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DO BANKS HAVE A CULTURE PROBLEM?

by **NAOMI SNYDER**

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IT BEGAN SEVEN YEARS AGO

with the financial crisis, which was chiefly blamed on large global banks. Next, a group of global banks were accused of rigging the London Interbank Offered Rate (LIBOR)—a crucial interest rate that impacts trillions of dollars in financial transactions—followed by the revelation that other banks had fixed foreign exchange markets.

Not only are big banks getting a nonstop black eye in the press, but regulators are questioning the onslaught of bad actors in the industry, and coming to grips with the fact that regulations alone do not make a safer, sounder banking system. Now, the question coming from regulators is increasingly this: Is there something wrong with the culture of banks?

This is mostly a question for the biggest global banks, which sell complex financial products and have to manage hundreds of thousands of employees in multiple countries, but it's also a question that is coming up for smaller and regional banks as well, particularly if they have been the subject of enforcement actions. While regulators give speeches about the role of corporate culture in the safety and soundness of the banking industry, the biggest banks, including JPMorgan Chase & Co., Barclays and Goldman Sachs, have published lengthy reports telling the world how they are working to instill their principles and values across their organizations.

It's one thing to tout your values, and another all together for your employees to actually practice them. So how do you know what your culture is, particularly as an independent member of a bank's board?

Banks are hiring consultants to do culture studies of their institutions, and sending the results to the board. They are incorporating concerns about risk management into hiring decisions and performance reviews and offering case studies to guide employees through ethical decision-making. Board members increasingly are expected to oversee their bank's risk management, and often that comes with questions about the institution's overall corporate culture and values. Your employees' attitudes toward risk and compliance with regulations are just one aspect of the company's overall corporate culture.

But what is culture?

Most descriptions sound similar: It's the sum of the behaviors of people in your organization over time. If your organization promotes ethical decision-making but the employees are all robbing the bank, then clearly there is something wrong with your culture. Most of the time, culture in a midsized or large institution can be hard to see even for members of senior management, let alone the independent members of the board. The "tone at the top" may be important for senior management to set, but if middle managers aren't buying it and are pursuing their own varied agendas, then employees down the line will be impacted by that. Every employee is battling competing demands to meet deadlines, reach internal goals and please their managers. The corporate policy statement is sometimes the last thing on anyone's mind.

There is little argument that regulators are increasingly focused on questions of bank culture. William Dudley, president of the Federal Reserve Bank of New York, used the word more than 40 times in a speech in October 2014. Thomas Curry, the Comptroller of the Currency, stressed in a speech last November that "laws and regulations only take us so far," and that supervision and the "health of an organization's culture" play a critical role in the safety and soundness of an institution. "We are asking [banks] to be a lot more specific in articulating their values," says Molly Scherf, an OCC deputy comptroller for large banks, in an interview. The LIBOR manipulations and other revelations are leading the OCC and other regulators to ask these questions. "I would not say we're automatically jumping to the conclusion that these banks have a bad culture as much as it is a point we want to clarify."

The focus on corporate culture, which follows the enactment of a host of new regulations and laws following the financial crisis, is global in scale. In an early sign of international thinking that may eventually translate into U.S. policy, the Basel Committee on Banking Supervision in July 2015 called on banking regulators everywhere to

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strengthen their ability to assess the effectiveness of a bank's risk governance and "risk culture," in guidance called "Corporate Governance Principles for Banks." Ernst & Young noted that the guidance used the word "culture" 10 times more often than in the previous guidance on the topic in the year 2010.

"For the last two years, we've got increasing requests from our clients, regulators came by yesterday and said, 'your models are fine, your governance is fine, but what do you think about risk culture?'" says Duncan Martin, senior partner at The Boston Consulting Group in charge of financial institutions in North America.

Interestingly, the Basel Committee also called on regulators to engage more with boards, particularly risk and audit committees. In general, the Basel Committee and U.S. regulators are increasing expectations for board involvement and oversight of risk practices, and for making sure the organization's ethics and values are understood and practiced by employees. "It's clear, culture really is a board issue," says Mark Watson, executive director in Ernst & Young's financial services advisory practice. This primarily impacts the largest and most complex banking organizations, but some say they see the impact trickling down to commercial banks that have no investment bank or trading floor.

Cliff Stanford, an attorney in charge of the banking group at Alston & Bird, says he sees questions of culture come up for banks he works with, typically in the $10 billion to $50 billion asset range, usually as part of a conversation about a bad result on an exam, such as a matter requiring attention. If the problem isn't solved soon enough, regulators may ask if there is something wrong with the bank's culture. "If there is an open, transparent sensibility about issues and concerns, regulators can see that," Stanford says. "They can see if there is just a bunch of words on paper, but if they really dig, there are problems in particular business lines, reports on allocations of resources. Just by talking to people, they can get a sense of what's going on."

There is a concern among bankers that the regulatory focus on culture will result in a one-size-fits-all regulated vision of the proper corporate culture. But Scherf says regulators "shouldn't be telling a bank what [the] culture should be. However, we can call out where the culture has been defined and articulated and we see people operating outside of it."

Even banks below $10 billion are starting to hear phrases like "tone at the top" showing up on exams, even though few of them think of themselves as being responsible for the financial crisis. In fact, many community and regional banks pride themselves on their conservative cultures and the way they treat their clients. But they are more vulnerable than large banks because just one bad actor can bring the bank to its knees.

To get a sense of what's going on at the bank, a board member of a small institution can walk through the branches and have a few conversations with people over coffee. It's nearly impossible to do that at a big global bank with hundreds of thousands of employees in multiple countries, and where visits to the trading floor, or any other part of the bank, are usually carefully orchestrated affairs. Board members need to make a real effort to understand what's going on at large institutions. One way that banks are doing that is by hiring consultants to do cultural studies of their institutions. A cheaper way might be to rely on existing annual surveys of employees but add a few additional questions that help management and the board get clues as to problems inside different departments at the bank. For instance, employees can be asked: Do you feel comfortable bringing up problems that you see with your supervisor? Do you feel as if your colleagues are upholding the company's values (or risk appetite statement)? Are people being promoted who represent the highest ethical standards that we seek to achieve? Metrics for the board to watch might include employee surveys, turnover in individual departments and other human resource problems, says Watson. Other metrics include complaints, overdue audit findings that haven't been solved in

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the proper time period and compliance failures.

Susan Ochs, a senior fellow at the New America Foundation, is developing an assessment tool that will allow banks to evaluate their individual cultures as well as benchmark their performance against peers and track performance over time. As part of a previous study of banking industry culture, "Inside the Banker's Brain," she says she found a problem with people not feeling comfortable enough to speak out when they saw problems. "It starts to distort behavior," she says. "[Employees] feel it's better to stay quiet rather than speak up and be wrong about what they see." She found five dominant mental models in the financial industry: a bias toward complexity, a desire for financial success and recognition of intelligence, a high level of self interest and a short-term outlook, where people are expected to maximize revenue in every transaction and reap the fruits of their labor quickly.

She thinks it's not only big banks that have problems. She points out that it was common a few years ago to reorder overdrafts so the largest item hit the account first, which created a public perception problem for banks and a subsequent regulatory crackdown on overdraft policies. "The $35 [overdraft fee] eight times per day became the industry norm," she says. "I think culture is a concern for every institution."

As a result, many banks have begun to address reputation problems and focus on how they treat their customers. Banks have developed risk appetite statements, and the largest banks have "qualitative statements," which include values statements such as: We won't sell products we don't fully understand. Those statements are brought into meetings whenever a decision is made about entering a new geography or introducing a new product, says Scherf.

JPMorgan issued a more than 100-page report last December following a series of scandals, including the London whale trading debacle. The report highlighted efforts the company was making to re-articulate and re-emphasize its cultural values and corporate standards "with the aim of ensuring that employees internalize these standards and live by them every day." As JPMorgan CEO Jamie Dimon says in the report, it's not enough to have well-articulated standards. "They must be embedded in the values of each and every employee through continued training and reinforcement, and must guide and be evident in our actions."

At JPMorgan, changes include paying operating committee-level executives over a multi-year horizon, while making sure performance evaluations include a review of the "risk and control focus" of the executive. Anyone identified as a "material risk taker" for the organization, as well as operating committee members, get deferred stock awards subject to forfeiture years down the road if performance thresholds aren't met. Such efforts are trickling down to smaller banks as well.

Zions Bancorp., a $58 billion asset institution based in Salt Lake City, Utah, has been making changes for years to its compensation plans. More than 10 years ago, executives could earn as much as 400 percent of their target bonus if they exceeded performance metrics, but that has gone down to a maximum of about 120 percent of target, partly because regulators no longer accept such a high upside award. The 2014 stock awards for the CEO and CFO vest on a four-year schedule, but only if the company meets certain targets related to regulatory issues and stress testing. Zions failed its stress tests in 2014 but passed this year after deciding to sell a portfolio of collateralized debt obligation securities, among other changes. Also, the compensation committee introduced risk management effectiveness scores to help determine annual cash incentives for top executives. The company's claw back policy states that any employee's bonus can be reclaimed, not just because it was based on inaccurate financial statements, but for "wrong doing" that impacts the bank, including reputational harm.

Banks above $50 billion in assets have spent a tremendous amount of time and energy on governance oversight and redesigning incentive plans, says Scott Law, a Zions executive vice president and director of compensation. "It's really changed. There is far more emphasis on how the plans

... BUT REGULATORS ARE QUESTIONING THE ONSLAUGHT OF BAD ACTORS IN THE INDUSTRY.

achieve risk balance." He thinks a lot of the changes were necessary because the banking industry previously awarded incentives to employees with almost no downside if they put the long-term viability of the company at risk. On the other hand, the sheer size of regulatory reports can be overwhelming. He recently submitted a report to regulators detailing incentive plans that was 1,300 pages long.

Even smaller banks are spending more time on risk management, and making sure their risk policies pervade their organizations. David Bilko, the chief risk officer for Union Bankshares Corp., a $7.5 billion asset institution in Richmond, Virginia, got approval this year from the board for a finalized risk appetite statement. He plans to use it as a tool in employee training programs so that everyone understands their responsibility for risk management. "The people in your organization have to understand that everyone owns risk management. It's not owned only by the chief risk officer," he says.

Regulators are increasingly emphasizing the point that a bank's business line personnel must take ownership of their own risks as the "first line of defense." Risk managers and auditors are the second and third lines of defense. Performance evaluations for business managers have begun to include scoring relating to compliance with regulations and risk management. For example, if a manager is unable to fix a problem found in an audit, that could mean not getting a bonus that year or a promotion. Compliance officers increasingly provide input into an individual's performance evaluation. Human resource officers are considering a candidate's compliance background and whether that person will fit into the bank's culture, rather than just evaluating his or her technical skills. Also, banks are beginning to offer case studies in training programs and walking through scenarios of potential conflicts. How should you respond when a customer wants you to do something that's a grey area ethically, and it is your company's policy to please the customer first? "Do your employees know how to navigate those two points?" Ochs says. "You make assumptions that people will know what to do."

Ultimately, whether or not the bank's values are reflected in actual behavior is hard to see or manage. Of course, independent board members will have an even tougher time than management understanding what's really going on in their institutions. Scherf, the OCC deputy comptroller, says independent directors are interested in learning about their bank's culture and often ask her or her staff if they are finding situations or actions that don't seem to align with the bank's risk appetite. "Our examiners have regular meetings with the CEO and independent board members, and the topic of culture is often a subject," she says. She also encourages board members to communicate periodically with people two or three levels below the CEO to encourage candid discussions about culture and risk management. Martin agrees. "If I was a board member, I would speak with the heads of risk and compliance one by one, off premises, where no one knows where you are," to facilitate off-the-record conversations.

Susanna Tisa, chief business officer at Treliant Risk Advisors, says that corporate culture was once thought of as something that didn't change and was uncontrollable. "Now, people are realizing that culture is something that can be changed, but it takes a long time, and it takes a lot of effort," she says.

Stanford estimates that it probably would take five years, not a few months, to really focus on and change a bank's culture. It's too early in the process for the biggest banks to have decided on any winning strategies for developing a great corporate culture. Many of these institutions are just now exploring how they would monitor their cultures, what metrics make sense and what practices seem to drive the best results. The biggest banks in the country are acknowledging that they have problems. Community banks may be in safer territory, but they need to pay close attention to their culture as well. **|BD|**

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