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Regulatory Alert

Financial Services Regulatory Insight Center

Misconduct Risk, Culture, and Supervision – FRBNY Whitepaper

Highlights

— Misconduct risk is gaining in importance for regulators and banking organizations as employee misconduct can threaten the stability of the financial markets and the economy in addition to the viability of a firm

— Supervisors consider the threat to the financial markets and the economy to be a "critical rationale for intervention"

— Cultural capital is an intangible asset that impacts an organization's production processes and requires ongoing investment

— Organizations likely underinvest in the risk management of cultural capital relative to what is socially optimal, creating a role for supervision

Synopsis

The Federal Reserve Bank of New York (FRBNY) recently presented its new white paper, "Misconduct Risk, Culture, and Supervision," to a "Culture Roundtable Session for Business Schools and the Financial Services Industry" acknowledging that misconduct within the financial services industry persists "despite regulations, supervisory focus, and firms' own efforts." Recent high-profile incidences related to reference rates, foreign exchange trading, and retail bank sales practices have highlighted the growing importance of this risk. For an organization, misconduct can divert management's attention, damage its reputation, drive changes in its workforce, and deplete its capital. Misconduct can also impact the financial markets and the economy by undermining consumer trust in financial institutions and the markets, adversely impacting their role in financial intermediation.

The authors suggest that although organizations build risk management frameworks to mitigate misconduct risk, for most organizations, their efforts will likely fall short of the investment needed to cover the potential external impacts. They characterize this as an underinvestment in cultural capital, an asset that impacts how an organization operates much like physical capital (equipment, buildings and property), human capital (the accumulated knowledge and skills of workers), and reputational capital (franchise value or brand recognition).

This investment gap creates a role for supervision (in contrast to regulation and organizational-level fines that alone may be insufficient to address misconduct, which, by its nature, is about circumventing rules.)

Supervisors across the globe are increasing their focus on misconduct risk, and looking to develop tools and practices to identify low levels of cultural capital. Their focus is directed toward decision-making practices and behavior as a core aspect of good governance, including issues identification, credible challenge, and early intervention. These efforts augment the ongoing efforts of individual organizations to identify behavioral patterns and trends, and enhance performance management through accountability, promotion, and compensation practices.

In the U.S., supervisors routinely evaluate the oversight responsibilities of directors, the stature and investment in control functions such as internal audit and compliance, and the response to internal and external incidences of misconduct.

The Federal Reserve Board has proposed guidance for board effectiveness and is expected to also release guidance for independent risk management and controls, including internal audit.

Organizations with a stronger culture may not only face lower misconduct risk but may also exhibit greater resilience overall, higher customer satisfaction, better employee morale and well-being, and enhanced productivity over time. The risk that organizations will underinvest in their cultural capital and potentially pose, individually and collectively, threats to the financial markets and economy will assure ongoing heightened supervisory oversight of misconduct risk, making conduct and culture a specific risk management challenge.

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