John C Williams: Now is the time for banking culture reform

Remarks by Mr John C Williams, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Governance and Culture Reform Conference, Federal Reserve Bank of New York, New York City, 18 June 2018.

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Introduction

It's a pleasure to speak at today's conference on this critically important issue, one that Bill Dudley and his colleagues have done tremendous work bringing to the forefront over the past few years. It's also an honor to be sharing a stage with Bill today, and I'd like to thank him for his outstanding leadership of the New York Fed.

I've learned a great deal from this conference, especially hearing the diverse perspectives and experiences of regulators from across the globe, industry leaders, and academic experts. The speakers and discussions have already covered a lot of ground, so I'll keep my remarks brief.

This afternoon I'm going to talk about the urgent need to focus our attention on banking culture in supervision and what that means in practice. Before I go any further, I have to give the usual Fed disclaimer that the views I express are my own, and not necessarily those of anyone else in the Federal Reserve System.

The Good Times Are When to Get Your House in Order

In the wake of the financial crisis and ensuing economic downturn, the world's attention was trained on financial services. The crisis severely eroded people's trust in the industry, both here and abroad.

Governments and regulators quickly got to work fixing the main deficiencies in the existing regulatory framework. These included requiring much stronger loss-absorbing capital to weather severe economic downturns, demanding greater liquidity cushions to withstand market and funding disruptions, and creating a robust resolution framework to protect both the economy and the taxpayer in the event of a failure of a systemically important firm.

These changes were appropriate and necessary. We must not lose sight of their importance in safeguarding the soundness of the financial system and in ensuring that future generations do not have to suffer the economic trauma that we lived through this past decade.

Bringing us to the present day, we are in a much, much better place, in terms of both the financial sector and the overall economy. We have a more robust regulatory regime in place, and banks are well positioned to survive future storms.

Furthermore, our economy's in great shape; we're in the second-longest expansion in history, and economic data from both the United States and countries around the world continue to trend upwards. As a policymaker, solid growth, a strong labor market, and inflation near our target are all exactly what I want to see.

Paradoxically, it's precisely this sense that things have gotten so much better that worries me most. Although we have seen marked improvements in the critical areas of capital, liquidity, and resolution, we have not yet fully addressed the root causes of many of the problems that have plagued the financial sector. I am thinking of not only the excessive risk-taking and leverage in the run-up to the crisis, but also the repeated scandals related to LIBOR, FX, money laundering, sales practices; unfortunately, the list goes on and on. Underlying these scandals is often an inadequate corporate culture, where accountability and ethical conduct have fallen by the wayside.

The good times we're in can exacerbate these problems in three ways. First, there's a risk of complacency setting in—an "if it ain't broke, don't fix it" mentality. Second, in a strong economy, the hard numbers that we tend to focus on when examining profits, losses, capital, and liquidity can look like everything's coming up roses, even when an uncomfortable reality lies beneath. And, finally, culture is a long-run investment that takes many years to develop and requires constant reinforcement to preserve. If you let it erode, you can't go to the market and obtain a new "culture" overnight.

As I mentioned, establishing a more robust regulatory framework was absolutely *necessary* for a healthier, more resilient financial system. But, it is far from *sufficient*. The danger we face today is that people may conclude that the hardened defenses are enough, and other supervisory activities around culture, conduct, and governance are superfluous.

This feeling that we've built a strong fortress able to withstand any onslaught may create a mood of complacency and detract attention from the dangers that could be growing within the walls of financial institutions.

This problem is aggravated by the fact that the hard numbers studied by regulators and supervisors *should* look great when the economy's doing well. Profits are high and loan losses low when the economy is humming along. But, strong numbers in a strong economy don't give you the full picture. They can't always tell you whether people are cutting corners, taking excessive risks, or violating rules and regulations. Even worse, they can distract you from digging into the truth and unearthing unethical business practices and misconduct that may hide below the surface.

The well-known challenge with culture is that, in contrast with things like capital and liquidity, culture feels "softer" and, therefore, more difficult to measure. And often in finance there's a tendency to disregard what can't be quantified. But just because it's hard to measure doesn't mean we should ignore it or downplay its importance. As we heard throughout today's conference, culture shapes every conversation, every decision, and every action; it is at the root of whether an organization performs in a manner consistent with its mission, or not.

How to Achieve a Better Banking Culture

This brings me back to the issue of culture as a long-term investment that can't be "fixed" overnight. Several years ago, Rich Lyons, Dean at Berkeley's Haas School of Business, spoke at the San Francisco Fed and talked about culture in a way that has stuck with me ever since. Transforming a culture is a five- to ten-year project; keeping it that way is an ongoing mission that requires strong leadership and consistent action.

As a leader of a large organization, I've taken that message to heart. I've found that a culture based on the principle of open and authentic dialogue, that embraces our diverse backgrounds and perspectives delivers better results. I've found that well-defined collective values and direction lead to greater collaboration and innovation. Finally, I've found that this work is never a finished project, but an ongoing one that constantly evolves.

I started by saying that I feel a sense of urgency in addressing banking culture. So where do I see the priorities for supervision?

As supervisors, we need to ensure that bank management and boards are exerting strong and effective leadership with robust governance. That means holding management and boards of directors to high standards in terms of culture and conduct, even when the numbers look rosy. It means ensuring corporate values are clearly articulated and incentives are squarely align with a bank's strategic goals. It means identifying, communicating, and mitigating risks in a timely and effective manner. It means that employees feel empowered to raise their hands if they see wrongdoing, and that comprehensive fixes are implemented when something goes wrong.

Conclusion

In conclusion, when times are good, we rarely feel an urgency to make changes. And these are certainly good times. But numbers can have a funny way of not revealing the whole truth. A sound spreadsheet may mask unethical behavior, a well-capitalized bank may be on the road to ruin, and a neglected corporate culture can turn toxic.

We must stay vigilant around the “softer” side of supervision. Strong culture and robust corporate governance are our first lines of defense. They’re a critical part of the tool kit when it comes to protecting people, banks, and the economy from risk, scandal, and harm.