Good morning. Thank you for the kind introduction, and for the invitation to speak at today’s forum.

We are all here today to talk about conduct and culture in the financial services sector, so I’m confident that you will agree that we have moved beyond the questions about “if” this an important issue and statements about “why” it is important. Rather, the focus is “how” the financial industry—both financial firms and the official sector—can continue to make progress in improving culture and reducing misconduct risk.

The New York Fed, under the leadership of former President Bill Dudley and current President John Williams, has been a strong advocate for reform of culture in the financial industry. Today, I’d like to offer some thoughts about the progress made to date and some of the challenges that remain. These challenges reflect, in large part, the complexity of the problem.

Please note that my comments today are my own and do not necessarily represent the views of the Federal Reserve Bank of New York or the Federal Reserve System.

Culture Reform as a Complex Problem

I’ll begin by observing that the issue of conduct and culture reform in the financial services industry is a “complex” problem and not simply a “complicated” one. Complicated problems have clear and relatively stable cause-and-effect patterns so that outcomes are largely predictable with the appropriate expertise and analysis. By contrast, complex problems are typically marked by interconnectedness of a large number of factors, constant evolution, feedback loops, “unknown unknowns”, and unpredictable outcomes. Culture reform is that type of problem.

A firm’s culture can be defined as the shared set of norms that influences decision-making and is evidenced through behavior. Now consider a global systemically important bank with trillions of dollars of assets; with operations that span diverse business lines, customers, counterparties, investors and regulators across multiple jurisdictions; and that competes in a global industry against similar firms. Add in tens, or even hundreds, of thousands of employees with a wide range of motivations and goals who interact in varied but interconnected operating environments with different regional, corporate and individual values, incentives, regulations, and laws, and the inherent complexity becomes clear.

This complexity makes it virtually impossible to fully comprehend the drivers of culture or predict its behavioral consequences. An implication is the need for a long-term, sustained commitment to addressing conduct and culture reform using a wide range of tools that are suitable for a complex problem.

Evolution of New York Fed’s Effort

In the ten years that followed the financial crisis, we have continued to see a stream of misconduct scandals and cultural failures, and a corresponding increase in significant litigation and enforcement activity, with costs estimated at an aggregate of $320 billion worldwide.

At the New York Fed, our work in advocating culture and behavior reform in the financial sector
started in late 2013 when our former President, Bill Dudley, delivered a speech on the “too-big-to-fail” problem. In that speech, he argued that “there is evidence of deep-seated culture and ethical failures at many financial institutions.” More recently, our current President John Williams concluded that “we have not yet fully addressed the root causes of many of the problems that have plagued the financial sector” and that there was still a “sense of urgency in addressing banking culture.”

Over the past five years, the New York Fed has focused on shining a spotlight on culture, behavior and conduct concerns, and pushed the industry to address these issues through a range of activities:

- Engaging with diverse thinkers on governance, culture and organizational behavior to better understand the complexity of culture reform;
- Convoking academic experts, and leaders in finance and the official sector through conferences and workshops on culture and behavior reform;
- Facilitating discussions among the supervisory community on assessing and influencing industry culture-related efforts;
- Building a platform for a partnership between business schools and industry representatives to influence culture reform through training of future leaders in finance; and
- Publishing a white paper on “Misconduct Risk, Culture and Supervision” that discussed a range of market failures that provide a conceptual rationale for intervention by bank supervisors.

Our white paper also summarizes work of supervisors from multiple jurisdictions around the world who are increasingly focused on the risks posed by poor culture and misconduct, and have developed a broad assortment of new tools and practices for identifying and supervising for misconduct risk. International efforts range from the creation of specialized units of behavioral risk experts to risk culture assessment frameworks to supervisory guidance that directs supervised institutions to develop and promote a sound corporate culture.

I view this variation in approach as a feature and not a bug of the official sector focus on culture reform. There is rarely a single solution to a complex problem with many interdependencies and deep uncertainty. Rather, the official sector must experiment and innovate; probe and adapt; and try new approaches to foster a healthy culture that promotes appropriate conduct.

One common thread of the recent innovations, however, is that supervisors can provide a horizontal perspective on culture reform that reflects broad social goals in a way that the private sector cannot. To be clear, it is not the supervisors’ job to dictate the internal culture of a firm, but when there are market failures such as externalities or information asymmetries, then there is a role for the official sector to push firms to do more to address these issues and mitigate misconduct risk.

We should be cautious, however, about our ability to influence precisely and predictably. Public health studies, for example, document “policy resistance” where interventions are defeated by the system’s response to an intervention. As an example, a rules-based regime that focuses on reducing conduct risk by prescriptive regulatory fiat runs the risks of creating a “check-the-box culture” where everything not explicitly banned is considered acceptable behavior. This has the potential to facilitate exactly the wrong type of culture, conduct and risk-taking.

**Challenges Related to Complexity**

While I have spoken so far about work by the official sector, progress has also been made over the past few years by the industry in terms of senior management focus and commitment to culture reform. Some firms have created Board-level committees looking at culture, others have
introduced behavioral risk into their audit programs, and still others have developed dashboards with a range of quantitative and qualitative factors to track their efforts and outcomes. Progress has been uneven, however, and there is still more to do. Let me identify several areas where I think additional work is needed—assessment, technology, and influence.

Assessment

Given the complexity of the problem, measuring and assessing progress is not straightforward. Assessment of culture and the factors needed to change it are difficult, but this should not deter us. Managers, investors, and the official sector all want to know what is changing and whether misconduct risk has been mitigated. The question then is, how will we really know whether change is happening and whether progress is sustainable?

I don't believe that there is a “silver bullet” for assessing culture change—no single solution, approach, or template will work for every firm in every circumstance. That said, standardized metrics will help in assessing changes over time and across firms. The UK Banking Standards Board (BSB), for example, provides one lens on assessing culture change for a broad cross-section of financial service firms operating in the U.K. I believe diagnostic tools like this are an important part of the cultural assessment toolkit.

Moreover, firms and the official sector need to evaluate a wide range of behaviors, signals, and outcomes to draw the most robust conclusions about the depth and pace of culture reform. I think it is critical for both firms and the official sector to continue to experiment with new approaches to assessing culture change, to collect and build new forms of data and measurement, to develop qualitative assessments to complement quantitative ones, to use new techniques and technology to understand how a firm’s culture and conduct are changing, and to continue adapting and course correcting to a sustainable business strategy as the operating environment evolves.

Influence

Fostering productive behavioral change is at the heart of culture reform. Behavior, in turn, is driven by a multifaceted set of factors including incentives, cues from peers, observations about leaders, and formal policies and procedures. Most of us are not experts in human behavior, so I believe we should be open to incorporating lessons from behavioral economics and other social sciences into programs to mitigate conduct risk and promote cultural change.

Behavioral economics blends psychology and economics to provide insight into why individuals may behave in a certain way and make decisions that may not be in their own economic best interest. For example, individuals often make choices that provide immediate recognition or satisfaction—higher status within a peer group, for example—often at the cost of a potentially better financial outcome in the long term.

This type of human behavior is at the core of the complexity of culture reform. Lessons from the field have increased understanding of where decision-making can depart from economic expectations. Sometimes, these lessons have been used to create circumstances and environments that positively influence individual outcomes by “nudging” individuals to better choices. These nudges, in turn, help reinforce acceptable behavioral norms, and ultimately a firm’s culture. How can we nudge in order to reduce misconduct risk? More broadly, how can the financial services sector, including firms and supervisors, leverage insights from the social sciences to promote environments that foster healthy group behavioral patterns with better decision-making?

Technology

The promise of new technology and big data for financial institutions is everywhere we look.
From artificial intelligence to machine learning to natural language processing, there seems to be unlimited potential for more efficient operations, better analytics and more accurate predictions, and more personalized product development. But, how will advances in technology, particularly the adoption of new technologies, such as artificial intelligence, influence the behavioral risks associated with human decision-making? And how does technology introduce new risks that prompt a rethinking of responsibility and customer relationships—especially with regard to privacy and information security?

Moreover, the disruptive potential of innovation is likely to exacerbate an already complex environment as decision-making becomes more opaque and new roles and responsibilities are introduced. For example, what will effective governance and risk management look like? Do artificial intelligence and machine learning introduce new model risk? Or operational risk? Or conduct risk? What does it mean to supervise or regulate conduct if decisions are made by self-learning algorithms? More broadly, what culture and conduct risk will be embedded in technology-driven financial services in the future? These are hard questions for financial firms and for the official sector, and our approach to the reform of financial industry culture will need to address them.

Conclusions

To return to the beginning of this discussion, culture reform in finance is a complex problem. Causal relationships are difficult to isolate, linkages are constantly changing, and accurate prediction is impossible. That does not mean that we are powerless, or that we should accept complexity as an excuse for not trying to foster change. Rather, we need a long-term commitment that brings the appropriate tools and approaches to bear. The costs and potential consequences of market failures associated with misconduct risk and culture suggests that it is vitally important that we do so.

Both financial firms and the official sector should focus attention on investigating and asking questions to better understand the underlying drivers, motivations and risks behind the behaviors of individuals and groups. We should ensure that we look at behaviors and outcomes from multiple perspectives, so we can gain a more robust understanding of the operating environment as a whole. No single perspective is likely to provide all of the insights. Experimentation and iteration, use of narrative and story-telling, and innovative methods for harnessing diversity of perspective are thought to be effective ways of tackling complex problems and we all need to innovate, adapt and seek new approaches.

I think this focus on conduct and culture is entirely consistent with a traditional supervisory focus on resilience, both for individual firms and the financial system as whole. This can be resilience of a firm’s balance sheet in response to financial risk or an unexpected loss that depletes a firm’s equity capital or resilience of a firm’s culture in response to conduct risk or an unexpected fraud that depletes its cultural capital. In all of these cases, a resilient firm will be better able to adapt and evolve in order to continue to function and provide the critical financial services necessary to support a growing and stable economy.

Thank you.

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1 I thank Stephanie Chaly, Robert Fitchette, Jim Hennessy, Jackie McCormack, and Tom Noone for helpful discussions and feedback on earlier drafts.


3 The Boston Consulting Group, Staying the Course in Banking, March 2, 2017.

4 William C. Dudley, Ending Too Big to Fail, November 7, 2013.
5 John C. Williams, *Now is the Time for Banking Culture Reform*, June 18, 2018.

6 *Reforming Culture and Behavior in the Financial Services Industry: Progress, Challenges, and the Next Generation of Leaders*.


8 John Sterman, “Learning from Evidence in a Complex World,” *Public Health Matters*, 96(3), 2006. For example, the overuse of antibiotics that spread resistant pathogens.


10 *Banking Standards Board*


13 See *Misconduct Risk, Culture, and Supervision* for more on the concept of “cultural capital.”