

Global Regulatory Network

Culture counts

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Culture counts. Doing things right is just as important as doing the right things. That's one of the lessons that supervisors are drawing from the financial crisis and from the flaws in conduct and compliance that continue to emerge.

For banks, this lesson is timely. Fines and settlements for misconduct have eroded capital, and remediation has preoccupied management. This is depressing returns and impeding growth (see box).

To create the financial and managerial capacity to pursue a growth agenda, banks have to improve their risk culture. A better culture can help reduce, perhaps even eliminate, costly compliance breaches. That in turn will preserve the bank's reputation, conserve its capital and free its management to focus on developing and implementing a strategy that will enable the bank to remain competitive.

Culture starts with the bank's risk management framework and its risk appetite statement. They effectively set the overall script. To improve culture, supervisors around the world are demanding that banks focus on four areas:

- ▶ **Tone from the top:** Does the bank's C-suite, especially its CEO, consistently send the right message on risk? Does the board reinforce this message? Is it communicated effectively across the organization, and consistent with the "tone from the middle"?
- ▶ **Accountability:** Does the bank hold senior managers accountable for managing risk effectively?
- ▶ **Incentives:** Do the bank's incentives support effective risk management? Or do they encourage contrary behavior?
- ▶ **Effective communications and challenge:** Does the risk message get through? Are escalation paths clearly defined and understood? If the message is wrong, or the delivery goes awry, will someone point this out? If so, will he/she be heard and heeded? Ensuring that this will be the case is one of the principal responsibilities of the bank's board of directors.

These supervisory initiatives should be welcome to investors. They are sound business. Indeed, they promise to provide some of the discipline that shareholders have found difficult to provide.



What constitutes a good risk culture?

Risk-taking is the essence of banking. Banks add value because they bear the credit, liquidity, interest rate, foreign-exchange and operating risks that individuals and institutions wish to avoid.

A bank's risk culture encompasses the processes by which it assumes and manages risk. A good risk culture is one that manages risk correctly from the perspective of clients, counterparties and investors. In such a culture, the bank treats customers fairly. It conducts itself with integrity in financial markets. It balances risk and reward, making sure that it is adequately compensated for the risks it takes. It complies with all applicable regulations. Hence, a good risk culture is about taking the right risks in the right way for the right price. Finally, its incentives both reflect and reinforce this culture.

Accounting for culture or the rewards of virtue

Over the past five years, banks have paid out more than US\$300 billion in fines, settlements and restitution as a consequence of malfeasance, malpractice and misconduct.² That's US\$300 billion that could have strengthened the bank's capital, been invested in improved controls or been paid to shareholders as dividends. And, these charges are a big part of the reason that banks' ROEs have fallen below their cost of capital.³

Although investigations into legacy issues from the crisis are coming to a close, supervisory scrutiny will continue, even intensify. When it comes to culture, supervisors will distinguish sharply between "good" banks and "poor." This will have significant implications for banks' capital.

In stress tests, supervisors are demanding that banks reserve now for the probable costs that they will incur over the test horizon for litigation, fines and settlements. This includes not only known cases but also some estimate of costs associated with incidents that are incurred but not reported or may occur in the future. Those supervisory estimates are likely to be higher if the supervisor views the bank's risk culture as "poor."

In addition, supervisors will consider culture in the supervisory review and evaluation process that they use to determine Pillar 2 capital requirements. Banks with "poor" cultures can expect to receive higher add-ons.

Together, the additional required core equity Tier 1 capital for a large bank with a "poor" culture can easily amount to US\$1 billion or more. That's capital that costs 10% to hold. That's also capital that banks must simply hold: it can neither support business growth nor be returned to shareholders. And if the bank doesn't have sufficient excess capital on hand to meet the additional requirement, it is capital that the bank may have to go to the market to raise.

¹ In April 2014 the Financial Stability Board (FSB) released a supervisory framework, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture*, for assessing the reliability and effectiveness of risk culture, particularly in the systemically important financial institutions (SIFIs). Since then, authorities across the world have addressed the FSB recommendations through detailed national requirements and guidance. Among the most recent is the European Banking Authority's (EBA's) *Final Report: Guidelines on internal governance under Directive 2013/36/EU*, September 2017. See also the proceedings of a global conference on risk culture held at the Federal Reserve Bank of New York (FRBNY), [Reforming Culture and Behavior in the Financial Services Industry: Expanding the Dialogue](#).

² CCP Research Foundation, *Conduct Costs Project Report*, August 2017.

³ EY, *Capital Markets: building the investment bank of the future*, October 2016.



Risk management framework and risk appetite statement set the script

A good risk culture starts at the very top. The board needs to ensure that the bank's executives, particularly its CEO, put in place an effective risk-management framework and develop an appropriate risk appetite statement. These documents should explain the risks the bank's strategy and business model will require it to take, and, just as important, the risks the bank will not take in order to reach its target rate of return on equity. This sets the context in which the bank's culture will develop.

Practically all major banks now have some form of risk-management framework and risk appetite statement in place, and banks are making progress in tackling key implementation issues. The first is a common definition of loss that could result from taking various risks. For financial risk, the industry and supervisors continue to move toward adopting the absolute amount of loss that the bank would incur in a stressed environment as the core risk appetite metric at group level. This approach makes it feasible to allocate the bank's overall risk appetite to individual business lines and legal vehicles within the group. This allocation in turn gives the senior managers responsible for those units objectives for which they can be held accountable (see below).

For nonfinancial risks, a more differentiated approach is needed. The EY/IIF 2017 survey revealed that reputational, conduct and strategic risk prove to be the most challenging types of risk to measure by a significant margin, possibly because more traditional techniques involving metrics and scenario analysis have not yet been fully adapted, and also because the nature of these risks requires a shift of assessment further toward the first line of defense (1LoD). However the results also showed that banks have recognized the challenge: 97% of respondents said they had started to design a risk appetite approach, with 84% making an attempt at quantification.⁴

Here, banks need to consider risks that could prove terminal if they were to crystallize. Cyber heads the list. An attack by a cyber terrorist could destroy the bank's systems or wipe out its data. Is the bank doing enough to protect itself against such a threat? Could the bank recover if such an attack penetrated the bank's defenses? There are also pervasive risks, such as climate change, that would impact a bank in various ways, not only with regard to everything the bank does but also to everything its customers do. Finally, there is the concentration risk that may result not only from the bank's own choice of business model but also from adhering to regulatory limits on geographic and product diversification or from believing that a zero-risk weight actually means the asset has zero risk.

Tone from the top

But frameworks and statements alone will not produce the right risk culture. Both the board and the bank's senior management, especially its CEO, need to signal and substantiate that effective risk management is "Job One" for each and every person at a bank. Managing risk well is the basis for bonus and advancement; managing it badly will curtail not only one's compensation but also one's career. That has to be the tone from the top at any institution.

⁴ EY and the Institute of International Finance (IIF), *Eighth annual EY/IIF global bank risk management survey*, 2017.

Tone from the top: actions speak louder than words

The tone from the top is just as much about how senior managers act as it is about what they say or write. Indeed, it is more about action than words, since most banks say the right things. But not all executives put into practice the principles that they generally preach.

People notice and act accordingly. They adjust their behavior in line with what senior managers do, not to what senior managers say. If the CEO ignores or denigrates risk management, so will others. If executives who have cut corners on compliance to boost revenues and income nonetheless get promoted, others in the bank will be tempted to do the same. If failing an internal audit has no consequences, it is hardly likely to be an effective line of defense.

So culture begins in the C-suite. To embed a good risk culture into a bank, its executives must lead by example.

Risk management is not about how decisions turn out, it's about how they are made. Achieving great results by taking inordinate risks is bad risk management.

Getting that message across is in many ways the acid test of a bank's risk culture. If managers feel that great returns will cause the bank to forgive or overlook a multitude of sins, they will be tempted to commit such sins to generate returns for the bank and rewards for themselves. Banks have to put in place controls and incentives that make good behavior the "way we do things here." That goes for retail banking just as much as wholesale banking and trading activities.

Accountability: senior manager regimes make key people personally responsible

Of all the statements made by bankers in the wake of the crisis, nothing infuriated governments, regulators and the public more than the assertion of executives that ignorance implied innocence. As they were unaware of the offenses their staff had committed, the executives contended, they should not be held responsible for them.

That is no longer the case. In practically every major jurisdiction, regulators and supervisors have introduced or toughened rules governing the responsibility of senior managers. Whether the bank is in the UK,⁵ the Eurozone,⁶ Hong Kong,⁷ Singapore,⁸ Australia,⁹ the US¹⁰ or practically any other major market, supervisors are sending senior managers a simple message:

If you run a bank, you are accountable for the actions the bank takes. You have to ensure that the bank recruits people who are fit and proper, as well provides them with the necessary training and appropriate incentives. In addition, you have to be able to demonstrate that the bank has effective controls in place. If you cannot, you can be held personally liable for the bank's misconduct or mismanagement.

⁵ UK Prudential Regulatory Authority (PRA), *Policy Statement 16/15: Strengthening individual accountability in banking*, July 2015; and UK Financial Conduct Authority (FCA), *Consultation Paper 15/22: Strengthening accountability in banking*, July 2015.

⁶ European Central Bank (ECB), Banking Supervision, *SSM supervisory statement on governance and risk appetite*, June 2016.

⁷ Hong Kong Monetary Authority (HKMA), *Bank Culture Reform circular*, March 2, 2017. The HKMA Bank Reform Circular categorized 3 pillars, namely Governance, Incentive Systems, Assessment and Feedback Mechanisms, to promote sound bank culture. In December 2016, the Hong Kong Securities and Futures Commission's (HKSF's) *Circular to Licensed Corporations Regarding Measures for Augmenting the Accountability of Senior Management*, identified eight core functions (including overall management oversight, key business lines, compliance, control and risk management) each of which require the appointment of a manager in charge, increasing the liability of individuals in positions of authority.

⁸ In October 2017 the Monetary Authority of Singapore (MAS) issued a "Survey on Financial Institutions' Approaches to Culture and Conduct" to regulated financial institutions in Singapore. The survey, which is viewed as an assessment process in advance of potential rulemaking or further supervisory scrutiny, seeks detailed, firm-specific information on how conduct and culture matters are addressed within risk governance, risk appetite, compensation, human resources practices and training.

⁹ James Eyers, "APRA backs more accountability for bank staff," *Australian Financial Review*, October 17, 2016 (accessed via <http://www.afr.com/business/banking-and-finance/apra-backs-more-accountability-for-bank-staff-20161016-qs3c0k>, April 2017. APRA announced the launch of cultural investigations into all Australian financial institutions.

¹⁰ The Office of the Comptroller of the Currency (OCC) Heightened Standards are the closest the US has to senior manager accountability, although not a formal regime. However, the Federal Deposit Insurance Corporation (FDIC) can bring civil lawsuits against directors and officers of a failed bank for demonstrated failure to satisfy the duties of loyalty and care. Also under Title II of Dodd-Frank, directors and officers can be personally liable in cases brought by the FDIC as receiver for gross negligence or failure to satisfy the duties of loyalty and care. Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111-203, Title II, *Orderly Liquidation Authority*, July 21, 2010. See Barnabas Reynolds and Reena Agrawal Sahni, "Individual Accountability: Sr. Managers & Beyond," *Banking Perspectives: The Clearing House*, Vol 3, Issue 4, 2015.



Regulatory regimes that demand senior management accountability require banks to map roles and responsibilities to each individual executive and director. This ensures that banks have designated individuals to cover each critical role and that those individuals know what their responsibilities are.

These regimes clearly reinforce supervisory instructions to banks to reinvigorate the “three lines of defense” model.¹¹ In particular, heads of major business lines must sign up to manage the risk that generates much of the return their business will produce. This ensures that they will, in fact, be the first line of defense.

Accountability: senior manager regimes make key people personally responsible

| Line of defense | Role | Function |
|-----------------|------|---|
| Overall | CEO | Chief executive officer provides overall direction to the bank subject to oversight by the board of directors. |
| | CFO | Chief financial officer has overall responsibility for the finances of the firm, including its funding, accounting and reporting. |
| | COO | Chief operating officer has overall responsibility for the internal operations and technology of the bank. |
| First | CBL | Chief (head) of each major business line has responsibility for managing that business line, including the risk the business assumes. |
| Second | CRO | Chief risk officer has overall responsibility for controlling the risk of the bank. |
| | CCO | Chief compliance officer has responsibility for controlling the bank's adherence to applicable rules and regulations. |
| Third | CIA | Chief (head) of internal audit has overall responsibility for managing the internal audit function. |

Indeed, in the eyes of both supervisors and banks themselves, improving risk culture hinges on making business line executives responsible and accountable for the risk their businesses take. This is shifting the focus of the bank from cure to prevention. Increasingly, line managers with responsibility for risk are building effective ways to measure and assess risks. This is enabling banks to limit compliance breaches and avoid risks that carry no return so that they can concentrate on taking appropriate risks for adequate rewards.

As the first line assumes more direct responsibility for managing risk, the second line (risk management and compliance) can revert to what it is supposed to do: namely, put the right risk framework in place; set appropriate policies, procedures and limits to ensure that risk does not exceed risk appetite; and control that the first line is implementing these properly.

Here, the chief risk officer plays the central role. Each bank must have one, who “must be involved in, and have the authority to provide effective challenge to, activities and decisions that may materially affect the institution’s risk profile.” The CRO should also be independent from business lines, the finance function and other revenue-generating responsibilities. To this end, the CRO should have a direct reporting line to the CEO and regular, unfettered access to the board and the board risk committee.

¹¹ US authorities have been actively pursuing the real ownership of risk in the front line and the clear independence of second-line control functions. The OCC Heightened Standards have been instrumental in the management of risk and have influenced how global regulators view the responsibilities of the first vs. second line.



The chief compliance officer completes the second line of defense. As the first line assumes responsibility for risk, the CCO's role is shifting toward controlling the effectiveness of the measures the first line has taken, toward developing ways to manage conduct risk more efficiently, and toward evaluating how new conduct risks may arise and what the bank can do to manage such risks.

The third line of defense is internal audit. Its role is to check via a program of risk-based reviews that the first and second lines are operating as they should, that the bank is aware of and is properly mitigating the risks inherent in its business model, that line management is assuming responsibility for managing risk, and that risk management and compliance are controlling that line management does so within the bank's risk appetite and in accordance with the bank's policies, procedures and limits. To ensure that internal audit is independent, the head of internal audit should report directly to the chair of the bank's audit committee.

Stricter accountability regimes pose numerous challenges (these will be the subject of a Financial Stability Board (FSB) review in 2018).¹² The first is the alignment of accountability and responsibility. Individuals need to make sure that the way the role operates also enables them to discharge the responsibilities for which they will be held accountable. For example, in the UK some group CROs have been questioning whether they can be the designated person for a subsidiary if they do not sit on the supervisory board and therefore cannot influence risk-taking directly.

The second challenge is enforceability. In several jurisdictions there is concern that enforcement may be overzealous or disproportionate, and/or that enforcement actions can be overturned by legal challenges. Finally, availability is also a challenge. In the EY/IIF risk survey more than half of banks said they were having difficulty finding risk or compliance officers with the required advanced data analytical skills.

Accountability: give people the tools they need to get the job done

If people are to fulfill the responsibilities for which they will be held accountable, they have to have the capabilities and tools necessary to execute the responsibilities they assume. In this respect, a senior manager's personal attributes go only so far. He or she will also need the necessary tools.

In today's environment, that increasingly means data management, advanced analytics and robotics. These permit banks to respond to supervisory demands for increased volume, frequency and accuracy of data as well as for better models. These tools may also help banks make controls more efficient

For example, as line managers at leading banks assume more direct responsibility for managing risk, they are employing new techniques to standardize and automate various procedures and activities, ranging from payments to foreign exchange to lending. This reduces the scope for misconduct or mispricing. The front line is also introducing surveillance techniques to monitor the adherence of staff to rules as well as using advanced analytics to pinpoint anomalies in product performance or customer complaints. This helps line management to nip issues in the bud.

As the second line of defense at leading banks focuses on control, risk management and compliance, departments are using the new techniques to automate (and reduce the cost of) tracking how well the first line is managing risk. They are also using modeling and analytics to better understand the dimensions of nonfinancial risks and to design defenses against these risks.

Finally, internal audit is using the new techniques to improve its efficiency. Thanks to technology, internal audit functions at major banks are literally doing more with less.

¹² FSB, *Stocktake of efforts to strengthen governance frameworks to mitigate misconduct risks*, May 2017.



Incentives

In addition to making people responsible, banks also have to ensure that they act responsibly and exercise effective risk management. Here, incentives play a key role.

Bonus is much, but by no means all, of the story. And it is with respect to bonus that banks have made the most progress in ensuring consistency with effective risk management. First, bonus has become an integral part of banks' capital planning. Finance directors at major banking groups now routinely factor into their forecasts both the aggregate amount of bonus and the form any payout is likely to take to ensure that the bank will have the appropriate amount and type of capital to support its strategy and to sustain it, should stress materialize.

Second, banks have made significant progress in reshaping compensation structures to support effective risk management. Eligibility for bonus increasingly depends on mitigating risk, not just generating revenues. Importantly, this now applies to front-line staff, reinforcing the precept that they should be the bank's first line of defense. The form bonus takes is also increasingly aligned with effective risk management. In some cases a significant proportion has to be deferred, and the deferred portion must depend on both the aggregate performance of the firm and the performance of the recipient. To achieve the former, banks typically frame the award in the form of shares (or some other capital instrument) that vests over time and may be subject to further restrictions regarding sale or pledging as collateral. To implement the latter, banks have instituted procedures enabling them to claw back bonus from individuals where it later becomes apparent that the recipient's risk mitigation efforts did not deserve the merit they were originally assigned.

However, banks still have much to do to ensure that incentives truly support effective risk management (see box). They have to recognize that the bonus is not the only form of incentive, and trading is not the only area in which incentives matter. Indeed, some of the gravest incidents of misconduct appeared to stem from largely non-pecuniary incentives to promote or feign the sale of retail banking products to ordinary consumers.

Incentives: pay for the culture the bank aims to achieve

Incentives both express and determine a bank's culture. Incentives tell staff what a bank really values. People very quickly work out what it takes to get ahead, what it takes to qualify or keep a bonus, and what it takes to avoid being shunned or even humiliated. People then act in accordance with the signals they perceive the bank to be sending.

How incentives are implemented, therefore, matters a great deal. Good in theory is not necessarily good in practice. For example, balanced scorecards will be little more than a fig leaf if "balanced" says nothing about the weight that will be given to risk and compliance. In such an environment, revenues and current profits are likely to predominate, with all the well-known dangers that such a focus implies.

In sum, when it comes to culture, banks generally get what they pay for. To help get the right culture banks should ensure that they are actually paying for the right things.



Effective communication and challenge

Ultimately, the bank's board of directors has overall responsibility for the direction of the bank. Its role is not to manage the bank but to approve its overall strategy and business plan and to ensure that it is implemented appropriately. When it comes to risk, the board's role is to challenge management to demonstrate that the bank has the right culture; that the tone from the top strikes the right note; that the message actually matters to managers throughout the organization, rather than going in one ear and out the other; and that incentives reinforce effective risk management.

To ensure that boards meet these responsibilities, supervisors have stepped up demands on all board members that they have sufficient expertise and can devote sufficient time to their duties as directors. In addition, jurisdictions have brought boards within the scope of the senior manager regimes and assigned specific responsibilities to key directors so that the board can challenge, approve and oversee the management's implementation of the bank's strategic objectives, governance and corporate culture. Whether boards are actually doing so now figures prominently in supervisory reviews.¹³

Senior manager regimes: key oversight roles at bank boards of directors

| Role | Function |
|---|--|
| Chairman | Chairs and oversees the performance of the board, including leading the board's development of the firm's culture. |
| Chair, risk committee | Chairs and oversees the performance of the risk committee. This includes ensuring and overseeing the integrity and independence of the firm's risk function (including the CRO). |
| Chair, audit committee | Chairs and oversees the performance of the audit committee. This includes ensuring and overseeing the integrity and independence of the firm's internal audit function (including the head of internal audit). |
| Chair, remuneration committee | Chairs and oversees the performance of the remuneration committee. This includes overseeing the development and implementation of the firm's remuneration policies and practices. |
| Senior independent director ¹⁴ | Ensures the independence of the board and leads the assessment of the chairman's performance. |

Particular importance is assigned to the board's risk committee, especially its chair. Jurisdictions are generally looking to ensure that significant institutions have a separate risk committee (rather than assigning its functions to the audit committee) chaired by an independent, suitably experienced and qualified NED. The risk committee should have direct access to the bank's CRO (and vice versa) and be

¹³ ECB, Banking Supervision, *SSM supervisory statement on governance and risk appetite*, June 2016. UK and US authorities have made similar statements. In its 2017/18 Business Plan, the UK FCA stated that it expected firms "to have effective governance arrangements in place to identify the risks they run – with a strategy to manage and mitigate those risks to deliver appropriate outcomes to consumers and markets." In the US, the OCC expects boards to hold management accountable and to independently question and challenge management's recommendations and decisions as necessary.

Asian regulators are also increasingly vocal regarding the accountability of boards for setting the tone for good culture. In December 2016, the HKMA introduced new requirements to empower bank INEDs (Independent Non-Executive Directors) prescribing, among other things, a minimum level of director fee and separate meetings with internal and external audit, compliance and the risk function, without the presence of executive directors or management. This is further augmented in the HKMA March 2017 Bank Culture Reform circular that requires all banks to have a designated board-level committee, chaired by an independent non-executive director to oversee the culture framework. The Monetary Authority of Singapore has also long been stressing the important role of the board in culture, particularly in setting a framework for good sales practices under the Guideline of Fair Dealing.

The October 2016 Australian Prudential Regulation Authority (APRA) paper on culture also raises questions about the current level of board involvement. Although APRA has seen increasing board engagement, they emphasize that the board should form a view of the risk culture of the organization and the extent to which it supports the ability of an institution to operate within risk appetite. The board should also identify changes to risk culture and take steps to address those changes.

¹⁴ This term is used in the UK for the most senior non-executive director.



the place for the board to conduct an in-depth review of the bank's risk appetite framework and risk appetite statement. This review should encompass not only whether these papers are consistent in concept with the bank's business model but should also determine whether the bank has policies and procedures in place that consistently keep actual risk within risk appetite.

The chair of the risk committee has a dual role. He or she not only must ensure that the risk committee performs the above tasks but also must communicate and coordinate with:

- ▶ The chair of the audit committee to ensure that the committee takes risk appropriately into account in its review of the bank's internal audit program and public financial statements and disclosures.
- ▶ The chair of the remuneration committee to ensure that the committee takes risk appropriately into account in its review of the bank's incentives.
- ▶ The chair of the main board to ensure that the entire board is aware of the conclusions of the risk committee and has the opportunity to challenge them; to this end, the two chairs must work together to ensure that directors who are not on the risk committee have adequate training and receive an appropriate amount of information.
- ▶ The senior independent Director to ensure that the Board uses its independence to challenge management effectively, especially with respect to risk issues.

In principle, these duties of directors apply to all banks. However, implementation poses certain challenges. In the case of unitary boards, the key issue is independence, especially where the chairman is also the CEO. In such situations, supervisors must place a greater reliance on the independent non-executive directors, especially the senior independent director but also the chairs of the risk, audit and remuneration committees. In the case of dual (supervisory and management) boards, the key issue is control – does the Supervisory Board have the expertise as well as the information required to challenge management? And, does it have the inclination and persistence necessary to do so effectively?

Subsidiaries also pose problems. Jurisdictions are increasingly demanding that certain subsidiaries be "independent" from the rest of the group, even though the group is the principal (and in most cases the only) provider of capital to the subsidiary. Examples include the ring-fenced retail bank in the UK and the intermediate bank holding company in the United States. In both cases supervisors insist that the director's first duty is to the institution on whose board s/he sits, not to the group that owns the institution.

More generally, boards have to ensure that directors are qualified, that they receive the appropriate amount of training and information in a timely manner, and that they take ample time to discuss the issues in depth. At a minimum, non-executive directors must understand the bank's business model and the risks entailed in it. Board Committees should review particular issues and report their conclusions (as well as the reasoning behind them) to the main Board. Only then will NEDs be able to challenge management effectively.

Effective communication and challenge: the board must exercise its voice, not just cast its vote

When it comes to culture, supervisors are asking the board to do what it is supposed to do: control management. That goes well beyond the votes by which the board approves the various resolutions, appointments and plans that the law requires the board to consider. It goes to creating and operating a board where NEDs voice – on the basis of their experience and judgment – their concerns about where and how management is taking the bank. But it is not sufficient simply for directors to speak out. For communication and challenge to be effective, management has to listen and respond.



What remains to be done, and what will be the reward for doing so?

It is much tougher to improve culture than to let standards slip, particularly when and where bad behavior has become the norm. Accordingly, only 39% of respondents to the 2017 EY/IIF risk survey felt that they had reached, or were close to, their target end-state for risk culture. This is only marginally higher than the result in 2016.

Why is the needle not moving as rapidly as regulators and banks would wish? According to the 2017 EY/IIF risk survey, several factors are at work. The first is the nature of the problem. Forty-two percent of respondents point to the conflict between sales-driven first line and risk culture; 37% to the diversity of cultures within a bank that are embedded in different geographies and business lines. The second is the failure to implement perhaps the most important single measure to improve culture: 44% of the respondents attributed the failure to make progress on culture to the failure to make the front line accountable for risk. Finally, the banks' messaging is missing the mark: 40% of respondents feel there is too much emphasis on numeric targets, and 58% believe that messages are not being cascaded effectively throughout the organization.¹⁵

What's the solution? First, each bank needs to stay on message and stick with implementing the measures outlined above to improve culture if it is to convince staff that this is not just another management fad but a change in paradigm. That's a lesson that can be read from practically any cultural change program. Until people are convinced that change is unavoidable, they see no reason to abandon their habits and routines, however harmful they may be.

Second, banks can – with the support of supervisors – take measures to raise standards across the board. This is already being done for trading in fixed income, currencies and commodities. Such market-wide codes lower the threat that staff members at a bank with strict standards may perceive that life is easier and rewards are potentially greater at a bank with looser standards or laxer controls. Correspondingly, higher industry standards remove the rationale for line managers to argue that a better culture will put the bank at a competitive disadvantage.

In fact, the opposite is the case. Banks with a good culture will require less capital, earn higher returns and be able to focus on innovation and improvement rather than remediation and restitution. At the end of the day and on the bottom line, culture does indeed count.

¹⁵ Similar conclusions were also found in a study *Capacity for change in the financial sector* by the Nederlandsche Bank (DNB) and the Netherlands Authority for Financial Markets (AFM) in 2014. Their premise was that commitment to effective change in the business models and culture sat at the heart of a healthy, sound and ethical financial sector that focuses on the interests of customer. In their review they found positive elements including a commitment in the industry to real change. They also saw a sense of urgency in management boards and senior management more broadly but more impediments to change for staff members struggling with regulatory burdens and outdated systems. They thought that failure to set clear priorities and sufficient guidance meant the vision was often too abstract. They saw the vision translated into objectives but too little attention paid to translating objectives into desirable conduct nor what it meant for the organization's culture. This led to staff reverting to their old ways or just continuing to behave as they did before. Also, those at the top of organization did not seek out dissenting opinions about the path. In general they saw too little diversity in leadership styles. They also saw top management closely involved in the start of a change process but not in implementing or anchoring change. They saw a particular tension in middle management in handling their daily workload and translating vision from the top into required behavior for those below.



EY Global Regulatory Network Executive Team Previous appointments

Mario Delgado: FROB (Spanish Banking Resolution Authority) Head of International Coordination and EBA and FSB representative; Spanish Ministry of Economy: Director of Office of the Secretary of State for the Economy in the Economic Affairs; Head of the Spanish Delegation in the Paris Club; Deputy Head of relations with the IMF.

Marie-Hélène Fortésa: Autorité de Contrôle Prudentiel (French Prudential Supervisory Authority); Association Française des Banques (French Banking Association); and French National Institute for Statistics and Economic Studies. She has also held senior roles at a global investment bank.

Dr. Thomas F. Huertas: UK Financial Services Authority's Executive Committee; Alternate Chair of the European Banking Authority, Basel Committee on Banking Supervision; and Financial Stability Board Resolution Steering Committee.

Kentaro Kobayashi: He spent 37 years as a financial regulator. He held positions in the National Tax Agency and later, Ministry of Finance (MOF), Japan's former financial regulator. After the establishment of the Financial Supervisory Agency (FSA) of Japan in 1998, he served as Chief Inspector and Inspection Administrator and continued to serve in this role after the FSA was reorganized into the Japan Financial Services Agency in 2000.

Christian Lajoie: As former head of Group Prudential Affairs, BNP Paribas, Christian has broad banking experience and a deep understanding of the regulatory and supervisory impacts on bank management and strategy. In recent years, he played an active role in regulation-making, participating in many international fora and also served as vice-Chair of the EBA Stakeholder Group.

John Liver: Divisional Compliance Lead at Barclays; Head of Department, Investment Firm Supervision, and prior roles in enforcement and supervision of investment management, life insurance and pensions at the UK Financial Services Authority and its' predecessors. He is currently EY/UK Financial Conduct Authority relationship lead.

Shane O'Neill: He has 20 years' experience in banking, capital markets, asset finance and prudential regulation in a variety of CFO, COO, Strategy & Planning, and Regulatory roles. Following the financial crisis, Shane was Head of Banking Supervision at a Eurozone Central Bank for four years, during which he influenced significant restructuring, recapitalization and change in the banking sector and in credit institutions, and executed numerous stress tests and asset quality reviews.

Keith Pogson: Immediate Past President of the Hong Kong Institute of Certified Public Accountants; more than 20 years of experience advising governments and regulators across Asia-Pacific on acquisitions, market entry strategy and due diligence across banking, asset management and securities.

Marc Saidenberg: Senior Vice President and Director of Supervisory Policy at Federal Reserve Bank of New York; Basel Committee Member and Liquidity Working Group Co-chair; involved in the development of supervisory expectations for capital planning, liquidity risk management and resolution planning.

Scott Waterhouse: He was capital markets lead expert for large banks at the Office of the Comptroller of the Currency (OCC) and Examiner-in-Charge of the OCC's London Office. He coordinated the supervision of trading, treasury and capital markets activities including Dodd-Frank implementation and Basel Committee requirements.

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