinels may oversee firms, to assure their scrupulousness and compliance with regulations and other public duties, while firms can push the limits of technology with a greater sense of confidence that they do so with the regulatory and political ‘cover’ that such innovation and experimentation may demand.

Such aspiration is seen in numerous initiative this year already. In January, for instance, the Monetary Authority of Singapore announced the successful completion of an initial phase of its ‘Veritas Initiative’ - a public-private partnership aimed at developing a fairer assessment methodology for use in credit risk scoring and customer marketing.\textsuperscript{819} Part of Singapore’s National AI Strategy, Veritas purposefully works to provide financial institutions with a verifiable way to incorporate the Fairness, Ethics, Accountability and Transparency (FEAT) principles into their artificial intelligence and data analytics solutions.\textsuperscript{820}

Also in January, Federal Reserve Board Governor Lael Brainard addressed an AI Academic Symposium, hosted by the Board of Governors, with a view to developing a greater understanding of AI uses in financial services, assessing methods for managing related risks, and determining where regulators can act to “support responsible use of AI and equitable outcomes by improving supervisory clarity.”\textsuperscript{821}

Founded in 2018 by Europol, the World Economic Forum and Refinitiv, the Global Coalition to Fight Financial Crime\textsuperscript{822} late last year urged a balance between data sharing and data privacy, maintaining that it is possible to make the case for both at once.\textsuperscript{823} In March, five U.S. bank regulators (the FRB, OCC, FDIC, CFPB, and NCUA) published a request for information seeking comments on the use of AI by financial institutions.\textsuperscript{824} In April, the U.S. Federal Trade Commission issued a document entitled “Aiming for truth, fairness, and equity in your company’s use of AI,” with information on what it views as responsible use.\textsuperscript{825} Around the same time, the European Commission released a much-anticipated draft regulation on AI use, seen by many as a first step towards a comprehensive EU law on machine-driven decision making.\textsuperscript{826}

February saw the release of a book on AI ethics from the Director of the UK’s intelligence agency, GCHQ. Writing in the Financial Times he argued that “AI is enabling us to do our job in different ways, allowing analysts to deal with ever increasing volumes and complexity of data, improving the quality and speed of decision-making.” In short, he wrote, AI “allows our people to focus their efforts where it matters.”\textsuperscript{827} However, he added, “The way in which AI is developed, implemented and exploited must show we are serious about ethics, inclusion and democratic values.” In March, the National Security Commission on Artificial Intelligence – a bipartisan U.S. commission of 15 technologists, national security professionals, business executives, and academic leaders – issued a Final Report.\textsuperscript{828} With a call for proportional levels of investment and expanded public-private partnerships, the commission described AI as, “the most powerful tool in generations for benefiting humanity.”
The federal government must partner with U.S. companies to preserve American leadership and to support development of diverse AI applications that advance the national interest in the broadest sense. If anything, this report underplays the investments America will need to make. The $40 billion we recommend to expand and democratize federal AI research and development (R&D) is a modest down payment on future breakthroughs... We envision hundreds of billions in federal spending in the coming years.

The timing for such collaboration between government, regulators and the private sector, and between emerging technology companies and established public and private institutions, could not be more critical.

**UPSWING**

Had every Athenian citizen been a Socrates, every Athenian assembly would still have been a mob.

attributed to James Madison
Federalist No. 55 (1788)

“We often think of movements as starting with a call to action,” write organizational theorists Edgar and Peter Schein. “But movement research suggests that they actually start with emotion — a diffuse dissatisfaction with the status quo and a broad sense that the current institutions and power structures of the society will not address the problem. This brewing discontent turns into a movement when a voice arises that provides a
positive vision and a path forward that’s within the power of the crowd.”

So, too, for company culture – it requires a movement, not a mandate, if it is to change for the better.


“A drift towards self-centeredness in private life is matched in the public square,” he laments.

In politics, an overfocus on the promotion of one’s own interests at the expense of others’ has created an environment of relentless zero-sum competition and a repeated failure of compromise. Public debates are characterized not by deliberation on differing ideas, but by demonization of those on the opposing side. Party platforms move toward the extremes. And those in power seek to consolidate their influence by disenfranchising voters unsupportive of their views.

In a series of charts, Putnam traces a downward swing in various measures of civic health: cultural solidarity, economic equality, political comity, social cohesion, and more. But Putnam also traces how these same measures fared in the period following America’s *Gilded Age*, which was followed by six decades of “steady upward progress toward greater economic equality, more cooperation in the public square, a stronger social fabric, and a growing culture of solidarity.” In short, an ‘upswing.’

Putnam suggests that we may be at the start of another such turn of the tide. We are called to seize the moment, and to do our part to reverse the trends of the last six decades. Given its importance to whole economies and societies, it seems to us that working to mitigate conduct risk in the financial sector is one good place to start.
Risk Culture and Precision Management Maturity Models

As regulators increasingly encourage firms to adopt stronger culture and conduct risk management strategies, those firms are likewise looking for guidance as to what programs, systems, and metrics they might adopt to meet these new expectations successfully. Regulators say they are reluctant to provide explicit guidance – for many, out of fear that firms will simply respond with some check-box exercise.

But if regulators can’t or won’t define what kind of information will serve to evidence that a firm has taken the correct proactive measures, then what are the firms to do? Most are unwilling to risk taking some new approach that has not won broad industry adoption, and they are understandably reluctant to make investments that may prove to be unnecessary, or unwise. As a result, innovation in culture and conduct risk governance is sidelined or delayed, giving an appearance of foot-dragging on the part of firms. It is a text-book case of what economists might call a “collective action” problem: no one wants to do it unless everyone else does as well.

The immediate challenge, then, is to fashion some means for reaching broad agreement – among regulators and firms alike – as to what good looks like. Indeed, the very nature of concepts like ‘management quality’ (the M in CAMELS scores) or ‘embedding an effective risk culture’ make it challenging to define what ‘done’ looks like. Or even just ‘better.’ For firms, this makes it almost impossible to establish industry ‘best practice.’ And with no established standards to permit horizontal peer review on an apples-to-apples basis, regulators are left open to charges of inconsistency when conducting examinations into these qualitative – yet highly material – risk management challenges.
## Risk Culture Approaches

### Who Does the Work? (additive across maturity)
- **IMMATURE**
  - Internal resources only
- **BASIC**
  - Internal resources
  - Independent external assessment
- **DEVELOPING**
  - Specialized risk and audit teams
  - Independent external assessment with behavioral expertise
- **MATURE**
  - Specialized risk and audit teams with behavioral expertise
  - Independent external assessment combined with data analytics, academic collaboration, and original research

### What kinds of activities do they do?
- **IMMATURE**
  - Conduct risk incorporated into existing surveys or pulse checks
  - Rely on self-reporting
  - Focus is on outcomes: risk incidents, breaches, and compliance metrics
  - broad-based approach with minimal functional specialization
- **BASIC**
  - Culture-specific surveys
  - Risk culture ‘dashboards’
  - Subjective data (e.g., interviews, focus groups)
  - Culture addressed by Internal Audit
  - Risk reviews and post-hoc incident/failures explicitly address behavior
- **DEVELOPING**
  - Deep-dive reviews differentiated to functions, roles, and responsibilities
  - Clearly defined governance models
  - Management accountable for culture and outcomes
  - Behavioral and cultural risk managed as a specific risk type
  - First line leads on evaluating conduct risks
  - Sub-cultures addressed with evidence-based, tailored solutions
  - Target drivers and cultural context, including formal drivers
- **MATURE**
  - Expert engagement on assessments and reviews
  - Operationalize predictive analytics
  - Track risk behaviors continuously and scaled to entire organization
  - Deep-dive reviews to include senior leadership team and Board
  - Adoption of behavior change interventions and nudge solutions
  - Organize culture sprints
  - Sponsor industry initiatives and cooperation; facilitate horizontal reviews

### What are the outcomes?
- **IMMATURE**
  - Focus on efficient reaction to poor outcomes
  - Checklist/compliance-based
  - General encouragement of good culture and desirable behaviors
- **BASIC**
  - Metrics on conduct risk outcomes incorporated into management reporting tools
  - Describe general behavior with minimal view on differences in norms across the firm
  - Minimal impact on root causes or drivers
- **DEVELOPING**
  - Boards and senior leaders prioritize culture and its drivers and incorporates them into initiatives.
  - Recognition of root causes in conduct risk
  - First line takes ownership and accountability for conduct risk
  - Clear conduct risk-related boundaries for decisions
  - Integrated and adaptive approach to both business and risk
  - Consistent with evolving regulatory expectations
- **MATURE**
  - Enterprise-wide, integrated and embedded behaviors aligned with risk and control systems
  - Balanced and consistent-decision making
  - Awareness and mitigation of blindspots
  - Proactive root cause analysis and intervention
  - Well balanced individual and collective accountability
One way to break through the stalemate is to help firms to evaluate the status of their current programs and to offer clearer benchmarks for how new projects might be taken to improve upon the status quo.

To this end, the following ‘organizational maturity scales’ that may be useful for just such an exercise. In both illustrations, ‘success’ is not defined as a single outcome to be achieved, or some static end-state designated as being ‘good.’ Rather, we outline a continuum of steps that should lead to ever more effective organizations, leaving it for boards, management teams, and their supervisors to set short and long-term goals, in line with the areas of highest risk or value, and to prioritize investment accordingly.

The first of these, the Risk Culture Maturity Model, was originally developed by the Australian risk transformation firm, Rhizome. This model describes the resources, activities, and desired outcomes required by firms as they work to implement improved culture and conduct risk management. Initial strategies focused on broad-based culture improvements provide a starting point, these generalized improvements gradually giving way to more specialized and differentiated approaches over time.

The second, Precision Management Maturity Scale, was developed by Starling. It places management of culture in the broader context of performance management and operational resiliency. At the earliest stages, firms may elect to rely on traditional survey tools and activity-based supervision to monitor for and to promote desired behaviors in a top-down approach. As firms invest in more sophisticated tools and practices that identify the drivers of conduct so as to shape behavioral proclivities, they may work towards a ‘Precision Management’ capability, whereby leaders can rely on leading indicators of risk and intervene surgically when necessary. This positions front- and back-office leaders to operate from the front foot rather than in perpetual remediation. And it allows firms to push responsibility for culture and conduct risk management closer to the coal-seam: down into business units and corporate functions.

These models are based on the learnings we have achieved in the course of compiling this series of reports and we hope that they present a useful summary to guide further thinking. As always, we would welcome any feedback.
Closing Comments
The changing role of a bank supervisor

by CAROLYN ROGERS

The last decade has been a challenging one for bank supervisors; there was a lot of work to do to fill the gaps laid bare by the Great Financial Crisis. However, the decade ahead is likely to be even more challenging. What’s more, the solutions deployed in the last decade are not likely the same ones needed in the decade ahead.

Early in my career as a supervisor, I was taught to stick very closely to my legislated mandate. Over-regulating was considered as big, or bigger, a risk as under-regulating since it would surely lead to competitive and market distortions and stifle innovation. A good supervisor was like a good referee: they kept the game fair and competitive but remained largely invisible.

Over my career, I also learned to mind the clear line between conduct supervision, or the fair treatment of consumers, and prudential supervision, or financial safety and soundness. In Canada, where I have spent most of my career as a supervisor, those mandates are considered distinct enough to be held by different authorities and even subject to different jurisdiction for some parts of the financial sector. This is true in many other countries, though not all.

Finally, for most of my career, I could define what a bank was, and what it was not, and by extension, what my responsibilities as a bank supervisor were.
Each of these bright lines seem to be rapidly disappearing. Banks and banking are increasingly diverging. Conduct and prudential risks on the other hand, are increasingly converging. Supervisors need to have one eye on the macro risks and the other on micro risks, and there is an open debate about the role of financial regulation in affecting social policy outcomes from climate change transition to decreasing inequality. All of this is happening in an environment of increased transparency and heightened public expectations. Combined, these trends mean that the legislated mandates given to many supervisors can leave them ill-equipped to be a good referee or to meet public expectations.

This evolving landscape requires us to think differently about the job of bank supervision. More forward-looking supervision and a greater willingness to use judgement and to act without perfect information will need to replace the dominant focus on rules and standards. Rules and standards are a necessary part of an effective regulatory regime but they will never keep pace with change and human ingenuity. We know this because time after time, when a crisis happens, we find that someone found a way around the rules and the risk management culture didn’t detect or stop the behaviour before it was too late.

If the last decade of bank supervision was about designing rules that lead to more resilient bank balance sheets, the next will be about designing supervisory tools and strategies that lead to more resilient bank cultures. And the goal in the decade ahead must be for banks to improve their risk culture and operational resilience by at least the same margin as they have improved their financial resilience in the decade past.

The Basel Committee and its member jurisdictions have incorporated this shift in focus into our thinking and future planning. It’s no small challenge; but like the last one, it’s a challenge I think we can meet.

Carolyn Rogers is Secretary General, Basel Committee for Banking Supervision. Ms. Rogers was appointed to the Secretary General role for the Basel Committee for Banking Supervision in March of 2019 and took up her duties in August of 2019. She has 20 years of executive management experience in the financial services industry, having worked in both the public and the private sector. Prior to joining the Committee Ms Rogers was the Assistant Superintendent of Regulation at the Office of the Superintendent of Financial Institutions (OSFI) in Canada and served as OSFI’s representative on the Basel Committee.
APPENDIX

The Starling Bookshelf

We speak a fair bit on the topics herein for audiences interested in learning how behavioral science and computational social science techniques come together in the context of culture and conduct risk management (and supervision). Nearly always someone asks, “Where can I learn more?”

So we’ve complemented our Compendium with reference to some of the works that sit dog-eared on our bookshelves, yellow highlighter marks competing with coffee stains and notes in the margins. We hope our readers will be inspired to give one or two of these terrific books a glance—and most particularly that by our advisor, Amy Edmondson, below.
“Every person is a compulsive group-seeker, hence an intensely tribal animal.”

“People must have a tribe. It gives them a name in addition to their own and social meaning in a chaotic world. It makes the environment less disorienting and dangerous. The social world of each modern human is not a single tribe, but rather a system of interlocking tribes, among which it is often difficult to find a single compass.”

“To an unprecedented degree, homo sapiens are adapted for acting and thinking cooperatively in cultural groups.”

“The problem is how we can get ourselves to join forces. This is not a trivial task since what I do depends on what I think you will do and vice versa, recursively, which means that we must be able to communicate and trust one another sufficiently.”

“One cannot be human by oneself. There is no selfhood where there is no community. We do not relate to others as the persons we are; we are who we are in relating to others.”

“Culture comes into being whenever persons choose to be a people. It is as a people that they arrange their rules with each other, their moralities, their modes of communication.”

“Much of what passes for economic motivation is ... actually rooted in the demand for recognition and therefore cannot simply be satisfied by economic means.”

“It is not enough that I have a sense of my own worth if other people do not publicly acknowledge it or, worse yet, if they denigrate me or don’t recognize my existence. Self-esteem arises out of esteem by others.”

“Psychological safety is present when colleagues trust and respect each other and feel able — even obligated — to be candid.”

“[It] is mission critical when knowledge is a crucial source of value.”

“People at work are not only failing to speak up with potentially threatening or embarrassing content, they are also withholding ideas for improvement.”
Social Chemistry: Decoding the Patterns of Human Connection

Marissa King

"Just as psychological safety is contagious, so is negativity. Anger, anxiety, loneliness and fear are all contagious. They propagate through networks."

"Humans have a profound need to feel seen, heard and understood. But it is a privilege we are not frequently granted."

"If we are going to have a society where people understand people who are different from them, work is where that is most likely to take root."

The Challenger Launch Decision: Risky Technology, Culture, and Deviance at NASA

Diane Vaughan

"People are both creators and carriers of culture."

"The premise of this book is that individual behavior cannot be understood without taking into account the organizational and environmental context of that behavior."

"Practices do not follow rules; rather, rules follow practices."

"Deviance from accepted practice is often essential to the ongoing enterprise, even when it appears to conflict with official goals."

The Rules of Contagion: Why Things Spread – and Why They Stop

Adam Kucharski

"We need to consider how beliefs and behaviours arise, and how they can spread."

"From innovations to infections, contagion is often a social process."

"If we improve our understanding of how something is spreading, we can come up with more effective control measures. We may be able to target interventions at high-risk groups, or identify other weak links in the chain of transmission."

Norms in the Wild: How to Diagnose, Measure, and Change Social Norms

Christina Bicchieri

"People do not make choices in isolation: they pay attention to what others do, and what others disapprove of. But who are these other people that individuals observe before acting themselves? In other words, who belongs to each person’s main reference network?"

"Mapping the reference network is an essential part of understanding social norms and how to change them, because the norm has to change within the reference network..."

Change: How to Make Big Things Happen

Damon Centola

"The vast majority of the time, the social influences altering people’s behavior take place beyond their field of vision — in their blind spot."

"Our modern communication infrastructure has revealed, for the first time, the precise pathways that behaviors follow as they move through populations."

"Social networks are not merely pipes that spread information... but prisms that color how people receive new ideas and innovations."
“Wicked problems refuse to cooperate. They are messy, ill-defined, open to many competing interpretations, more complex than we understand, and lacking correct answers.”

“Facing such an impossible or intractable problem, we usually choose one of three options, each of them flawed. We attempt to ignore or deny it, wishing that it would go away; we repeat the same attempts to solve it as we have always done in the past; or we simply hope for a miracle.”

“In studying the evolution of human organizations, it is not always advantageous to consider the individual members of the organization merely as simplified generic agents.”

“All around us are facts that are related to one another. Of course, they can be regarded as separate entities and learned that way. But what a difference it makes when we see them as part of a pattern!”

“Complexity economics builds upon the proposition that the economy is not necessarily in equilibrium: economic agents (firms, consumers, investors) constantly change their actions and strategies in response to the outcome they mutually create.”

“Complexity, in other words, asks how individual behaviors might react to the pattern they together create and how that pattern would alter itself as a result.”

“Adam Smith had a deep, intuitive understanding of emergence and was arguably the first complexity economist. Smith and other early economists were aware that aggregate patterns emerge from individual behavior and interactions, and that individual behavior responds to these aggregate patterns. There is thus a recursive, reflexive loop at the heart of the economy. Complexity economics asks how this loop drives behavior of the system over time.”

“Prediction takes information you have, often called “data,” and uses it to generate information you don’t have.”

“Prediction machines enable managers to move beyond optimizing individual components to optimizing higher-level goals and thus make decisions closer to the objectives of the organization.”

“Each new prediction has an indirect effect: it makes choices feasible that you would not have considered before.”
Reimagining Capitalism in a World on Fire
Rebecca Henderson

"Architectural innovations change the relationship between the components of a system — the system’s architecture — without changing the components themselves. And because most people in most organizations are focused on the components of the system they’re embedded in, rather than the relationship between them, architectural innovations are hard to spot and hard to react to."

The Future of Capitalism: Facing the New Anxieties
Paul Collier

"Firms are at the core of capitalism. The mass contempt in which capitalism is held — as greedy, selfish, corrupt — is largely due to their deteriorating behavior."

"The dangerous leaders are those who rely only on enforcement. The valuable ones are those who use their position as communicator-in-chief at the hub of their networked group — they achieve influence through crafting narratives and actions."

Bowling Alone: The Collapse and Revival of American Community
Robert Putnam

"Social capital refers to connections among individuals — social networks and the norms of reciprocity and trustworthiness that arise from them."

"The core idea of social capital theory is that social networks have value."

"Civic engagement and social connectedness can be found inside the workplace, not only outside it. Thus our workplace agenda should include new means of social-capital formation on the job."

The Social License for Financial Markets: Reaching for the End and Why It Counts
David Rouch

"The relationship addressed by the social license is that between society as a whole and those of its members that engage in financial market activity. That is expressed, in practice, in a myriad of individual and group relationships."

"Individuals do not act in isolation... Financial markets are an ecosystem of individuals and groups — places of social interaction."

"Trust is derived from the reality of relationships and is implicit in the idea of a license."

Corporate Crime and Punishment: The Crisis of Underenforcement
John C. Coffee, Jr.

"Time and again, defendant corporations receive substantial sentencing credit for a compliance plan that was a dismal failure and that missed misconduct that continued for years."

"Continuing failure begins to call into question the legitimacy of our legal system."

"The unavoidable policy implication then is that corporate prosecutions need to be supplemented by individual prosecutions in order to generate minimally adequate deterrence."
APPENDIX

2021 Compendium Survey

1. What organization are you representing in this survey?

2. If you represent a regulatory body, how has the Coronavirus pandemic affected your priorities? Which of these changes do you think will persist into the future? What new priorities may follow in COVID’s wake?

3. Does your agency have a mandate to supervise culture or conduct risk concerns, is that mandate express or implied?

4. Do you expect to launch new initiatives related to supervising culture or conduct risk in the coming year? If your agency does not currently have a mandate, do you expect that to change in the coming year?

5. Is there anything you would like to share regarding new initiatives planned for the coming year?

6. Is culture and conduct risk supervision communicated to the firms you oversee in a rules or principles based manner?

7. Do you have a dedicated culture or conduct supervision/risk assessment team?

8. If no, do you expect to initiate efforts in that direction in the coming year?

9. Has your regulatory agency engaged in any significant supervisory actions or assessed fines for perceived cultural issues or instances of misconduct?

10. If so, how has that shaped forward-looking views regarding culture or conduct risk supervision?

11. Does your agency hold firm senior managers accountable for their organization’s culture and/or any conduct related risk management failures?

12. Is this reflected in a formal ‘senior managers accountability regime’?

13. In your examination efforts, or other supervisory engagement with firms, is culture and conduct specifically assessed or discussed?

14. If so, do you engage only with senior management, or do you also engage mid-level managers?

15. In the past year has your organization sponsored or participated in any conferences or events focused on culture or conduct risk governance and supervision?

16. Do you have plans to organize or participate in any such events in the coming year?
17. Does your organization engage in any international collaborations relating to culture or conduct risk supervision? (e.g., through the Global Financial Innovation Network, or BIS Innovation Hub, etc.) Do you expect to engage in any such during the coming year?

18. Has your organization established a center that aims to promote innovation?

19. If so, have you conducted any trials of innovative products or services in the context of culture or conduct risk supervision?

20. If not, do you expect to initiate efforts to promote innovation or trialing innovative approaches in the coming year?

21. Have you engaged with RegTech or SupTech companies with a view to developing the use of these technologies within your agency?

22. If so, has this been in the context of culture and conduct risk supervision?

23. If not, do you expect to initiate efforts in this direction in the coming year?

24. Are any financial institutions in your jurisdiction implementing regular culture and/or conduct risk audits? If so, has this been at your agency’s prompting?

25. Can you provide additional detail about your engagement with audits? (e.g., encourage firms to forward completed audits for review, etc.)

26. Has your organization issued any new rules or mandates to address culture or conduct concerns?

27. If not, are any contemplated for 2021?

28. Many supervisory agencies are looking to hold themselves accountable to the same culture and conduct standards as those they oversee at regulated institutions. Is your organization looking to implement new policies in this direction?

29. Would you call our attention to any past or expected legislation that your government specifically intends to address culture and conduct related risks in the financial sector?
Culture and Conduct Risk Regulatory Landscape

Our Methodology

For the second year Starling offers its Culture and Conduct Risk Regulatory Landscape, summarizing in chart form the various culture and conduct-related strategies and initiatives pursued by leading global regulators and supervisors. Our intent is to provide a framework for a broadly objective means to summarize approaches that regulators and supervisors have taken across their respective jurisdictions one which permits for a trend-line comparison.

As with last year’s chart, the inputs for this analysis were drawn from public as well as non-public sources. Each year Starling collects responses to a survey of global regulators, supervisors, standard setters, industry associations, and other relevant organizations. These responses are complemented by the detailed submissions we received from many regulatory authorities that went into the production of this report, as well as by policy papers, interviews and other public commentary collated by our staff in the past year. This data was then used to generate scores for each regulator on over a dozen factors.

For 2021, we made several updates to the landscape based on feedback we received. Most significantly, we have modified the axes to provide a more informative comparison between different regulatory strategies and initiatives. As a result of these changes, some of the factors used in last year’s report were removed and others were added. Overall we believe these changes provide a more meaningful comparison going forward.

We are grateful to the many supporters that offered input into this process. In this, our second year of producing this chart, we have been grateful for the attention it has generated and we look forward to continued changes in years to come as regulators continue to evolve their approaches to addressing the challenge of culture and conduct risk supervision. We welcome reactions at compendium@starlingtrust.com
APPENDIX
See Also

TRUST MATTERS

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DIVERSITY, EQUITY & INCLUSION

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**ESG MATTERS – STANDARDS & METRICS**

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**NORMALIZATION OF DEVIANCE**

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