William C Dudley: Reforming culture for the long term

Remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Banking Standards Board, London, United Kingdom, 21 March 2017.

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Thank you for your kind welcome.

I am grateful to the Banking Standards Board for organizing this meeting. For several years, the Federal Reserve Bank of New York and the Banking Standards Board have each worked to improve culture within the financial services industry in the world's two most important financial centers. I would like to especially thank Sir Richard Lambert, Dame Colette Bowe, Alison Cottrell, and the members of their team—all of whom have traveled several times to New York to attend meetings and conferences on this issue of culture. I am very pleased to have the opportunity to reciprocate and to join you today in London. As always, what I have to say reflects my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.[1]

This morning, I would like to highlight three issues that are critical to improving culture within the financial services industry:

- First, defining and clarifying purpose, because clear goals are necessary if one is to assess performance;
- Second, measurement of how firms and the industry are performing; and
- Third, whether incentives encourage behaviors consistent with the goals one wishes to achieve.

I will then conclude by offering some thoughts on why good culture is critical to success in financial services.

Let us start with purpose because it is a prerequisite for the other two. Baroness Onora O'Neill, a member of the Banking Standards Board, was the keynote speaker at the New York Fed's third culture conference, held in October 2016. Her message to the audience of senior bankers and regulators was a challenge to think about the purpose of their organizations. Namely, what are you for?[2]

I believe the question "what are you for" can be a litmus test for a firm confronted with challenges. Let me give you just one example, from the Salz Review in 2013. Employees in the eight divisions of Barclays were asked to state their core values. Three of the eight divisions did not rank "customer service" as a core value. Two of these divisions were retail lines—UK retail banks and the Barclays credit card. The third was the firm's African subsidiary, which also offered retail banking services.[3]

My intent here is not to pick on Barclays. Indeed, the firm should be commended for first commissioning and then publishing the Salz Review—Sir David Walker set an example of leadership in his candor and transparency. Instead, my purpose is to make the point: If you cannot answer the question "what are you for," or if your answers do not make sense in light of your business, then it is time to re-examine your purpose.

For any bank, a statement of purpose should emphasize sustainable success, not short-run profit. This is because of the many important roles that banks play in the economy. They are critical intermediaries between savers and borrowers; they provide essential infrastructure; they support well-functioning financial markets; and they act as custodians of our wealth. These functions require long-term commitment. They should not be erratic or ephemeral. The economy needs a steady supply of competent, honest, and reliable banking services in order to function. That is why any bank should emphasize the long term over the short term.

After purpose comes measurement. In the context of culture, however, calculating particular metrics is less important than the goals of such measurement. The first goal is to assess how you are doing compared to what you have set out to do. In other words, are you fulfilling your purpose? The second goal is to assess how you stack up against your peers. In both ways, measurement provides critical benchmarking, without which firms and the industry cannot assess whether they are making progress.

Since the beginning of our work on culture, my colleagues and I have recognized that measurement is indispensable to improving bank culture. We have not been alone in this view.

At the New York Fed's first conference on cultural reform, in October 2014, Sir David Walker encouraged banking leaders to measure behavior within their firms in order to promote accountability. Pursuing this theme, several panelists addressed the use of measurement as a corporate governance tool. They argued that standardized metrics could help quantify the judgment and behavior of individual employees, making the behavioral components of annual performance reviews more objective. The same information could also aid a firm's senior leaders in assessing the effectiveness of their communications about how the firm conducts its business. For my part, I encouraged the industry to collaborate on a common culture survey that could serve as a benchmark for behavior. I also agreed with Sir David that measurement and accountability should not be decoupled.[4]

Last week, the BSB published the results of its industry-wide benchmarking survey on culture. This is a critical step forward in the industry's effort to get better data on how firms are doing on cultural issues, to identify areas for improvement, and to demonstrate a public commitment to improvement. Several facets of the BSB's report struck me as particularly significant.

First, in addition to creating a benchmarking survey—which generated approximately 28,000 responses—the BSB conducted focus groups with junior employees and interviews with senior leaders to add depth to what the survey results indicated. That represents a significant investment of time by the BSB and those who participated in the qualitative review. That commitment is essential for understanding the context and meaning of responses within individual firms.

Second, the survey asked respondents to agree or disagree with a number of statements. Those statements were direct and cut to the core of cultural issues in banking. Some of the standouts, in my view, included:

- "I believe senior leaders in my organization mean what they say."
- "In my organization we are encouraged to follow the spirit of the rules (what they mean, not just the words)."
- "I see people in my organization turn a blind eye to inappropriate behavior."
- "If I raised concerns about the way we work, I would be worried about the negative consequences for me."[5]

Third, the results suggest that the respondents did not pull their punches. Nearly 30 percent answered that they would be worried about negative consequences if they raised concerns at work. That shows, perhaps more than any other finding, that there is still a long way to go in creating a culture for long-term success in banking. In addition, approximately one quarter of employees did not affirmatively agree that their organization puts customers at the center of business decisions. That is also of concern if we want an industry that is sustainable over the long term.

I encourage you to read the BSB's report, if you haven't already. And let me emphasize that the report is not intended as a cudgel or to assign blame. Rather, as I see it, the report gives the industry an opportunity to improve against a benchmark. Again, I want to acknowledge the BSB's contribution and thank them for all their work.

Now the burden shifts from the BSB to you, the industry. What will you do with these results? We all want to see progress on culture and behavior. How will you—both within firms and collectively—move the needle on culture and behavior over the next few years?

I suggest that if you want next year's results to be better than this year's, you might start by focusing on incentives.

As I have argued before, incentives shape behavior, and behavior drives culture. If you want a culture that will support your long-term business strategy, you need to align incentives with the behaviors that will sustain your business over the long haul.[6]

Incentives—compensation and promotion, in particular—are powerful tools for communicating the conduct and culture you desire for your firm. Of course, the cultures of firms can and should vary. But, the culture of every bank should share a common theme: stewardship—a word that implies professional care, exercised year after year for the benefit of the firm and its stakeholders. A commitment to the long term must be at the core of banking. Incentives within a firm should support that goal, not undermine it.

My emphasis on incentives is not new, but it bears repeating. Bad incentives were a key contributing factor in the financial crisis. In the United States, the Financial Crisis Inquiry Commission concluded that "Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences."[7] This theme applied to all levels of banking organizations. One notable example was mortgage brokers, who were paid based on the volume of loans they generated, not their quality.[8]

The financial crisis came to a head in the fall of 2008. Fast forward eight years to the fall of 2016. Wells Fargo's chairman and CEO resigned after regulators uncovered what appeared to be widespread fraud in the retail bank. Compensation, once again, seems to be at the center of a scandal. Neighborhood bankers were paid based on the volume of new accounts opened, apparently with utter disregard for whether customers wanted them or even knew about them. And, like mortgage brokers in the early 2000s, it appears that job security depended almost exclusively on meeting targets, regardless of how those targets were met. There was a serious mismatch between the values Wells Fargo espoused and the incentives that Wells Fargo employed.[9]

Investigations into what happened at Wells Fargo are continuing, so I will wait before drawing more definitive conclusions. For now, though, it is sufficient to note the powerful role—for good or for bad—that incentives can play in an organization. I understand that making progress on culture is difficult. But, if you want the next round of metrics to look better than the last, use a powerful lever—use incentives.

Today's discussions—here at Mansion House and later at the Bank of England—are evidence that the issue of culture is important to the private and public sectors alike. We have to keep working on this. The public sector must continue to shine a spotlight on the issue, and the industry must continue to demonstrate that it is taking responsibility for its culture. And, culture cannot be a subject that only receives attention because bad conduct has occurred in the recent past.

I am convinced that a good or ethical culture that is reflected in your firm's strategy, decision-making processes, and products is also in your economic best interest, for a number of reasons:

- Good culture means fewer incidents of misconduct, which leads to lower internal monitoring costs.
- Good culture means that employees speak up so that problems get early attention and tend to stay small. Smaller problems lead to less reputational harm and damage to franchise value. And, habits of speaking up lead to better exchanges of ideas—a hallmark of successful organizations.
- Good culture means greater credibility with prosecutors and regulators—and fewer and lower fines.
- Good culture helps to attract and retain good talent. This creates a virtuous circle of higher performance and greater innovation, and less pressure to cut ethical corners to generate the returns necessary to stay in business.
- Good culture builds a strong organizational story that is a source of pride and that can be passed along through generations of employees. It is also attractive to clients.
- Good culture helps to rebuild public trust in finance, which could, in turn, lead to a lower burden imposed by regulation over time. Regulation and compliance are expensive substitutes for good stewardship.

Good culture is, in short, a necessary condition for the long-term success of individual firms. Therefore, members of the industry must be good stewards and should seek to make progress on reforming culture in the near term.

Thank you for your kind attention, and thank you again to the Banking Standards Board for inviting me to speak and to the Lord Mayor for hosting. I would be happy to answer your questions.

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1 Sarah Bell, Stephanie Chaly, James Hennessy, Thomas Noone, and Joseph Tracy assisted in the preparation of these remarks.

2 Onora O'Neill, What is Banking For?, Remarks at the Federal Reserve Bank of New York's Conference: Reforming Culture and Behavior in the Financial Services Industry: Expanding the Dialogue, Oct. 20, 2016.

3 Anthony Salz, *Salz Review: An Independent Review of Barclays' Business Practices* 81 (Apr. 2013).

4 A summary of the New York Fed's October 20, 2014, conference on reforming culture in the financial services industry is available at www.newyorkfed.org/newsevents/events/banking/2014/1020_2014.

5 Annual Review 2016/2017: The 2016 Assessment & Evidence, Banking Standards Board, March 2017, available at www.bankingstandardsboard.org.uk/annual-review-2016–2017/assessment.

6 William C. Dudley, Remarks at the Culture Imperative—An Interbank Symposium, Jan. 11, 2017.

7 Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report* xix (Jan. 2011).

8 *Id.* at 64.

9 *In re Wells Fargo*, Consumer Financial Protection Bureau Administrative Proceeding 2016-CFPB-0015 (Sept. 8, 2016) (Consent Order) ¶¶ 8-9 ("Respondent set sales goals and implemented sales incentives, including an incentive-compensation program, in part to increase the number of banking products and services that its employees sold to its customers. Thousands of Respondent's employees engaged in Improper Sales Practices to satisfy sales goals and earn financial rewards under Respondent's incentive compensation program. During the Relevant Period, Respondent terminated roughly 5,300 employees for engaging in Improper Sales Practices.").