Ed Sibley: Is it legal? A question of culture

Speech by Mr Ed Sibley, Deputy Governor of the Central Bank of Ireland, at the Eversheds Sutherland Conference "Leadership and Culture Change in Financial Services", Dublin, 14 November 2017.

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Introduction

Good morning, ladies and gentlemen. I am delighted to be here this morning to speak at this well-timed and highly relevant event.

There has been much discussion on culture in Irish financial services in recent months, particularly, but not exclusively, with reference to the Irish retail banks.

I spoke at an event recently[1] during which I highlighted the breakdown in public trust and confidence in banking, and the need for meaningful cultural change to repair and restore trust. I will expand further on this issue today as it extends beyond banking, and will also cover the work of the Central Bank with regard to behaviour and culture and the connected topic of diversity.

The importance of culture

Culture is a somewhat nebulous concept, and much more difficult to define and measure than profitability, pricing, compliance with regulatory requirements, such as minimum capital requirements, liquidity coverage ratios, and so on. But, that does not make it any less important – as the saying goes, it eats strategy for breakfast[2].

The Financial Stability Board defines culture as an "*institution's norms, attitudes and behaviours related to risk awareness, risk taking and risk management, or the institution's risk culture*."[3] Or to put in another way, an organisation's culture is formed by the assumptions, values, expectations and beliefs, which drive behaviours of staff. When we talk about culture, what we are really talking about is behaviour.

Culture therefore drives the values and beliefs that govern how individuals treat others, perform their tasks, take decisions, assess risk, and perhaps most importantly, do the right thing to ensure they operate in a safe and sound manner. It is the foundation upon which effective governance is built and is critical to firms' long-term prosperity. Importantly, experience[4] shows that behaviour has a predictive value with respect to firms' future stability.

It is clear, therefore, that regulated firms' behaviours and cultures are within the purview of regulators, both from a prudential and a conduct perspective[5].

While culture may be somewhat nebulous, the impacts of cultural problems are not. The list of scandals affecting both the treatment of customers and the financial strength of firms is long and inglorious. These are not limited to financial services, as we can see from politics, and the entertainment, telecoms, airline industries and so on, but pension misselling, payment protection insurance misselling, LIBOR rigging, 'rogue' trading, and so on, and most recently tracker mortgages have had a corrosive effect on trust in financial services. As has, obviously, the catalogue of failures that led to the financial crisis, the effects of which are still very much with us today.

It is clear that there were multiple failures and multiple individual and collective decisions leading

up to the financial crisis, for example, collective groupthink, business model and strategy failures, governance and control issues, financial misconduct, excessive optimism, regulatory failures, political interference and so on. There are behavioural and cultural linkages across all of these failures.

The behaviours and underlying cultures within financial services firms were wholly inappropriate. Short termism was incentivised, particularly with respect to shareholder returns. Effective internal challenge of the prevailing views was not.

Decisions were made in the short-term interest of the shareholder (or at least management's interpretation of it), and whether decisions were legal, with too little consideration of whether they were ethical or in the interests of the customer. Ironically, this behaviour has been massively destructive for long-term shareholder value, as well as customers, and financial stability.

Unfortunately, as the tracker mortgage scandal has amply demonstrated, this '*is it legal?*' attitude still pervades in too many institutions. On this specific point, the Central Bank is under no illusion that continued and concerted pressure is required to ensure all affected customers receive redress and compensation and banks comply with our findings. I expect all the main banks will be subject to Central Bank enforcement investigations. As part of these investigations, interviews with relevant individuals have been and will be conducted, and large volumes of documentation have been and will continue to be gathered and reviewed.

Moreover, I expect the boards, the individuals on the boards and the executives to be accountable and to be held to account for not only the initial decisions which started the consumer detriment, but the persistent and ongoing behaviours and decisions that magnified this harm over an extended period. As well as answering to the Central Bank, I would expect them collectively and individually to be taking a long hard look in the mirror, and as pre-approved control function holders to be actively considering their responsibilities regarding disclosure and whistleblowing.

In more general terms, as the reputation of financial services firms has been damaged there is a tendency for a greater degree of commoditisation of services, products and product providers. If consumers do not trust providers or their products, they are understandably going to be more driven by price, when other factors may also be important in terms of suitability. Concerns are so deep rooted that there is a lack of trust regarding pricing (e.g. car insurance, mortgage pricing), and customer treatment (e.g. re mortgage and SME borrowers in distress).

In this context, it is unsurprising that the Central Bank, together with other international supervisory bodies, including, *inter alia:* the Bank of International Settlements, the European Central Bank; the Group of 20; the New York Federal Reserve and the Bank of England[6] have identified culture as an important issue.

What does good look like?

While regulators have strengthened the structural requirements around governance risk, including remuneration rules, these rules are only a partial solution and are not sufficient to drive appropriate culture in firms, which is the responsibility of the board and senior management.

In its paper on Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform, the G30 outlined that "Banks should specify their cultural aspirations through a robust set of principles, and fashion mechanisms that deliver high standards of values and associated conduct consistent with the firm's purpose and broader role in society"[7]. While focused on banks, this paper resonates and is relevant across other financial services sectors.

Although there is no one action that will ensure that a good culture is achieved, there are clear actions that can be taken to seek to ensure a firm's culture is improved and in line with that

espoused by the board. These include:

1. The board taking responsibility for the culture of the firm and understanding the behaviours that culture drives – for example through the establishment of an ethics subcommittee to the Board; or a measurement or monitoring by the board of the firm's culture through engagement with management, employee surveys or employee focus groups.

2. The board overseeing (e.g. through an ethics subcommittee):

- recruitment policy,
- hiring decisions,
- implementation of remuneration policies that reward and incentivise appropriate behaviours in line with the desired culture; and
- reviews of board effectiveness, committee structures and staff performance review processes.

3. The board overseeing product development and usage, including considering how behavioural economics and marketing are being used, to ensure that customer interests are at the heart of the process – i.e. products are truly in the customers' best interests, and not taking advantage of, for example, short term benefits with longer term costs.

4. As I will come to, the board actively promoting diversity and inclusion at all levels of the firm to improve decision-making.

5. Requiring Internal Audit to include a culture audit in the annual audit plan. This might include the extent to which culture is cascaded by the articulation of expected behaviours.

6. Ensuring all three lines of defence have a responsibility for driving culture at a business line level rather than enterprise level so that culture is truly embedded in the institution's risk management framework.

7. Ensuring incentivisation (in its broadest sense, i.e. not just financial) is fundamentally linked to appropriate behaviours; for example, ensuring promotion, recognition, and the variable compensation element of remuneration is consistent with the behaviours expected of employees to ensure the culture of the firm is reinforced.

8. Driving consistent communication of the desired culture from the Board, recognising the importance of 'tone from the top', to all staff levels of an institution.

9. Actively celebrating, incentivising (e.g. recognising and promoting), those who come forward to identify issues and behaviours that are not in line with or at least risk factors regarding the espoused values and desired culture of the firm.

And all of the above to be informed by questions that not only relate to whether the actions are legal, or in compliance with regulatory requirements (important as they are), but rather questions such as:

- Is this sustainable?
- Is it in the long-term interests of our customers?
- Does this fit with our espoused values?
- Is this right?
- How are my staff incentivised to act? and
- How does my organisation treat people that raise problems, issues and concerns?

Diversity

There is strong evidence that diversity and inclusion has a role to play in improving culture.

Groupthink has been identified as a contributing factor to the financial crisis. There is strong research to show that diversity at senior levels of regulated entities can help to reduce the likelihood of groupthink,[8] improve decision-making,[9] increase the level of challenge,[10] and improve risk management.[11]

There are also increasing numbers of studies that show that diversity is a competitive differentiator; specifically, that when companies embrace gender and ethnic diversity at the leadership level, they are more likely to be successful – or to put it another way, they are less likely to fail. Correlation and causation are sometimes difficult to determine, but the correlation between greater diversity and business performance is certainly clear.

McKinsey's[12] research in this area suggests that companies in the top quartile for gender or racial and ethnic diversity are more likely to have financial returns above their national industry medians. Companies in the bottom quartile in these dimensions are statistically less likely to achieve above-average returns.

In my own experience, a lack of diversity at senior management and board level in organisations is a leading indicator of elevated behaviour and culture risks – again as evidenced in the tracker mortgage scandal.

In this context, it is concerning that a significant imbalance in gender and other diversity aspects remains at senior levels operating in most regulated firms in Ireland. Approximately 80% of the most senior and influential appointments in regulated firms in Ireland between 2012 and 2016 were male.[13] Comparisons are almost certainly worse for any other measure of diversity. This is not a unique circumstance in Ireland. The Empowering Productivity Report, sponsored by the UK Treasury and the Bank of England, concluded that UK Financial Services had an average of 23% female representation on boards, but only 14% on Executive Committees.[14]

This is not to suggest that diversity is all about gender. Experiments from behavioural science has shown the importance of personality types on our risk taking behaviours. These findings suggest that having a board made up of more optimistic individuals than pessimistic individuals is dangerous and should be avoided.

The UK Financial Services Authority report[15] into the collapse of the Royal Bank of Scotland identified significant overconfidence by board members prior to the financial crisis, and in particular in relation to the acquisition of ABN AMRO. The Dutch Central Bank[16] has also identified a tendency towards consensus and optimism in organisations. Overconfidence and optimism can depend on our biological makeup.

Studies have shown (e.g. Mischel)[17] that more depressed people, who have a low psychological immune system tend to self-rate their performance in various tests quite accurately. Individuals with higher psychological immune systems tend to rate themselves far higher than their actual performance (i.e. they are overconfident).

The cookie jar experiment[18] asks people to estimate how many coins there are in a transparent cookie jar. When people do this independently, the accuracy of the average judgement rises with the number of estimates and is generally very close to the actual number of coins. But if people hear or see each other's estimates, the mean can shift wildly up or down. This experiment has been completed across many different groups by age, sex, culture and so on, all giving the same result. The experiment highlights an important point; better results are achieved through diversity and *independent* opinion.

As I have commented on in the past, we have reviewed a sample of diversity policies in regulated firms, which many financial services firms are now required to have (under the CRD, Solvency II and the Central Bank's Corporate Governance Codes). In the main, they are striking for their lack of ambition. They should not just be about ticking the box from a compliance perspective – again, that question of 'is it legal' arises. Much more is needed to be done, and our supervisory efforts in this regard are going to increase.

Regulatory response

The Central Bank continues to enhance its approach to behaviour and culture, including learning from international best practice. Work has been undertaken in banks and insurance firms from a prudential perspective, and in the consumer area we have developed a framework for the assessment of culture in regulated entities. As has been well documented, this work will be expedited across the retail banks over the coming months, and be rolled out further after that.

A variety of tools will be used to assess culture in regulated firms, including how boards and senior management are delivering against the good practices outlined earlier. These include considering:

- key risk indicators and triggers, for example; staff turnover, and risk appetite breaches;
- approach to staff incentivisation;
- staff training;
- onsite inspections;
- staff surveys;
- board and executive management meetings observation;
- interviews across the organisation; and
- product design, development and monitoring (including how customers are incentivised).

This is not with the aim of delivering the impossible and frankly undesirable outcome of a standardised culture across all financial services firms, but of assessing the extent to which regulated firms are delivering the cultures they espouse and identifying improvements that reduce prudential and conduct risks.

We expect institutions to critically evaluate their culture, considering what type of culture they want to develop, how staff are incentivised to behave, and to be held to account as to whether the culture they want is the culture they have and how would they know if it is not.

We will also be stepping up our work from a diversity and inclusion perspective – linked to our work on culture. It will increasingly feature in our ongoing supervision and inspection work, supported by analytics. We expect regulated firms to meaningfully address diversity and inclusion in the boardroom, at the executive level and the pipeline of talent needed to run the organisation in the long-term.

Conclusion

I will conclude here.

Restoration of trust in the financial services system is necessary for the delivery of the Central Bank's vision for financial services as a whole – specifically, that it functions well, is well-managed and well-regulated and it serves the needs of the economy and its customers over the long term. Rebuilding trust, undoubtedly is in all of our interests.

In this context, culture is a critically important topic. I am under no illusions that creating the right culture within organisations can be difficult to achieve. That does not mean that we should not

try, and in the effort, necessary improvements will be made. These improvements will reduce the risks of further failures to add to the litany of historic failures, and that when they do occur in the future, they are identified and resolved more quickly.

When planning this speech, I had hoped to spend more time on positive aspects of culture, and to give positive examples of it working well in certain firms. The aim of this would have been to differentiate between the good and the bad, to avoid dis-incentivising change, by suggesting that all firms are the same. I have chosen not to do this today, not because there are no examples of good practice, but because I believe my limited time was better focused on the need for change.

There are real opportunities for leadership (across sectors, and by individual firms) to turn the dial, to drive change, to differentiate positively, to show: that the mistrust is no longer valid, that lessons have been learnt, that you have demonstrably, definitively and permanently changed, and that the behaviours and cultures by and within your firms and industries are in the long term interest of both your customers and your shareholders.

This opportunity for change is every bit as urgent as the technology, business model and regulatory changes that are frequently focused on.

I am still sceptical as to whether the cultures and values that firms espouse are, in many cases, the ones that they really want and believe in, and will be sustained at moments of real pressure. But, it is my job to be sceptical. It is your customers' views that are more important, and it is the treatment of them, that you are demonstrably putting them first, that is the true test. And only through cultural change can you pass this test again and again, and in doing so, restore trust in the system.

I thank you for your attention.

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1 Address to the Association of Compliance Officers - 10 November 2017

2 "Culture eats strategy for breakfast" was first articulated by Peter Druker.

3 Financial Stability Board Guidance on Supervisory Interaction with Financial Institutions on Risk Culture, 7 April 2014.

4 Examples: Honohan Report 2010 ' ..risky borrowing and lending behaviours'; DIRT inquiry 1986–1998 'misbehaviour by banks in facilitating tax evasion'; Tracker mortgage review 2017.

5 For details on the Central Bank's financial regulation structure, see Address to the Association of Compliance Officers – 10 November 2017

6 Examples: Bank of International Settlements, 2016; ECB, 2015; Federal Reserve Bank of New York, 2017; Bank of England, 2016.

7 Group of thirty (G30), Banking Conduct and Culture: A Call for Sustained and Comprehensive Reform, 2015.

8 Daily, C.M., Dalton, D.R. and Cannella, A.A. (2003) *Corporate governance: Decades of dialogue and data.* Academy of management review, 28(3), pp.371–382.; Maznevski, M. L. (1994) *Understanding our differences: Performance in decision-making groups with diverse members.* Human Relations, 47(5), pp. 531–552.; Robinson, G. and Dechant, K. (1997) *Building a business case for diversity.* Academy of Management Executive, 11, pp. 164–177.; Zelechowski, D. and Bilimoria, D. (2004) *Characteristics of women and men corporate inside directors in the US.* Corporate Governance: An International Review, 12(3), pp. 337–42.

9 Hoogendoorn, S., Oosterbeek, H. and van Praag, M. (2013) *The impact of gender diversity on the performance of business teams: evidence from a field experiment.* Management Science, 59, pp. 1514–1528.

10 Terjesen, S., Sealy, R. and Singh, V. (2009) *Women directors on corporate boards: A review and research agenda.* Corporate Governance: An International Review, 17(3), pp. 320–337

11 Adams, R.B. and Ragunathan, V. (2015) *Lehman sisters.* FIRN Research Paper.; Kirrane, S (2017) Should

financial regulators require regulated entities to have gender diversity on their boards, Warwick Business School.

[12] Vivian Hunt, Dennis Layton, and Sara Prince, McKinsey & Company, January 2015.

[13] See Central Bank of Ireland - Gender breakdown of applications received for certain roles in regulated firms 2012 to 2016.

[14] Jayne-Anne Gadhia, CEO, Virgin Money, Empowering Productivity – Harnessing the Talents of Women in Financial Services, March 2016.

[15] FSA Report into failure of RBS, 2014.

[16] DNB, Supervision of Behaviour and Culture*, 2015.*

[17] Mischel.W , *The Marshmallow Test: Why self-control is the engine of success*. Little,Brown, and Company, 2014.

[18] Kahneman, D. *Thinking Fast and Slow*. Farrar, Straus and Giroux, 2011.