Kevin Stiroh: Misconduct risk, culture and supervision

Remarks by Mr Kevin Stiroh, Executive Vice President of the Financial Institution Supervision Group of the Federal Reserve Bank of New York, at the Culture Roundtable Session with Business Schools and Financial Services Industry, Federal Reserve Bank of New York, New York City, 7 December 2017.

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Good morning everyone.

Thank you for joining us at the New York Fed today and for your ongoing participation in the important discussion around culture and ethics in the financial services sector. This workshop and discussion are a critical part of our ongoing collective efforts on promoting financial industry culture reform. Business schools serve as a major supply source of the talent pool for mid-level management positions in the industry. This relationship makes aligning business education curricula and pedagogy with demands around improving industry culture a mutually beneficial strategy.

While your conversation today has focused on the role of academia and industry, I want to take this opportunity to share with you how I've been thinking about the role of bank *supervisors* in the culture reform dialogue. I am the head of the Supervision Group of New York Fed, but my perspective and approach are influenced by my background and training as an economist. You'll hear me talk about frictions and market failures; about production processes and intangible capital; and the conceptual rationale for a role for the official sector.

There are, of course, multiple ways to consider the relationship between culture and bank supervision. I hope my remarks, which are based on a whitepaper we published earlier today, will offer a complementary perspective to the type of work already underway by other supervisors and regulators, including the UK regulators (FCA and PRA), the Australian Prudential Regulation Authority (APRA), DeNederlandsche Bank (DNB), the Hong Kong Monetary Authority (HKMA), and other institutions like the Financial Stability Board and the Group of Thirty (G30). I am focusing my remarks today specifically on "misconduct risk," but the conceptual arguments and framework apply more broadly to financial sector risk management in general.

Please note that the views I express today are my own and they do not necessarily reflect those of the Federal Reserve Bank of New York or the Federal Reserve System.[1]

Misconduct Risk

A primary goal of bank regulators and supervisors is to support the sustained provision of financial services to households and businesses in a fair and transparent way. In order to do this, we examine financial institutions, individually and collectively. We assess safety and soundness to ensure firms have the appropriate risk identification and risk management processes for prudent banking. We hold them to standards that require them to be resilient to a broad range of potential risks such as credit, market, liquidity, and operational risk.

One specific risk is employee "misconduct risk." We define this as the potential for behaviors or business practices that are illegal, unethical, or contrary to a firm's stated values, policies, and procedures. The impact of employee misconduct extends beyond the individual and can impact the firm as a whole, as well as the economy and financial markets more broadly. That is, misconduct risk has both prudential and financial stability implications.

For a firm, employee misconduct can make it less resilient by diverting management attention, by harming the firm's reputation in a way that impedes its business, by driving adverse change in the composition of the workforce, or by depleting its capital through losses or fines. Since 2008, for example, firms have paid, in aggregate, in excess of $320 billion in fines related to misconduct.[2]

For the broader economy and financial markets, misconduct can inflict harm directly on consumers and employees. In addition, over time, market participants may lose confidence in the financial sector as a whole and adversely impact the sector's critical role in financial intermediation. In 2016, for example, Gallup found that confidence in the financial sector had fallen by half over the previous decade.[3]

These incidents of misconduct can introduce frictions and raise the cost of financial intermediation, which in turn, reduces the flow of productive financial services. These sorts of external effects that spill over to other firms, consumers, and businesses are a critical rationale for official sector intervention related to employee misconduct.

In the U.S., official sector concern with the damage inflicted by employee misconduct dates back to the Banking Act of 1933.[4] More recently, supervisors have traditionally addressed firm's management of misconduct risk by assessing the effectiveness of firms' risk management and internal control functions, such as compliance and audit. Yet, despite regulations, supervisory focus, and firms' own efforts, significant misconduct risk and bad outcomes continue. Why? What explains this persistence?

One hypothesis is that recent problems are just a stream of idiosyncratic events, random draws of "bad apples." Another hypothesis is that some firms have operational weaknesses, "bad processes," that allow these outcomes to occur. I don't believe, however, that either of these hypotheses tells the whole story.

Root cause analyses of many recent cases of misconduct in the financial sector suggest that misconduct is not just the product of a few individuals or bad processes, but rather the result of wider organizational breakdowns, enabled by a firm's culture. From both a prudential perspective and a financial stability perspective, misconduct risk threatens our core supervisory objective to sustain the efficient provision of financial services to the economy. This suggests that supervisors have an obligation to promote strong internal practices and behaviors that mitigate misconduct risk and create a healthy culture.

Misconduct Risk and Cultural Capital

One way to think about this is "cultural capital."[5] A firm's *cultural capital* is a type of asset that impacts what a firm produces and how it operates. It is analogous to *physical capital,* like equipment, buildings and property, or to *human capital*, like the accumulated knowledge and skills of workers,[6] or *reputational capital,* like the franchise value or brand recognition.[7] Cultural capital is an input into a firm's production process—impacting how it does its business.

Cultural capital is an intangible asset. That is, we generally experience the impact rather than the thing itself—but its impact can be measured, assessed, and ultimately influenced. For example, in an organization with a high level of cultural capital, misconduct risk is low and observed structures, processes, formal incentives, and desired business outcomes are consistent with the firm's stated values. The unspoken patterns of behavior reinforce this alignment. Problems are escalated to senior managers routinely, as employees feel empowered to raise their hand and believe that their efforts will result in meaningful responses. And senior leaders advance through the organization because, in addition to strong business performance, they set a credible tone from above by modeling behaviors consistent with the firm's values.

By contrast, consider some characteristics of an organization with low levels of cultural capital. In these firms, formal policies and procedures do not reflect "the way things are really done." The stated values of the organization are not reflected in senior leader behaviors and actions of the organization's members, and misconduct results from norms and pressures that drive individuals to make decisions that are not aligned with the values, business strategies, and risk appetite set by the board and senior leaders. Employees do not speak freely when they have concerns, and senior managers or the board of directors do not find out about improper conduct until it is uncovered by the authorities. Rules may be followed to the letter, but not in spirit. All of this increases misconduct risk and potentially damages the firm and the industry over time.

Like other forms of tangible and intangible capital, firms must invest or its capital will deteriorate over time and adversely impact the firm's productive capacity. To be clear, cultural capital is not loss absorbing like equity capital, but it can be loss preventing by influencing decisions, behaviors, and outcomes over time.

Market Failures and Misconduct Risk

If this is the case and misconduct risk is bad for the firm, some obvious questions follow: Why don't firms invest in cultural capital and reduce the risk themselves? Why do regulators and supervisors need to get involved?

I believe firms are ultimately responsible for these decisions and we do observe progress. Many large financial firms have increased their attention to misconduct risk and cultural drivers in the wake of serious frauds and enforcement actions over the past several years. But, the degree of commitment and progress in these efforts has not been even across the industry and serious or persistent misconduct continues in some firms.

So, why wouldn't a firm do more? One can turn to traditional economic theory to offer an explanation for why a firm might underinvest in cultural capital. Firms may operate with levels of cultural capital beneath both the social optimum and even the private optimum due to different types of market failures. Today I will consider three well-known phenomenon—*externalities*, *principal-agent problems*, and *adverse selection*—that may explain why misconduct risk persists and why firms might underinvest in cultural capital relative to what might be socially optimal.

Externalities

Externalities are the impact that one actor has on other, unrelated actors. Externalities can drive a wedge between private and socially optimally outcomes and, from a supervisors' perspective, lead firms to underinvest in their own resiliency by ignoring the broader impact of bad outcomes on the financial sector and the real economy.

In other contexts like environmental policy, externalities such as pollution motivate government intervention. In banking regulation, externalities are the conceptual driver behind the enhanced prudential standards for capital, liquidity, and risk management that are currently applied to the largest, most systemically important financial institutions.[8]

Principal-agent problems

Principal-agent problems reflect incentives for employees to act in ways that don't align with the broader interests of management or shareholders. This can lead to excessive risk-taking, underinvestment in risk-reduction and risk-control mechanisms, and a focus on short-term returns at the cost of long-run viability. Think about the trader who is compensated on short-term P&L and not long-term value creation.

These issues can be amplified by the opacity intrinsic to many financial activities that allows misconduct to persist and erodes the cultural capital of the firm.

Adverse selection

Adverse selection occurs when those particularly ill-suited for something are the most likely to participate. This could be a complicating factor in this context if conduct-related events change the composition of a firm's workforce. Firms with relatively low cultural capital (and a relatively high tolerance of misconduct risk) may attract and retain employees and clients more inclined to take inappropriate risks and push beyond internal limits and controls. Further, high-quality directors, executives, and employees might leave such firms or decline to join them, depleting the firm's human capital and contributing to the deterioration of cultural capital.

Role of the Official Sector

These are some of the types of market failures that may explain why a firm might not invest enough in its cultural capital to mitigate risks, including misconduct risk. And they suggest a role for the official sector to encourage resiliency, including investment in cultural capital, beyond what the firm would choose to do on its own. That is, if firms don't have sufficient incentives to overcome these forces, then the official sector should push toward a better outcome.

In the case of misconduct risk, supervision seems like a particularly appropriate approach because the hard-to-define and evolving nature of behavior likely prevents easy regulatory solutions.[9] Though some rule-writing could help re-align incentives, misconduct risk can take many different forms and, by its nature, seek to circumvent the rules.

Essential drivers of culture and of misconduct risk, for example, relate to leadership and "tone from above," areas that are inherently behavioral and qualitative in nature. Supervisors can assess behaviors in an ongoing manner and help to identify potential risks.[10]

I'll note that the need for a supervisory focus on employee misconduct and its underlying drivers dates back one and a half centuries to the origins of bank supervision. Then, in the U.S., the emphasis was on the "responsibility and integrity" of bank managers and directors and its relationship "to public confidence."[11] Part of the role of supervisors is to close gaps in the rules to advance safe and sound banking practices that support the sustained provision of financial services. Issues like misconduct risk and culture likely fall in these gaps because they involve the attitudes, norms, and behaviors and suggest a critical role for supervisors in addressing these risks.

Conclusion

To conclude, misconduct risk poses clear threats to both prudential and financial stability objectives. The work supervisors do to address misconduct challenges is critical because there are limits to the regulatory or deterrence and enforcement approach. To understand how a firm manages misconduct risk and to improve resiliency and reduce the potential for unwanted disruptions to financial intermediation, we must increase our focus on firms' decision-making practices and behaviors as a core aspect of good governance. We can draw from the growing literature about the root causes of misconduct and the underlying factors that drive unhealthy cultures to support this goal.

However, as I am sure you already appreciate, addressing culture reform across an entire industry is a complex challenge and there is no one action or approach that will fully address it. We all must be willing to work at this from our various vantage points, as supervisors, as academics, and as industry participants. As you reflect on the conversations you have had today, the points that were raised, and the potential paths forward, I encourage you to consider the important role you each play and the potential impact we, collectively, can have by working together toward the ultimate goal of ensuring a safe and sound financial system that supports economic growth and stability.

[1] These remarks are based on a whitepaper: Misconduct Risk, Culture, and Supervision. I thank Stephanie Chaly, Jim Hennessy, and Jackie McCormack for help preparing these remarks.

[2] Gavin Finch, "World's Biggest Banks Fined $321 Billion Since Financial Crisis," Bloomberg (March 2, 2017).

[3] Gallup, Confidence in Institutions, *In Depth: Topics A to Z* (June 1-5, 2016).

[4] Banking Act of 1933, Pub. L. 73–66, 48. Stat. 162, Section 30.

[5] The term "cultural capital" has been defined differently in other contexts—i.e., defined as those symbols, skills and tastes a person acquires overtime from parents, institutions and surroundings that can be used as resources to achieve mobility in a stratified society. See Pierre Bourdieu "The Forms of Capital," *Handbook of Theory of Research for the Sociology of Education* (1986).

[6] Gary Becker, *Human Capital: A Theoretical and Empirical Analysis* (1964).

[7] See Thomas Noe, "A Survey of the Economic Theory of Reputation: Its Logic and Limits," *The Oxford Handbook of Corporate Reputation*, Timothy Pollock and Michael Barnett, eds. (July 2012). See Rebecca Demsetz, Marc Saidenberg, and Philip Strahan, "Banks with Something to Lose: The Disciplinary Role of Franchise Value," *Economic Policy Review*, 2 (October 1996) and Michael Keeley, "Deposit Insurance, Risk, and Market Power in Banking," *American Economic Review*, 80(5), 1183–1200.

[8] See "Consolidated Supervision Framework for Large Financial Institutions," Supervision and Regulation Letter 12–17, December 17, 2012.

[9] See Beverly Hirtle, Anna Kovner and Matthew Plosser, *The Impact of Supervision on Bank Performance,* (February 1, 2014) for more on the distinction between supervision and regulation and the relative effectiveness of each.

[10] Financial Stability Board, Guidance on Supervisory Interaction with Financial Institutions on Risk Culture (April 7, 2014).

[11] An Act Supplementary to the Act to Incorporate the State Bank of Ohio, and Other Banking Companies, Chapter 299, *Laws of the State of Ohio* (January 6, 1846).