Approaching the crossroads of conduct and culture

Improving culture in the financial services industry

Financial services regulatory point of view

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Introduction

Nearly eight years after the financial crisis, instances of misconduct (i.e., professional misbehavior, ethical lapses, and compliance failures[1]) continue to be reported in the press with troubling frequency, many of which have resulted in widespread financial impacts to customers and the markets, and significant monetary and reputational costs to financial firms. Coverage includes activities across the spectrum of the financial services industry, striking an uncomfortable contrast with the intensity of effort the industry and the regulators have focused on reforming and remediating the weaknesses that were brought to light. Overall, this environment has further strained the public's failing trust in the integrity of the financial services industry as a whole, including the people it employs and the markets it supports. The critical question now is what must happen, or what must the public see, in order to trust that the industry is working to meet a threshold of care for their customers and the markets?

KPMG LLP believes that for financial services firms to regain the public trust, they will need to rebuild and enhance their relationships with customers, regulators, and shareholders to ones that are based on truth and fair dealing, uprightness, honesty, and sincerity. Further, the firms must behave according to sound moral and ethical principles that are nurtured and supported by a strong, positive culture, one that promotes and reinforces "doing the right thing" at every level of the organization—notably a respect for the letter and spirit of the law, and placing the interests of customers at the center of the business strategy. Such a culture would serve to strengthen a firm's reputation and the life of its brand, sustain the business into the future, and should prove to be the best defense against material misconduct and heightened regulatory interest. The regulators will likely take progressively harsher actions against firms and individuals should material misconduct fail to abate, and in an effort to accelerate correction or stem any potential for systemic risk, they may also move toward imposing explicit requirements to tie culture to prudential supervision and regulation.

Deborah Bailey
Managing Director
Risk Culture Lead
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"Everyone recognizes that something went wrong and needs to be fixed. The frustration that comes through is that despite huge focus and attention and expenditures and fines and consequent actions by the regulators, there's still a sense that the fixing hasn't finished yet and that it's not reaching down to the grass roots of some organizations."[2]

Elizabeth Corley, Chief Executive Officer of Allianz Global Investors, February 19, 2015

Culture as the root of misconduct

Following the financial crisis, lawmakers and regulators in the United States and abroad, passed rules requiring financial institutions to implement stronger governance structures, including the establishment of effective risk appetite frameworks. These efforts were supported by a presumption that the application of risk controls and compliance management systems should be applied across the enterprise and over product life cycles, and, as such, would resolve both financial stability and misconduct issues with a focus on the sustainability of business. For culture, this has not proved to be the answer. Breakdowns in conduct have continued to occur despite this heightened attention, clarifying for regulators that the solution to material misconduct cannot be achieved simply by requiring firms to develop new policies to coincide with prescribed procedures.

> *"...clearly regulators and firms still require rules to function effectively. But experience tells us red tape is more easily hurdled than principles. So as we move forward, firms will begin to see themselves held up against stricter ethical standards."*
>
> *Martin Wheatley, Chief Executive of the U.K. Financial Conduct Authority, March 4, 2014*

The regulatory focus has now turned to shortcomings in the prevailing culture of the financial services industry as the root cause for continued misconduct. More simply, they equate poor conduct with poor culture. The regulators suggest the scale and scope of the incidences of misconduct since the financial crisis have been too large to assume that merely a few "bad actors" are responsible; the actions must therefore stem from the prevailing attitudes and behaviors rewarded within the firms more widely.

Regulators hold Board members and senior management, as the leadership of their organizations, directly responsible for establishing and maintaining their firms' culture and now expect them to push their organizations toward cultural and ethical change. The regulators suggest that to restore public trust, it is imperative that each firm implement business strategies that place the interests of customers (retail, commercial, and wholesale) and the integrity of the markets ahead of profit maximization. That is, they must conduct business in the "right" way (i.e., right price, right allocation, right product, fair treatment followed by ongoing execution) – doing what they "should" rather than what they "can." Beyond this directive, limited regulatory guidance has been made available and firms are largely responsible for defining their own parameters of a "good culture."

> *"…regardless what supervisors want to do, a good culture cannot simply be mandated by regulation or imposed by supervision."[3]*
>
> *William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, October 20, 2014*

The risk of misconduct will remain a current and pressing concern as firms individually, and the industry more broadly, take steps to instill cultural changes that promote good actions and good conduct. As Martin Wheatley, Chief Executive of the U.K. Financial Conduct Authority has observed, "*The conundrum for leaders here is that it's clearly more problematic to manage so-called 'soft risks' – such as behaviors, choices, and values – than it is to set controls and ratios that are governed by mathematical models.*[4]" Firms

> *"…if those of you here today as stewards of these large financial institutions do not do your part in pushing forcefully for change across the industry, then bad behavior will undoubtedly persist. If that were to occur, the inevitable conclusion will be reached that your firms are too big and complex to manage effectively. In that case, financial stability concerns would dictate that your firms need to be dramatically downsized and simplified so they can be managed effectively. It is up to you to address this cultural and ethical challenge."[5]*
>
> *William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, October 20, 2014*

must show that the root causes of the behaviors precipitating the crisis are being taken seriously and will be fully addressed. Regulators will need to see what actions firms are taking to assess and improve their risk culture as well as the commitment of the Board and senior management to execute the necessary changes through to fruition. Regulators will also look closely at the degree to which line and middle managers, who are frequently responsible for implementing organizational changes and strategic initiatives, are committed to adopting and manifesting the required cultural change. Where the Board and management may fall short, the regulators will rely on available authorities to effect change and correct shortcomings identified through the supervisory process, including product interventions, restrictions on business lines, capital requirements, and public enforcement actions. In the near term, the scale of fines, though already quite significant, will likely remain elevated and could escalate.

The radical and possible implications of William Dudley's statements (see page 2) should not be underestimated.

Factors identified as contributing to failures of culture include:

Lack of clear corporate values and priorities

A **lack of clear corporate values and priorities,** such that employees may not know the firm's values and priorities, or the expected behaviors, or may witness employees being rewarded (or not penalized) for behaviors that are inconsistent with the stated values and priorities of the firm.

Governance gaps

Governance gaps, such as where micro-cultures operate within specific groups or business lines according to values and principles that are inconsistent with the stated values and priorities of the firm, or when multiple management layers block clear lines to senior management's values and expectations creating opportunities for misinterpretation or misinformation. Governance gaps can also be related to issues with information sharing, technology constraints, measuring the effectiveness of compliance, and independent testing and review.

Competing objectives

Competing objectives, such as a priority on short-term financial performance statistics rather than long-term franchise sustainability, or a focus on revenue goals without consideration of compliance costs.

Skilled employees – employee mobility

Increased competition for **skilled employees** combined with increased **employee mobility**, which can generate a focus on short-term benchmarking for performance and compensation and inhibit the development of firm loyalty and desire to protect the firm's brand.

Increasing complexity

Increasing complexity in the size and scope of financial services organizations, as well as in the types of product and service offerings.

Shifts in the business model

Shifts in the business model, such as an increasingly depersonalized approach to the business caused by moving away from a client-based orientation, which focuses on building long-term relationships, to a transaction-based orientation, which generally reduces customers to the role of a trading partner or counterparty, or the introduction of "cross-subsidy" models, where one product or service is supported by revenues generated from another product or service, which can promote adverse sales behavior or result in customer detriment.

Indicators of culture

Culture is the intangible that is reflected in the choices and behaviors, or conduct, of a firm's employees. It has been described as "the implicit norms that guide behavior in the absence of regulations or compliance rules—and sometimes despite those explicit restraints. [It] exists within every firm whether it is recognized or ignored, whether it is nurtured or neglected, and whether it is embraced or disavowed."[6]

The values, goals, and priorities chosen by a firm to define "business success" work together to create a firm's culture. A "good culture" is marked by specific values—integrity, trust, and respect for the law—carried out in the spirit of a fiduciary-type duty toward customers (that is, keeping the customer's best interest at the heart of the business model) and a social responsibility toward maintaining market integrity. It embodies the "ethic of reciprocity"[7] at all points of interaction between a firm and its customers and between the individuals that compose the firm, fostering an environment that is conducive to timely recognition, escalation, and control of emerging risks and risk-taking activities that are beyond a firm's risk appetite.

Indicators of a "good culture" include:[8]

- **Tone from the top** – The board and senior management set the core values and expectations for the firm and their behavior is consistent with those values and expectations
- **Accountability** – All employees know the core values and expectations as well as that consequences for failure to uphold them will be enforced
- **Effective Challenge** – At all levels, decision making considers a range of views, practices are tested, and open discussion is encouraged
- **Incentives** – Financial and nonfinancial compensation available to all levels of employees reward behaviors that support the core values and expectations.

A strong and positive culture can:

Reduce
The risk of misconduct.

Promote
Innovation and new product development designed to serve customers.

Diminish
The risk of regulatory scrutiny and the risk of related supervisory action and monetary fines, as well as diminish other potential costs, such as operating or capital charges.

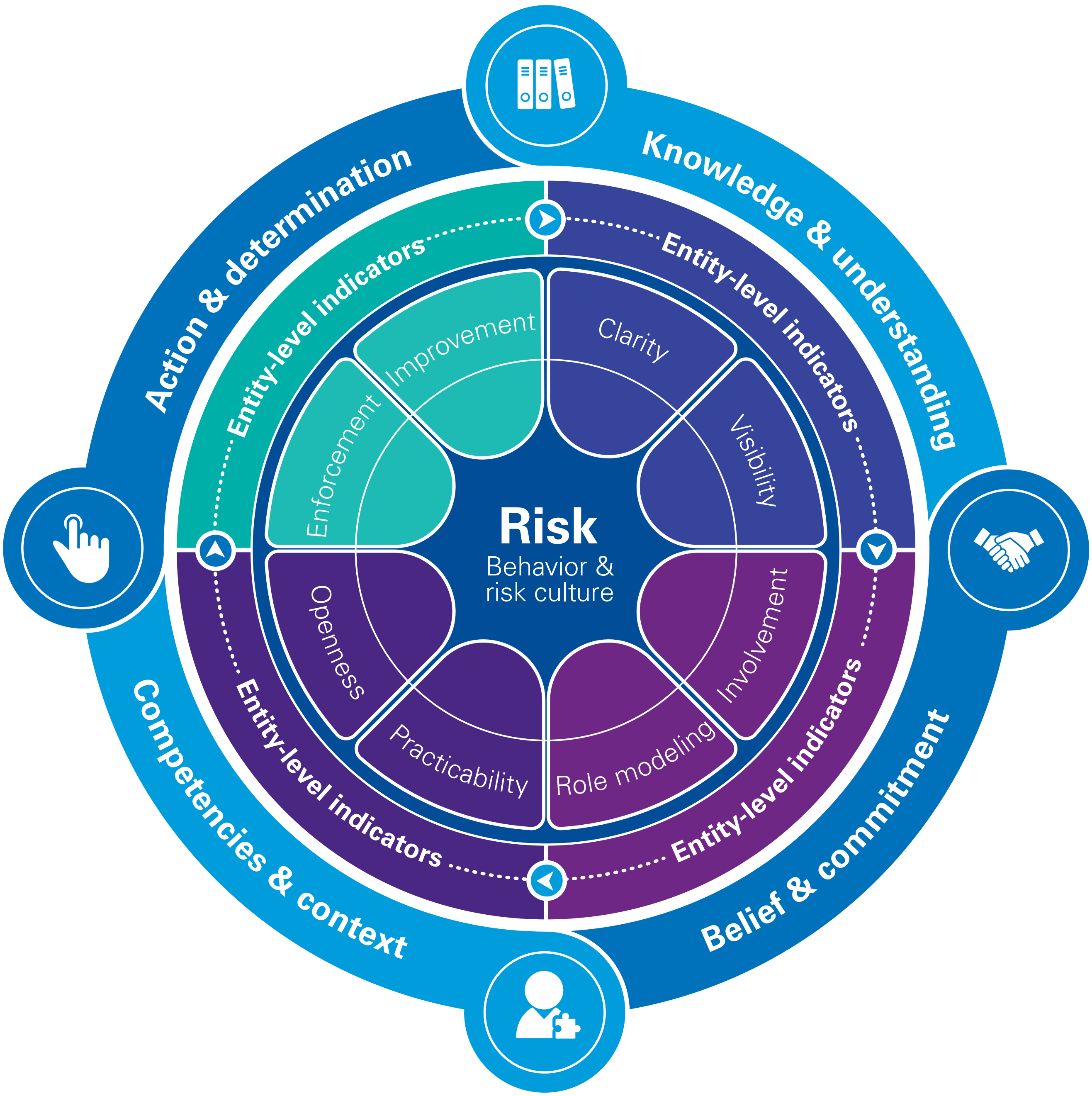
Attract and Retain
Highly qualified talent that similarly values a strong positive culture behavior, and reduce counterproductive behavior and employee turnover.

Strengthen
Asset quality.

Protect
The life of the brand.

Enhance
A firm's reputation with:
– Customers/clients (who perceive the firm to be looking out for their interests)
– Employees and management (who have an alliance with a positive corporate citizen)
– Shareholders
– Regulators (who perceive the firm to be less risky, i.e., more "safe and sound").

A framework
for influencing risk culture



Influencing culture: KPMG's framework

It is possible for an organization to evaluate its culture as well as to measure the system of values and behaviors throughout the organization that shape risk decisions. KPMG has developed a conceptual framework to aid in this assessment.

The framework is broadly organized around the following four categories that capture key aspects of influencing behavior changes:

- **Knowledge and Understanding** – Employees need to understand what is expected of them and how their actions impact the organization
- **Belief and Commitment** – Employees must believe in the value added by risk management, and must be committed to the firm's risk appetite and risk management approach
- **Competencies and Context** – Employees have the skills necessary to complete what is asked of them, and feel comfortable to ask questions or pose challenge
- **Action and Determination** – An organization must have the determination to consistently and persistently apply the risk strategy and to make use of mistakes and failures to identify areas for enhancement or improvement.

Ensuring that people within an organization behave with integrity and in accord with the values and goals of the firm depends upon the balance between the firm's stated rules and expectations, referred to as the entity-level instruments, and other factors that frame and condition an individual's expectations of proper behavior, the cultural drivers. The entity-level instruments and cultural drivers work together, and both elements are needed to control the risk culture. Where the stated rules and expectations are inconsistent with the behaviors that are rewarded, the prevailing culture will not reflect the stated values or the desired culture.

Entity-level instruments guide an individual's behavior toward the firm's stated values and goals. They are based on the key risks derived from the firm's business strategy and include, among other things: laws and regulations; policies, procedures, and controls; governance structures and reporting lines; defined roles and responsibilities; codes of conduct and ethics; skills requirements and training programs; and compensation and reward structures.

Cultural drivers are abstract but discernable factors that can influence an individual's behaviors. Cultural drivers include:

- **Clarity** – Employees at all levels need to understand what is expected of them and how their behavior contributes to the overall performance of the organization. The entity-level instruments must be clearly written, accurate, concrete, and complete, giving clarity to acceptable and unacceptable behavior.
- **Visibility** – Employee behavior is transparent within the organization and employees understand how their behavior can impact others. Recognition is given to those that uphold the firm's values.
- **Involvement** – All employees know the values and expectations of the firm and feel accountable for upholding them and for promoting the goals and strategies of the organization. Employees feel trusted and involved, and believe that their views will be heard.
- **Role modeling** – The Board of Directors and senior management set the core values and expectations for the firm and, along with all levels of management, live the values and lead by example.
- **Practicability** – The goals and targets set for the organization, business lines, teams, and individuals correspond to the risk appetite of the firm and its overall risk strategy. In addition, they are practical to apply, realistic, and achievable. Employees are enabled to do what is requested of them.
- **Openness** – People at all levels must feel comfortable to discuss issues and dilemmas that arise in an atmosphere that is accepting of challenge and assures mutual respect.
- **Enforcement** – The system of rewards and punishments must be clear, explicit, directly related to the values and goals of the firm, and consistently enforced. When the rewards and punishments are inconsistent with the values and goals, employee behaviors will shift toward the behaviors that are rewarded.
- **Improvement** – Incidences of mis-behavior and "near misses" are evaluated to determine potential risks, and employees feel that they learn from their mistakes and can share ideas for improvement.

The entity-level instruments and cultural drivers work together to influence the choices and behaviors that individuals make within an organization, and adjustments to some or all of them may be warranted to facilitate the balance needed to bring about a desired culture.

Improving culture: What to do

There are three steps management needs to take to strengthen risk culture: assess, analyze, and improve.

Assess

Board members and senior management, with the assistance of line and middle management, must initially assess the current culture within their organization. To gain a full understanding, they should:

- Determine if values, goals, and expectations have been established for the firm and whether they were developed by the Board and senior management.
- Evaluate whether the values, goals, and expectations have been conveyed throughout the organization, giving consideration to whether they are:
  - Coordinated
  - Communicated to all employees and available in writing
  - Reinforced through public statements and actions of Board members and senior management that show support for these values and their importance to the franchise value of the firm
  - Reinforced through the statements and actions of middle management in a manner that is consistent with the statements and actions of the Board and senior management.
- Review the entity level instruments and the cultural drivers for consistency with the established values, goals, and expectations.
- Assess whether employees understand the stated values, goals, and expectations, as well as their perception of whether the values, goals, and expectations are supported by the culture of the organization. Such assessments can be based on a variety of sources, including personal interviews, information gathering workshops, "town hall" meetings, hotline reporting, and independent perception surveys.
- Solicit the perceptions of key customers regarding whether, in their experience, the values, goals, and expectations of the organization are supported by the culture. Such information might be obtained through personal interviews, information-gathering workshops, and independent perception surveys.
- Review additional sources of feedback, including consumer complaints and social media Web sites.

Analyze

Based upon the information gathered, senior management can begin to qualitatively analyze the firm's current culture, employing additional workshops and interviews to ascertain a deeper understanding of the relationship between the different elements of the framework (the entity-level instruments and the cultural drivers). Consideration should be given to whether certain of the entity-level instruments or cultural drivers could be strengthened to better promote behaviors that support the desired culture, and plans to address any identified gaps should be developed.

Importantly, the analysis should also consider whether the stated values, goals, and expectations should be strengthened to better articulate and promote a strong, positive culture.

The analysis should take stock of certain types of attributes that generally support a positive culture, including, among others:

- Modeling of desired behaviors visible at the Board, senior and middle management levels
- Complying with the letter and spirit of the law
- Serving the needs and the best interests of the customer (e.g., as reflected in product design and customer targeting or how customer interactions are captured, observed, and managed)
- Emphasizing "how" revenue is generated rather than "how much" revenue is generated
- Self-policing, self-identification and correction, and self-reporting of misconduct

- Rewarding behaviors that align with the values, goals, and expectations, and imposing penalties for conduct failures (employees should be aware of the penalties for misconduct)
- Ensuring individuals at all levels (Board, senior and middle management, and staff) have the necessary knowledge and skills to perform the duties of their role
- Assessing the quality, effectiveness, and execution of the compliance program across the company
- Escalating risks in a timely manner
- Responding to customer complaints
- Accepting challenge at all levels
- Tying incentives to the long-term enterprise value of the firm rather than its short-term performance or share price.

Improve

With a clearer picture of the culture that functionally exists within the organization, the Board and senior management can begin to develop a plan to actively establish a set of values, goals and expectations that sustain a strong, positive culture and encourage consistent employee behavior. It is critical to anticipate the process will be lengthy and iterative, requiring continuous management, measurement, and reinforcement.

The plan must hinge on the leadership of the Board and senior management, who will establish (or confirm) the firm's values, goals, and expectations, and, in turn, must demonstrate through their personal actions and decisions the importance the organization places on those attributes. Similarly, senior management should be visible proponents of the plan, conducting "town hall" meetings, personally encouraging feedback, and establishing direct communication lines with middle management to support their role in further nurturing the firm's values, goals and expectations to all levels of the organization. Senior management should also maintain an ongoing dialogue with customers, investors, regulators, and other stakeholders to evaluate external perceptions of the firm's culture and the potential need for adjustments.

To be sustainable, the firm's values, goals, and expectations must be reflected in all facets of the organization, including its corporate strategies, risk governance frameworks, business models, affiliations and alliances, product and service offerings, recruitment and retention, and workplace environment. To manage the breadth and depth of this application, it is advisable to consider:

- Developing measures and metrics to assess the effectiveness of efforts to communicate the firm's stated culture (values, goals, expectations) and employees' adherence to those standards (e.g., frequency of problems, magnitude of problems)
- Developing attributes to measure the firm's effectiveness at meeting its goals with regard to fiduciary duty and market integrity, including ongoing surveys of customer experience, assessments of consumer complaints and social media as well as monitoring for emerging industry risks
- Promoting escalation channels to encourage effective challenge, employee participation, and commitment to maintaining the desired culture
- Proactively assessing potential risks to the firm/brand based on identified issues within the firm as well as issues identified within the industry.

A strong compliance culture drives compliance accountability.

The current heightened regulatory landscape, marked by a multitude of regulatory changes, significant fines and penalties, and growing concerns over reputation risk, demands enhancements to the current compliance management program and presents a case for change, a compliance transformation, that is built on an expectation of expanded accountability for compliance and the integration of compliance into all facets of the business model.

Firms that are making progress in this area are asking tough questions and working toward having credible responses for their organizations as well as their regulators.

01 How does our culture impact the level of trust we elicit from our stakeholders?

02 To what extent are our desirable values practiced throughout the organization?

03 What are the capabilities, values, and principles that define our desired culture?

04 How do we encourage the adoption of our desired culture across multiple businesses and markets?

05 How do we monitor, assess, and report on our culture for audit and regulatory purposes?

06 How has our culture enabled or dissuaded misconduct and how do we improve?

07 Why has our culture-change program stalled?

08 What is the relationship between our corporate culture and our customer experience?

09 How can we leverage or improve our culture to respond to an immediate crisis or event?

10 What will the right culture be in the future and how can we start incorporating those values today?

11 Do we monitor people risks in the same way and in the same forums as operational, market, or credit risk?

Compensation and Culture

A number of regulators have suggested that compensation structures can be used to enhance culture and promote financial stability by tying a portion of an individual's compensation to the long-term performance of the firm. As acknowledged by Federal Reserve Board Governor Daniel Tarullo, compensation frameworks can be important. *"Assuming that they are able to discern factors that generally explain patterns of hiring, raises, promotions, demotions, and dismissals, employees receive very strong signals as to what those running the organization actually value. This set of signals has, I suspect, considerably more influence on employee behavior than a corporate statement of values or purposes, particularly if the system of rewards and punishments appears at odds with that statement."*[9]

Compensation and incentives frameworks, including clawback and forfeiture provisions, could be designed to take into account conduct, credit, and market risks, as well as customer outcomes, thus aligning the interests of the individual with the values, goals, and expectations of the firm. Regulators are also looking to the relationship between incentives structures and individual accountability, and are increasingly initiating actions against individuals personally to account for their misconduct in addition to taking actions against their employers. Such actions can include monetary fines, sanctions, and industry bars.

Effectively measuring the influence that compensation structures may have on culture will only be possible if, after establishing the values, goals, and expectations, benchmark metrics related to performance measures or initiatives can be derived, which, if achieved, could be shown to correlate with meeting the culture standards. The measurement and assessment would also serve to inform management where additional training and communication is needed.

Footnotes:

[1] Examples of misconduct as characterized by William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, October 20, 2014, *Enhancing Financial Stability by Improving Culture in the Financial Services Industry*. Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry.

[2] Elizabeth Corley, Chief Executive Officer of Allianz Global Investors, and chair of the independent Market Practitioners Panel of the Fair and Effective Markets Review, as quoted in a February 19, 2015 article by Jenny Anderson for the *New York Times*.

[3] William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, October 20, 2014, *Enhancing Financial Stability by Improving Culture in the Financial Services Industry*, Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry.

[4] Martin Wheatley, Chief Executive of the Financial Conduct Authority, May 28, 2015, in a speech entitled *Debating Trust and Confidence in Banking*, given at the ResPublica Vocational Banking event.

[5] William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, October 20, 2014, *Enhancing Financial Stability by Improving Culture in the Financial Services Industry*, Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry.

[6] William C. Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, October 20, 2014, *Enhancing Financial Stability by Improving Culture in the Financial Services Industry,* Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry.

[7] The "ethic of reciprocity" is also referred to as the "Golden Rule" and is a concept that describes a "reciprocal," "two-way," relationship between one's self and others that involves both sides equally, and in a mutual fashion. Essentially, it states that people should treat others in a manner in which they themselves would like to be treated. The concept can be explained from the perspective of psychology, philosophy, sociology, and religion, and has been reflected in writings worldwide going back nearly 4,000 years.

[8] Consistent with Financial Stability Board, *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture:* A Framework for Assessing Risk Culture, April 7, 2014. http://www.financialstabilityboard.org/wp-content/uploads/140407.pdf

[9] Daniel Tarullo, Federal Reserve Board Governor, October 20, 2014.

Conclusion

KPMG has observed that industry participants are quite familiar with the "whys" of heightened regulatory attention on culture but are less familiar with the "hows" of going about an evaluation of the culture within their own organizations. The task of managing risks related to the behaviors, choices, and values of individuals is clearly more problematic than managing to numerical thresholds or other quantifiable metrics. Risk management, however, is fundamental and familiar to the business of financial services and it lies at the heart of the regulatory focus on culture.

Boards of Directors and senior management must gain an understanding of the culture that exists within their organizations and, to the extent they determine there is need for improvement, begin to develop a plan for making improvements. The broad concepts of tone from the top, accountability, effective challenge, and compensation/incentives are critical to this effort and should be reviewed closely by the Board and senior management as they are indicators of "good culture" and will guide regulatory reviews. Additionally, consideration should be given to the "tone at the middle," the access of the legal and compliance departments to the Board, and the opinions of customers, all of which can impact the effectiveness of cultural improvements. Firms should be prepared to document and explain their efforts, anticipating that regulators will want to understand the "what" and "why" of their efforts. KPMG's conceptual framework approach offers clients a way to begin the process of assessing, analyzing, and improving an organization's cultural environment.

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