Thomas C Baxter: The rewards of an ethical culture

Remarks by Mr Thomas C Baxter, Executive Vice President and General Counsel of the Federal Reserve Bank of New York, at the Bank of England, London, 20 January 2015.

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These remarks are personal and do not necessarily represent the official position of the Federal Reserve Bank of New York, or any other component of the Federal Reserve System.

Introduction

Let me begin by thanking Sir William Blair and the Bank of England for inviting me to participate in this Project and at this Conference. At the New York Fed, we have made ethical culture a priority for financial services. We have done this not as a formal part of a supervisory program, but more as a call for reform. In the short time that I have this afternoon, I will speak about the reasons why I believe reform is necessary, highlight some of the important practical features of a strong ethical culture, and conclude by setting out a few of the rewards that might result from it.

Bad behavior in the financial services industry prompted the New York Fed's call for a stronger ethical culture in banking. My list of the most serious transgressions is probably not much different from anyone else's. It includes the evasion of taxes and economic sanctions; conspiracy and market manipulation with respect to LIBOR and foreign exchange rates; and misselling financial products, including residential mortgages and insurance, to people who should not have acquired them. This list is only illustrative. It is not by any means exhaustive.

The traditional means to address bad behavior are enforcement actions against the bad actors and the organizations where they worked.[1] This traditional response, in my view, is appropriate and I strongly support the actions that have been taken and that will continue to be taken. All enforcement actions, though, are essentially retrospective. Of course, we like to think that enforcement actions will not only punish but also deter. But I wonder if this hope is really a prospective strategy. We would better serve the public good if we could do something – anything – more forward looking, and complementary to what our enforcement colleagues are doing to deter future bad behavior.

Ethical culture

The new emphasis on an ethical culture within financial services firms arises from the policy interest in preventing some of the bad behavior that has been observed. Now I use the phrase "some of the bad behavior" deliberately. I fully embrace the goal of eliminating all bad behavior. But we cannot let the goal of perfection become the enemy of progress. We need to start making progress, so let us agree that perfection is probably not realistic. Even an organization with the strongest ethical culture will have episodic bad behavior. Although culture is no panacea, I believe that the ethical culture of an organization can improve the behavior of the people who work there. Strengthening the ethical culture of financial services should therefore reduce the volume of bad behavior we have been seeing.

Some of the skeptics say, "Prove it." I confess that proof is hard to come by. Yet, I am not alone in the fundamental belief that a strong ethical culture will lead to better behavior. A 2010 Corporate Executive Board survey of more than 500,000 respondents shows a widespread

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[1] To call enforcement traditional is not to say that it is static. Eric Holder, the Attorney General of the United States, recently recommended that Congress create new criminal liability for bank officers who were in a position to detect and deter illegal conduct, but failed to do so. That is, individual executives could be criminally liable for failings within their organization without specific bad intent. *See* Eric Holder, Remarks on Financial Fraud Prosecutions at NYU School of Law, September 17, 2014.

view that corporations with strong ethical cultures experience less misconduct.[2] This makes intuitive sense even in the absence of empirical proof.[3] Further, the natural tendency to go with the intuitive is bolstered by the potential benefit of a reduction in enforcement actions against financial services firms, and by a healthy change in the public perception of the financial services industry. And, of course, there is ready evidence for the contrapositive view. Few would disagree with the following: The bad behavior that contributed to the Financial Crisis was evidence of a culture that was not strongly ethical.

Let me also pose a challenge to those who are skeptical about the benefits of a strong ethical culture: If this is not a suitable method to prevent bad behavior by bankers, what alternative proposal do you advocate? The status quo is not acceptable. As a wise man once said, "Plan beats no plan."

The components of a strong ethical culture

So what are the key components of a strong ethical culture? It is said that lawyers love a metaphor, and this lawyer is no exception. I like to think about ethical culture as if it were a package. The culture that we will have is derivative of what we put into the package, and there are clear choices to be made. The contents depend upon the type of organization, the kinds of people, and the nature of the skills needed to conduct the organization's activities. Time will not permit me to cover this thoroughly, so let me cover a few items with a very broad brush.

What goes in

For starters, the conduct of the people in any organization will be strongly influenced by incentives. Let me mention the "big three." Bankers, like lawyers, want to do [1] quality work, [2] with people they like and respect, and [3] receive fair recognition in return. I will touch on all three but will focus on two species of recognition: compensation and promotion. Each should be tied to ethical considerations. If the only consideration with respect to compensation and promotion is how much money the individual made for the firm, then that communicates a message that is inhospitable to a strong ethical culture.

A second key component is what I call "character at the top." The usual expression is "tone at the top," and it refers to the message from the people who occupy the upper most positions in any organization (the board of directors and the "C" Suite). My worry with the typical expression is that it tends to focus on words, rather than conduct. The implication is that if you sing the right notes in the right key then all will be fine. I do not believe this. Employees will be influenced by the actions of key management, and not merely by the songs they sing. If those actions are in harmony with stated mores, then the combination should foster a strong ethical culture. But if the observed actions are not congruent with the words (or, worse, conflict with the words), then employees will follow suit: They may say the right things, but they will not behave the right way. Worse still, they will sense that they work for a firm lacking in integrity. This has long-term, deleterious consequences. Recall that one of the key attractions in working for a particular organization is association with people who are liked and respected. Do people like

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[2] *See* Corporate Executive Board, Research Reveals That Integrity Drives Corporate Performance: Companies With Weak Ethical Cultures Experience 10x More Misconduct Than Those With Strong Ones, Press Release, September 15, 2010. *See also* Anthony Salz, Salz Review: An Independent Review of Barclays' Business Practices, 189-191 (App'x C) (discussing the impact of culture on two archetypes of employee behaviors, and collecting sources).

[3] Somewhat tautologically, the proof of a good culture might be the absence of bad behavior. As Bill Dudley, the President of the Federal Reserve Bank of New York, has observed: "How will a firm know if it is making real progress [on culture]? Not having to plead guilty to felony charges or being assessed large fines is a good start." William C. Dudley, Enhancing Financial Stability by Improving Culture in the Financial Services Industry, Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry, October 20, 2014.

and respect leaders who lack integrity? Good luck attracting top talent in that kind of organization.

A third key component in a strong ethical culture is values. Most firms elaborate rules of proper behavior, often in well-crafted codes of conduct. In some large, complex organizations, the rules can be difficult and tedious, like the rules for conflicting interests and for avoiding trading on insider information. In better run firms, the rules are built on a foundation of the shared and well-understood values of the institution. These values reflect a bank's public function as a financial intermediary and recognize the privileges that come with a banking charter.[4] In other firms, however, compliance rules can be undermined by the values of the organization, resulting in an unhealthy dissonance. For example, if there are elaborate rules for complying with the tax laws of a particular jurisdiction, but the organizational value is to facilitate flight capital, a mixed message may be sent that tax compliance rules are just technicalities. Similarly, in the area of economic sanctions, if the sanction is perceived as something technical and implicating only a single currency, the bank might be sending an unintended message – that we comply with the sanction only because it represents a mandatory but silly rule of a single sovereign issuing a specific currency, and not because the sanction seeks to address a problem that all should find abhorrent, like financing a jurisdiction engaged in genocide.[5]

What to leave out

Thinking about culture like a package, there are some things that I would leave out. Again, without being exhaustive, here are three examples.

First, I would leave out any depiction of the persons that an organization does business with as "counterparties." If you went to your doctor and overheard her refer to you in conversation with office personnel as a "counterparty," rather than as a "patient," would you worry? I would. Similarly, if you went to your personal lawyer and overheard him refer to you in conversation with his associate as a "counterparty," rather than as a "client," would you worry? You should. My point here is not that banking is a profession like medicine or law. My point is about how you see your customer and the service provided to that customer. A counterparty is not someone needing your help; "it" represents a profit opportunity – something to be exploited. Their loss is your gain. A customer, by contrast, is someone to be served. It is right to charge a fee to a customer, client, or patient, but the transaction is driven by the other person's needs. Many financial services firms, however, refer to the people they do business with as counterparties. This is no accident. It characterizes the way in which the organization views the person it is facing in its businesses. Viewing customers as profit opportunities is inconsistent with a strong ethical culture. In my experience, firms that consider their operational model as service provider tend to have a better culture than those firms that consider their operational model as money maker.

The second item that I would leave out is a conception of a bank as a money making machine. This is not to say that I would ignore profitability; that would be foolish and would destine a firm to a short life. But a bank's goal should be to provide service to its customers through financial intermediation, as Mark Carney has explained so eloquently.[6] Christine Lagarde sees this as a

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4 *Cf*. E. Gerald Corrigan, Are Banks Special? Federal Reserve Bank of Minneapolis Annual Report, January 1983, ("[T]he presence of the public safety net uniquely available to a particular class of institutions also implies that those institutions have unique public responsibilities and may therefore be subject to implicit codes of conduct or explicit regulations that do not fall on other institutions.").

5 *See* Thomas C. Baxter, Jr., Reflections on the New Compliance Landscape, Remarks at "The New Compliance Landscape: Increasing Roles – Increasing Risks" Conference, July 24, 2014.

6 *See* Mark Carney, "Inclusive Capitalism: Creating a Sense of the Systemic," Address to the Conference on Inclusive Capitalism, May 24, 2014.

question of animating purpose – of "telos" – and I agree.[7] Similarly, the Archbishop of Canterbury, Justin Welby, has called for financial institutions to reset to the first principle of service, playing a role in the world that contributes to "human flourishing."[8] If you don't believe me, listen to the Archbishop: It is possible to do good and do well at the same time. And remember one of attributes that attracts the best and the brightest to an organization is the prospect of quality work. Having a work force that feels they are contributing to the greater good should benefit the organization in its effort to recruit the best minds, but also in the effort to recruit those with the best hearts (who presumably will be less likely to become malefactors).

The last item that I will leave out is "short termism." Permit me to describe the concept. With increasing frequency, people working in a financial services firm have no loyalty to their employer because they do not intend to work there long. Instead, the idea is to get some experience and a decent bonus and then move to the next employer – or, if the bonus is large enough, to work for oneself.[9] 10 Given the specialization that tends to accompany various financial services, people with near-term career horizons tend to develop loyalty to the special group of individuals with whom they transact business and who might provide the next job opportunity. These specialized bankers or traders increasingly resemble independent contractors or freelancers – careerists with no institutional loyalty. In foreign exchange, for example, we saw people orchestrating a manipulative scheme across a network of individuals at many institutions. This is all rational and understandable – specialists need the long-term allegiance of their network to continue to ply their trade, and this allegiance is far more consequential than loyalty to the organization currently employing them. So, when in conflict, career trumps institution. Some of this is simply generational; there is more employment mobility now than thirty years ago. But compensation plans bear some degree of responsibility as well. Annual bonuses that reward immediate book value without reflecting tail risk to the organization reinforce short termism. Changing the time horizon for compensation will be a significant feature of meaningful cultural reform.[10]

Conclusion

The principal benefit to a financial services firm in having a strong ethical culture is the avoidance of bad banker behavior. Bad banker behavior often leads to enforcement actions that can carry significant monetary fines, that can inflict destructive damage to the organization's reputation, and in the worst case, that can cause the death of a franchise (recalling that all financial services firms depend upon public confidence to survive). A strong ethical culture also attracts the best and the brightest personnel, who will seek out the bank as the place to build a career doing high quality work, for fair compensation, with people they like and respect. As for those with whom the bank does business, they may come to see the organization as customer focused, looking to serve them well, and not turning them into the next "profit opportunity." Finally, from the perspective of the supervisory community, an industry comprising personnel who have a strong ethical culture will be a safer and sounder industry, certainly safer and sounder than an industry full of miscreants. This could be a powerful factor toward financial stability. Thank you for your kind attention.

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[7] Christine Lagarde, "Economic Inclusion and Financial Integrity," Address to the Conference on Inclusive Capitalism," May 27, 2014.

[8] The Archbishop offered these comments at an October 12, 2014 panel discussion that was part of the International Monetary Fund 2014 Annual Meetings. A video of that discussion is *available at* http://www.archbishopofcanterbury.org/articles.php/5426/archbishop-to-take-part-in-imfworld-bank-panel-onethics-and-finance. Notably, the Archbishop described his role at the conference as a "lion in a den of Daniels."

[9] Even the skeptics of cultural reform concede that there is "almost universal accord that remuneration structures contributed to excessive risk-taking in financial institutions and that excessive bonuses paid on anticipated accounting profit at the time of deal origination distorted decision-making and resulted in asymmetric riskholding." Paradigm Risk Consulting, To boldly supervise . . ., February 2014.

[10] *See* Dudley, Enhancing Financial Stability by Improving Culture in the Financial Services Industry, supra n.4.