

## **Daniel K Tarullo: Good compliance, not mere compliance**

Speech by Mr Daniel K Tarullo, Member of the Board of Governors of the Federal Reserve System, at the Federal Reserve Bank of New York Conference “Reforming Culture and Behavior in the Financial Services Industry”, New York City, 20 October 2014.

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In the aftermath of the financial crisis, ongoing increases in capital buffers, reductions in funding vulnerabilities, improvements in risk management, and attention to orderly resolution are producing a substantially more resilient financial system. Yet even as the financial position of firms has been strengthened, headlines describing misconduct in financial firms have appeared with disturbing regularity. For a time, these stories were the legacy of pre-crisis errors and misdeeds, with a focus on the mortgages and mortgage-related products that lay at the heart of the crisis. But soon they were accompanied by allegations of post-crisis actions: rigging of LIBOR (London interbank offered rate) and foreign exchange rates, facilitation of tax evasion, inadequate controls on money laundering, and front running through dark pools, among others.

A pattern of antitrust, market regulatory, and consumer protection problems would of course be troubling in any firm or industry. From a prudential regulatory perspective, such a pattern in financial institutions creates additional concerns, particularly as it poses a threat to continued progress toward a safer and more stable financial system. It is noteworthy that supervisory assessments of risks to the earnings and balance sheets of major financial institutions have, like those of many private analysts, placed increasing emphasis on exposure to public fines and private litigation losses. And senior management is surely diverted from the challenges of fashioning sound business strategies when major legal problems arise.

Behind much of this malfeasance lies something other than the excessive credit and market risk that led to the crisis itself, although there may be some common roots of these problems. The hypothesis that this is all the result of “a few bad apples,” an explanation I heard with exasperating frequency a year or two ago, has I think given way to a realization within many large financial firms that they have not taken steps sufficient to ensure that the activities of their employees remain within the law and, more broadly, accord with the values of probity, customer service, and ethical conduct that most of them espouse on their websites and in their television commercials.

Today’s conference addresses the sources of the problems and some of the corrective measures that have been, or might be, taken by both firms and regulators. While the title of the conference refers to both “culture” and “behavior,” I am going to focus mostly on the behavior that regulators and the public can observe, since culture is a somewhat contested academic concept and, however defined, is difficult to observe and assess from the outside. It is the behavior of the employees of banking organizations with which we, as regulators, are ultimately concerned, since it is only through its employees that a firm can act. Where there is significant incidence of behavior that violates laws or regulations, or runs afoul of supervisory guidance, then we will need to consider some combination of tougher sanctions, additional regulation, or more intrusive supervisory oversight.

After stating a few general premises relating to the manifold influences upon behavior in financial firms, I will briefly address two topics: first, what regulators have learned about the shaping of behavior within the firm from our work on risk management and, second, the role of reward and punishment systems in affecting employee behavior.

## **Influences on behavior**

Without attempting a rigorous definition of “culture” or “corporate culture,” I think we can usefully posit that in every organization there is a set of norms that appear to inform behavior of those within the organization, even in the absence of explicit and specific rules or instructions. These norms are of course related to the rules, guidelines, structures, incentives, and punishments that the organization creates. Indeed, one important determinant of behavior is the shared expectation as to which of the stated values and rules of an organization will be supported and reinforced by management action, and which are generally regarded as window dressing. The identifiable norms may well differ within an organization, especially a large one in which different functions are performed in pursuit of overall organizational ends.

Debates over the sources and nature of these norms are the stuff of the academic literature to which I referred a moment ago. I will not attempt to synthesize this learning, much less to fashion my own theory. Again, though, I think one can pragmatically note that these norms are shaped by both internal choices and external influences and constraints.

For a private, profit-making corporation the most important internal choices are obviously made by management under the oversight of the board of directors. However, the revealed preferences and choices of employees will also affect a firm’s culture. For a financial institution, external influences and constraints include shareholders and market analysts, regulators, prosecutors, elected officials, the media, and the public. Market conditions and the actions of competitors can also be significant.

## **Nature of risk management**

Financial risk-taking is arguably the fundamental activity of financial intermediaries.<sup>1</sup> Unlike most non-financial firms, a financial institution more or less continually makes risk decisions, whose implications can vary significantly based on the nature of the asset involved, market conditions, counterparty identity, and many other factors. The processes by which risk appetites are set and activity managed so as to conform to these risk appetite decisions are central to determining outcomes, and thus the firm’s near-term profitability and longer-term stability.

For these reasons, there is considerable regulatory interest in these processes, an interest that has been formalized in the Federal Reserve’s annual Comprehensive Capital Analysis and Review (CCAR) and informs the emphasis of our supervision throughout the year. Each year, in conjunction with our supervisory stress tests, we provide an assessment to every participating firm of their risk-management and capital planning processes, indicating where specific improvements are needed. The interactions between supervisors and firms on these matters are extensive, focused, and consequential. For this reason, I think we have gained considerable insight into, if not precisely the “culture” of the firms, then at least the attitudes of senior and mid-level management toward these risk functions.

In some firms the attitude we perceive is one of a mere compliance exercise. The firm proceeds to address the deficiencies identified by the Fed in a discrete, almost check-the-box fashion. To oversimplify a bit, I would say that our sense is that management at these firms wants the hurdle to capital distribution removed, but once the specific problems have been remedied, they want to move on. If this is the attitude we perceive, I suspect the working level employees of such firms do the same. The supervisory reaction in such cases is quite likely to be an inclination toward greater scrutiny.

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<sup>1</sup> Intermediaries without sizeable balance sheets of their own, such as mutual funds, may not themselves be assuming risk, but they are creating it for their investors.

Other firms, by contrast, seem to have internalized the aims of the risk-management processes and systems that we expect of them. In these firms the dialogue can be quite different, with supervisors observing that, even as a specific problem is addressed, such as deficiencies in estimating losses for a particular loan portfolio in a tail event, the firm has gone back to think about how the identified shortcomings fit into their overall risk decision-making and management processes. These firms will, on their own, then consider whether changes in other areas are needed. Again, I suspect that the line employees in these firms are also hearing a different message and presumably, to at least some degree, will behave in accordance with that message when they encounter risk-management issues not covered specifically by Fed communications.

Needless to say, nothing here is meant to suggest that a focus on compliance is problematic. On the contrary, particularly as applied to areas like antitrust, securities laws, and consumer protection, well-crafted compliance programs are essential. But what we want to see is good compliance, not mere compliance. As in financial risk management, the perceived importance of what appear to be similar compliance efforts can vary greatly across firms. Are compliance programs put in place by risk managers or general counsels understood as a kind of background noise that should not drown out the voices urging employees to “make their numbers,” or are they seen as reflecting the views and priorities of senior management?

A related question is whether compliance with applicable law or regulations is understood to be just that, and that alone. Do employees understand their job to be maximizing revenues in any way possible so long as they do not do anything illegal, or do they understand their job to be maximizing revenues in a manner consistent with a broader set of considerations? In the former case, the message is that the law is a constraint to be observed, but that the purposes or values that underlie it have no additional importance for determining corporate activity. It may not be too great a leap from this attitude to a conscious weighing of the profitability of a particular practice that violates laws or regulations against the penalty that would be assessed for the violation, discounted by the probability of enforcement.

In the latter case, the message to employees is that constraints on practices or products may be self-imposed as well as external. The potential sources of such internal constraints are manifold. For example, there might be a fear that always running close to the line will inevitably result in swerving over it at some point. Or management may worry that reputational harm will result if clients and customers believe the firm is always seeking an advantage over them that, literally or metaphorically, is buried in the fine print.

This second concern recalls the much-discussed issue of whether a trading mentality has migrated to other parts of large financial firms, so that the position communicated by management to both employees and others is that the firm has no “customers” or “clients,” only counterparties. While such an attitude is typical for trading in anonymous markets or with equally sophisticated institutions, it hardly seems designed to engender trust on the part of those who have ongoing relationships with the firm. This tendency may pose another challenge in managing complex banking organizations – the need to foster different kinds of norms and expectations across the different parts of the firm, which may do business with individuals and institutions of widely varying financial expertise.

To encourage behavior among their employees that reflects something other than a narrow mentality of compliance and constraint, firms need to take tangible steps that reinforce stated norms such as respect for customers. Some interesting possibilities along these lines are suggested in a recent book by Thomas Huertas, a former U.K. banking regulator.<sup>2</sup> Although Huertas focuses directly on how banks can avoid suffering losses from conduct and operational risks, his proposals would also serve the purpose just noted. One idea is that firms develop a score for conduct risk. While analogous to long-established scoring systems

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<sup>2</sup> Thomas Huertas (2014), *Safe to Fail* (London: Palgrave Macmillan), pp. 158–59.

for credit risk, this method would, in his words, “include ranking the business or product against factors that frequently give rise to conduct issues, including without limitation the sophistication of the customer, the complexity of the product, the level of training of the staff, and so on.” A second, complementary idea is for the firm to have a formal system in place to, again in Huertas’ words, “monitor adherence to the original product approval criteria, especially where the product is growing rapidly and/or is generating extraordinary profits.”

These particular ideas may or may not be best for specific firms. The point, though, is that some concrete organizational systems are needed for firms to carry into effective action the goals or values that they nominally espouse.

Before leaving this topic, I want to observe that regulators can unwittingly reinforce what I have termed a mere compliance mentality. I would first note that the detail of many regulations means that attention to narrow issues of compliance is sometimes wholly understandable and, indeed, essential. Banks, like other regulated entities, need to be able to determine how a regulation actually applies to them. Beyond that kind of unavoidable focus on narrow compliance, however, management and line employees are more likely to adopt a mere compliance mentality where regulations appear to them to have been poorly drafted or implemented.

Sometimes this too is unavoidable, since regulators may simply conclude that the public interest requires a form of regulation opposed by the firm and most of its employees. Sometimes regulated firms are really complaining about the type or purpose of regulation, even when they say they are only criticizing its specifics. But in cases where those inside a firm would stipulate the stated objective of the regulation and still find a regulation badly conceived or implemented, there will be less possibility of internalization or integration into a broader set of firm norms and expectations. This is an outcome that regulators *can* avoid, and something with which the regulated firms themselves can assist by pointing out what they would regard as more sensible methods for achieving stated regulatory purposes.

## **Rewards and punishments**

An important determinant of behavior in any organization is the system of rewards and punishments applicable to its employees. Assuming that they are able to discern factors that generally explain patterns of hiring, raises, promotions, demotions, and dismissals, employees receive very strong signals as to what those running the organization actually value. This set of signals has, I suspect, considerably more influence on employee behavior than a corporate statement of values or purposes, particularly if the system of rewards and punishments appears at odds with that statement.

Indeed, the significance of reward and punishment signals is probably magnified by their role in shaping the composition of the firm’s workforce – by influencing which people are attracted to work at the firm in the first place, which acquire more authority over time, and which are asked to leave. To take one example: if a financial firm’s recruitment of young professionals is driven almost entirely by promises of the large amounts of money they can make and the speed with which they can make it, then the firm should not be too surprised when those same young professionals give short shrift to values such as respect for customers, or skirt risk-management guidelines, or perhaps even ignore regulatory and legal compliance requirements.

One topic within this broader area of reward and punishment that has received considerable attention is incentive compensation. The deleterious effects of many incentive compensation arrangements were recognized by firms well before regulators began to focus on them in earnest following the financial crisis, as reflected in a survey conducted early in 2009 on behalf of the Institute of International Finance, which reported that all but one of 37 large

banking organizations believed that compensation practices were a factor underlying the crisis.<sup>3</sup>

Compensation arrangements that created high-powered incentives using rewards dominantly based on equity had their origins in efforts to align better management and shareholder interests. And compensation arrangements that rewarded incentives for loan officers to write more loans or traders to generate more trading revenue were grounded in efforts to increase firm profitability. But the revenues that served as the basis for calculating bonuses were generated immediately, while the risks associated with these revenues might not have been realized for months or years after the transactions were completed. When these or similarly misaligned incentive compensation arrangements were common in a firm, the very purpose of sound risk management could be undermined by the actions of employees seeking to maximize their own pay.

Since the financial crisis, both firms and regulators have devoted considerable attention to incentive compensation practices for senior managers and others with substantial decision-making authority. Several years ago the bank regulatory agencies issued guidance on incentive compensation and then began a horizontal monitoring of practices at large banking organizations.<sup>4</sup> Prior to the crisis, incentive compensation arrangements at many firms incorporated virtually no adjustment for risk. Today, firms routinely take into consideration adverse outcomes. A greater proportion of pay is deferred, and a greater proportion of that pay is at risk of a variety of clawback and forfeiture provisions.

There is still considerable work to be done in developing and implementing incentive compensation arrangements that truly give appropriate incentives to employees. In many cases risk metrics need to be better targeted to specific activities, and risk adjustments should be more consistently applied. And it is important that compensation arrangements, including clawback and forfeiture provisions, cover risks associated with market conduct and consumer protection, as well as credit and market risks. These kinds of improvements would give more precise signals to employees as to the risk calculus expected of them in making decisions that affect the firm. I hope the long-awaited interagency final rule implementing section 956 of the Dodd-Frank Wall Street Reform and Consumer Protection Act will be forthcoming in the not-too-distant future, so as to provide a common objective baseline for incentive compensation programs.

Beyond regulatory and supervisory requirements, however, there is obviously more that firms can do to use their compensation practices to encourage certain practices and conduct by employees. For example, firms might reward employees with increased compensation or promotion not just for increasing revenues, but also for forestalling losses, such as by identifying non-obvious risks in proposed transactions or products. In order to be effective signals, though, the fact of these rewards, and the standards under which they were granted, need to be transparent.

Punishment systems provide the complement of negative incentives to the positive incentives created by compensation and promotion practices (even where qualified by clawback or similar provisions). Here the role of the government differs. With respect to positive incentives, regulators affect individuals only by way of requirements or expectations for firms. When it comes to disincentivizing egregious bad behavior, however, the government can play a more direct role. Because of the required standard of proof and other constitutional protections, criminal prosecutions of individuals are harder to bring successfully

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<sup>3</sup> Institute of International Finance (2009), *Compensation in Financial Services: Industry Progress and the Agenda for Change* (Washington: IIF, March).

<sup>4</sup> See Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Office of Thrift Supervision, and Federal Deposit Insurance Corporation (2010), "[Federal Reserve, OCC, OTS, FDIC Issue Final Guidance on Incentive Compensation](#)," press release, June 21.

than criminal prosecutions of firms. But, as I think was learned decades ago when individuals were criminally prosecuted and imprisoned for antitrust law violations, it is difficult to imagine a more effective deterrent to such conduct.

Banking regulators do not have criminal enforcement powers, of course. But we can, and do, require dismissal of employees as part of our enforcement actions against firms. And we do have the authorities to remove malefactors from their positions in any institution that we regulate and to prohibit them from working in the banking industry. Somewhat like criminal prosecutions, these are not easy cases to make. But it is important that we be willing to expend the resources to initiate such actions in appropriate cases.

For quite some time, large banking organizations usually dismissed employees who had engaged in significant misconduct or exercised very bad judgment in a quiet, almost surreptitious way. This was particularly true of someone in a responsible position, who would be ushered out the door discreetly, with no recognition internally or externally of the fact of dismissal, or the reasons behind it. Frequently, this person would turn up at another financial firm not long thereafter. The dismissing firm's reasoning was that any public awareness of the dismissal could hurt the reputation of the firm and perhaps cause customers or counterparties to rethink their willingness to do business with it. But the effect of this private way of doing things was to signal the rest of the firm's employees that dismissal, even for very serious reasons, carried quite manageable consequences.

At least some firms are rethinking this traditional approach, though different banks seem to be reaching different conclusions about what to put in its place. Some are moving toward a more public system of dismissals, so as to let employees, regulators, and other potential employers know of the consequences of malfeasance and the identity of the responsible individual. Others are inclined toward the view that, because most serious infractions in a firm involve failures by many people and systems, there should not be excessive emphasis on the culpability of just one or two individuals. They are opting instead for a more transparent internal process to dissect the failures of action, judgment, and oversight that lay behind a significant problem, and then act more broadly in applying disciplinary or remedial measures. Whatever approach a firm takes, it is important that the consequences of violations of a firm's norms and expectations, much less regulations and laws, be well-specified and clearly communicated to employees.

## **Conclusion**

In these very selective remarks on the factors that affect employee behavior, I have intentionally concentrated on the roles of management and regulators. I realize, of course, that there are other forces at work. There is, for example, an interesting debate among corporate law professors as to the merits of giving shareholders more direct influence over firm policies, in order to reduce agency costs within the firm. Some fear that this would focus employees of financial firms even more on short-term equity market movements, with potential bad effects on both conventional risk management and the kinds of conduct problems noted at the outset of my remarks.

Those broader concerns are relevant, to be sure, but they implicate a broader set of actors than the banks themselves, or even bank regulators. My expectation is that if banks do not take more effective steps to control the behavior of those who work for them, there will be both increased pressure and propensity on the part of regulators and law enforcers to impose more requirements, constraints, and punishments.