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Culture in financial services
One year on

CENTRE *for* REGULATORY STRATEGY EMEA

And progress has been made in recent years to improve governance, conduct and culture. Still, I will argue that the journey is far from complete [...] Decisions are always embedded in and guided by culture.

Andrea Enria
Chair, European Central Bank Supervisory Board

Why we are issuing this update

A year ago, we issued a paper entitled Culture in Financial Services. Its purpose was to set out senior regulators' key messages on culture and to explain how, in practice, supervisors go about the complex task of assessing a firm's culture, particularly the key positive and negative indicators on which they focus.

Since then, there has been no let-up in the regulatory focus on culture. Indeed, it has spread across jurisdictions and been accompanied, increasingly, by the introduction of formal regulatory accountability regimes which seek, inter alia, to drive improved firm cultures. Regulators have continued to emphasise the importance to firm culture of leadership (e.g. the tone from the top), governance and remuneration. However, they are now also placing increasing emphasis on overall business purpose, the 'tone from above', diversity, and 'psychological safety' (that is, whether a culture is one in which people feel able to speak up).

Given this continuing rapid evolution in supervisory thinking and approaches towards culture, we are issuing the following short update to our previous paper to:

- summarise the latest messages on culture from regulators across the globe;
- set out developments in the supervision of culture including in the context of the global trend towards increased individual regulatory accountability; and
- highlight new and emerging areas of supervisory focus.

Latest regulatory messages on culture

Headlines in the financial news illustrate the lack of progress...stories of money laundering and fraud have been an all-too-frequent feature. Culture is at the heart of many of these [misconduct] issues, and addressing the root causes of misconduct must remain a high priority for the industry and regulators.
John C Williams, President and CEO of the Federal Reserve Bank of New York

Regulators acknowledge that, starting at board level, many firms have invested significant effort, over the course of the past few years, in responding to the emphasis on improving their culture. In spite of this, the perception amongst regulators generally seems to be that progress to transform the culture of the financial services industry has been slow and inconsistent. As such, culture remains a regulatory and supervisory priority globally. In Australia, for example, the Australian Prudential Regulation Authority (APRA) has said that it will *'increase supervisory intensity for governance, accountability and culture for all regulated institutions'*[1]; whilst in the UK culture and governance is, for the fourth year running, a key priority of the FCA's business plan.

Recognising the continuing imperative for cultural change, regulators are focused on ensuring meaningful consequences for individuals, particularly at the board and senior manager level, when things go wrong. They are increasingly incorporating individual accountability for poor culture or breaches of conduct within the scope of their senior managers' regimes. Notably, in the UK, where the Senior Managers and Certification Regime (SMCR) has been in operation since 2016, the number of open enforcement investigations related to culture and governance has risen from 15 in April 2017 to 70 as at the end of March 2019[2]. The FCA has also recently indicated that it considers culture as part of its assessment of the 'reasonable steps' taken by senior managers to prevent misconduct.

The concept of reasonable steps is part of the Duty of Responsibility [...] our expectation of senior managers is that they should be doing what they reasonably can to prevent misconduct. Appropriate controls and processes are an important part of this but we also look to senior managers to think more broadly and to create an environment where the risk of misconduct is minimised, for example through nurturing healthy cultures.
FCA, Senior Managers and Certification Regime Banking Stocktake Report

References

1 APRA, Information Paper – Self-assessments of governance, accountability and culture, 2019

2 FCA, Enforcement annual performance reports, 2017/18 and 2018/19

Latest regulatory messages on culture

As they highlight their continued commitment to improving culture, regulators will become increasingly alert to the potential for *'culture fatigue'*; that is, the perception, amongst some firms at least, that this area has been subject to too many regulatory and management initiatives, creating a risk of employee apathy and disengagement. Particularly in jurisdictions where there has been a longstanding focus on conduct and culture, the G30 has *'detected some desire* [amongst industry leaders] *to move on and get on with business'*[3]. The risk of fatigue is further reflected in the findings of the most recent Banking Standards Board (BSB) survey which concluded that, despite continuing investment of time and resource by firms in managing their cultures, the gains of previous years have not been extended and that firms may now find themselves in the *'hard yards'* of achieving progress in improving their culture[4].

Recognising this risk, regulators have spoken of the need to ensure that culture change is not treated as a one off event, but rather as a continuous effort that is constantly reinforced. For example, John C Williams observes that culture *'is a long-term project, a constantly evolving one, which is never done'*[5]. However, whilst firms continue to work at ensuring that the management of culture is properly embedded into their business, they are also facing widening regulatory expectations as to what constitutes good outcomes for consumers. Increasingly, regulators are articulating a desire to encourage cultures where decisions are driven by what is right and fair for all consumers. This includes consideration of the needs of customers who are, or may be, vulnerable, as well as whether products and services are, by both design and operation, delivering value for money for all customers.

We want to see doing the right thing for vulnerable customers deeply embedded in the culture of firms.
FCA's draft guidance for firms on the fair treatment of vulnerable customers

References

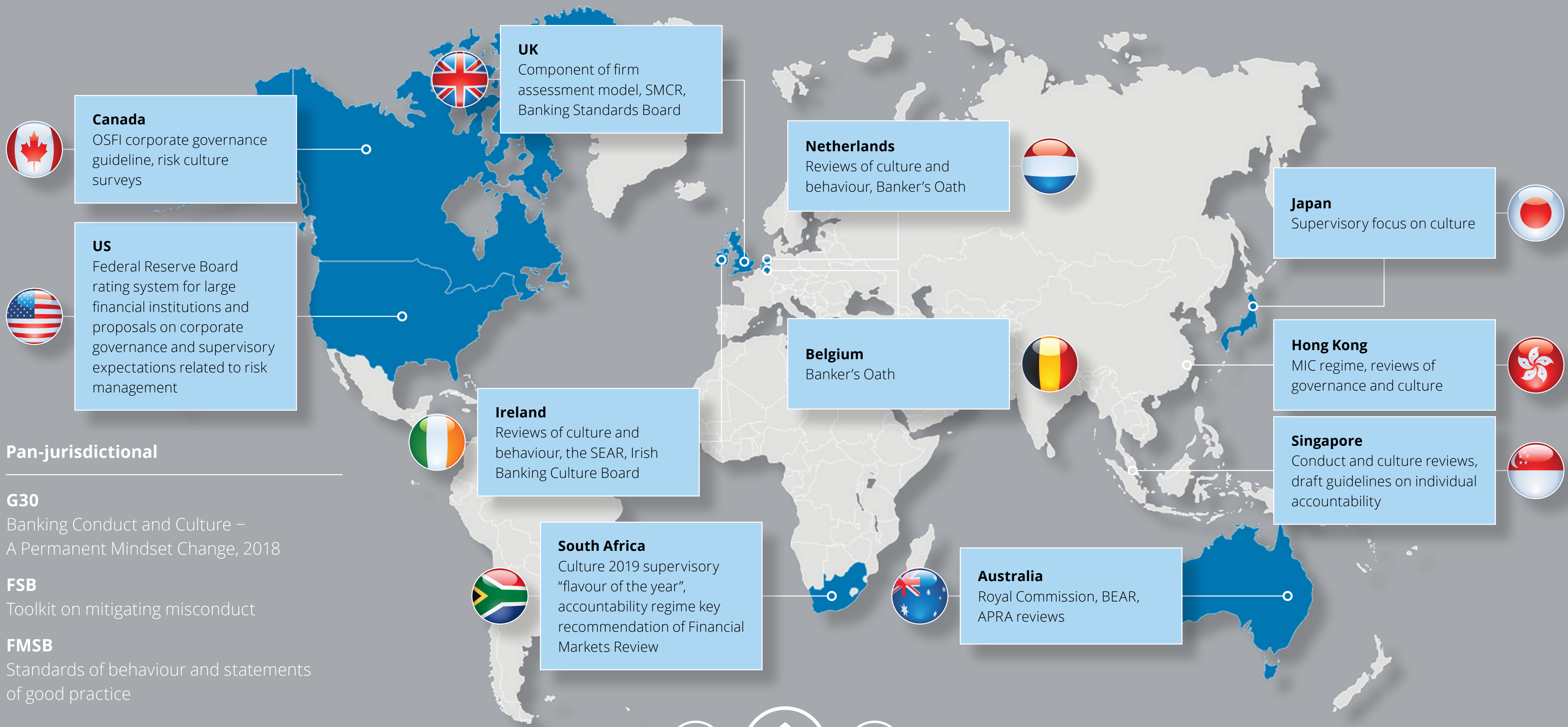
[3] G30, Banking Conduct and Culture – A Permanent Mindset Change, 2018

[4] Banking Standards Board, Annual Review 2018/19

[5] John C Williams, Banking Culture – The Path Ahead, 2019

Section B

Global developments on culture and accountability



Pan-jurisdictional

G30
Banking Conduct and Culture – A Permanent Mindset Change, 2018

FSB
Toolkit on mitigating misconduct

FMSB
Standards of behaviour and statements of good practice

Global developments on culture and accountability

Whilst culture has been a longstanding priority in jurisdictions such as Netherlands and the UK, supervisors in other jurisdictions are intensifying their focus on culture, both through targeted assessments and 'business as usual' supervision.

Some recent examples include:

- In **South Africa**, culture is what the Prudential Authority (PA) has characterised as its supervisory 'flavour of the year' for 2019. As part of this initiative, it is requiring banks to present on how the ethics of their organisation are governed in such a way as to support the establishment of an ethical culture[6].
- In **Hong Kong**, the Hong Kong Monetary Authority (HKMA) is requiring firms to conduct a self-assessment of measures to foster a sound culture; this follows its circular which focused on governance, incentive schemes and assessment and feedback mechanisms. The HKMA will be carrying out site visits to assess and benchmark firms' cultural practices and management and will be meeting boards and senior management to gather insights and lessons learned[7].
- In **Singapore**, the Monetary Authority (MAS) has conducted a stock-take of culture and conduct practices across selected financial institutions including one-on-one conversations with staff at all levels. The objective has been to enable supervisors to gain insights into staff's perceptions of culture and their level of risk awareness[8].
- In **Australia**, where a succession of misconduct issues has resulted in the appointment of a Royal Commission inquiry into the financial sector, APRA asked the boards of large regulated entities to conduct a self-assessment of their governance, accountability and culture following similar terms of reference to its inquiry into Commonwealth Bank of Australia. It published its examination of these self-assessments in May 2019, stating that *'despite focus on culture increasing in recent years, the quality of institutions' self-assessment indicates to APRA that significant scope for improvement and investment remains'*[9].
- In **Japan**, the Japanese Financial Services Authority (JFSA) has signalled its intention to shift its supervisory activities to focus more on firms' governance and institutional cultures. As part of this, it has stated that it will engage with firms' senior management and auditors and will prompt financial firms to consider the interests of customers and other stakeholders[10].
- In **Canada**, the Office of the Superintendent of Financial Institutions (OSFI) has revised its Corporate Governance Guideline to include specific expectations that board members and senior management promote a risk culture that stresses integrity and effective risk management throughout financial institutions. The Guideline also allows for OFSI to assess the effectiveness of financial institutions' corporate governance focusing on the discussions and deliberations at the board and the board's behaviour, objectivity, degree of challenge and independence in its decision-making process. OFSI has also used risk culture surveys modelled on the FSB guidance on risk culture to assess the risks posed by financial institutions' cultures and behaviours. In 2018 OSFI signalled its growing interest in this domain by establishing a Culture and Conduct Risk Division within the Risk Support Sector.

References

6 South African Prudential Authority, Letter G4/2019
7 HKMA, Supervision for bank culture- guidelines and circular, 2018
8 Ravi Menon, Strengthening trust in finance, 2019
9 APRA, Information Paper – Self-assessments of governance, accountability and culture, 2019
10 JFSA, JFSA's supervisory approaches: Replacing checklists with engagement, 2018

Global developments on culture and accountability

On the accountability side, following the introduction of the UK's SMCR, similar regimes have emerged in a number of other countries including Ireland (the Senior Executive Accountability Regime), Australia (the Banking Executive Accountability Regime), and Hong Kong (the Manager-In-Charge regime). Singapore has proposed Guidelines on Individual Accountability and Conduct whilst the introduction of an accountability regime was one of the key recommendations of the South African 2018 Financial Markets Review. In Europe, the European Commission is seeking views on the benefits and drawbacks of an accountability regime under CRD.

Other jurisdictions are driving increased accountability through different mechanisms. The Belgian Parliament recently announced the introduction of a 'Bankers Oath' similar to the one that has been in operation in the Netherlands since 2015. In the US, the Federal Reserve Bank has produced a package of measures clarifying and delineating the responsibilities of the board, senior management and business lines including expectations that the board hold senior management accountable for implementing the firm's strategy and risk tolerance and maintaining the firm's risk management and control framework and three lines of defense model. In addition, the Federal Reserve's update for the confidential rating system that is applied to the largest financial institutions it supervises includes a "Governance and Controls" rating that has reinforced accountability.

Voluntary efforts

In some jurisdictions, efforts to improve culture have been cross sectoral. The BSB in the UK conducts an annual assessment across banks and building societies aimed at promoting better behaviour and competence in firms. In Ireland, a similar body, the Irish Banking Culture Board, has recently been launched, using the responses from a public consultation and bank employee culture survey to determine its areas of focus.

MAS has worked with the Association of Banks of Singapore to set up a Culture and Conduct Industry Steering Group which will serve as a platform for industry participants to share leading practices on culture and conduct.

New and emerging areas of focus

In our report, **Culture in Financial Services,** we identified six areas that we expected to attract particular supervisory scrutiny. These are:

The 'tone from the top'
The role of the leadership in setting, communicating and challenging the firm's culture

Mindsets and behaviours
Mindsets and behaviours that reflect the firm's target culture and values

Governance and controls
A culture that reinforces good governance and controls

Purpose and strategy
A clear sense of purpose and alignment between strategy, culture and values

Individual accountability
Enhanced individual accountability for specific roles and responsibilities

Remuneration and incentives
Remuneration and incentives that promote good outcomes for the firm, customers and the market

Whist these are core to supervisors assessment of firm culture, we set out in the next section of this report four areas that have been receiving steadily greater supervisory scrutiny. These four areas are likely to receive strong emphasis in jurisdictions where culture is already an established supervisory priority, such as the UK. However, we expect them gradually to gain prominence in other jurisdictions where the focus on culture is increasing.

New and emerging areas of focus

I. PURPOSE

[...] many banks that devote considerable attention to their business strategies and actions spend insufficient time thinking about their purpose and the role that they play in society
G30, Banking Conduct and Culture – A Permanent Mindset Change

Regulators are increasingly focused on the extent to which a firm's purpose influences its culture. In its 2019/20 Business Plan, the FCA says that it will *'will look more deeply at the concept of purpose in financial services and the case for creating purposeful cultures'* whilst the G30 has emphasised the importance of purpose in enabling executives to make decisions for the longer-term sustainability of the firm.

By purpose, regulators mean the reason why a firm exists and whether this poses any risk of detriment or harm to its customers. From a supervisory perspective, they will look at the purpose of a firm to understand what it is trying to achieve in practice, not just what is written in its mission statement, and will assess the extent to which a firm's purpose is cognisant of, and orientated towards, the outcomes achieved for customers or the market. Supervisors will expect firms to have a clearly articulated purpose, linked to their culture, values and expected behaviours.

They will be particularly alert to the risk of poor outcomes in firms whose culture leads them to couch their purpose primarily or exclusively in terms of the generation of profit or one which emphasizes compliance with the letter rather than the spirit of the rules.

Firms with a 'good purpose' (i.e. one that strives for positive consumer outcomes) have, according to Jonathan Davidson, Director of Supervision at the FCA, *'a much better record of getting it right'* and will, he argues, eliminate activities, products and services that are inconsistent with their purpose, even if they are profitable.

Notably, Christine Lagarde has sounded a similar note on purpose arguing that to restore trust in financial services *'individual purpose must always be linked to social purpose, to the common good'*[11]. In this regard, support for sustainable and inclusive investment is an opportunity, she argues, for financial services to pursue a *'broader sense of purpose'*[12].

References

[11] Christine Lagarde, The Financial Sector: Redefining a Broader Sense of Purpose

[12] Christine Lagarde, The Financial Sector: Redefining a Broader Sense of Purpose.

New and emerging areas of focus

II. THE 'TONE FROM ABOVE'

There is increasing awareness that tone from above is as important as tone from the top, and this requires a shift in how managers at all levels of the organisation are trained, promoted and supported.
G30, Banking Conduct and Culture – A Permanent Mindset Change

Over the past few years, much of the regulatory effort to improve culture has focused on the role of the leadership and the setting of the 'tone from the top'. However, the concept of a 'perma-frost' at middle management level, with its ability to frustrate board attempts at culture change, has long featured in writings on culture. Recognising this, and with the aim of ensuring that a 'healthy' culture is embedded at all levels of the organisation, regulators are increasingly emphasising the importance of 'the tone from above', that is, the behavioural examples and cultural signals being sent by an employee's immediate manager or supervisor at all levels in the organisation.

Regulators recognise that, in large firms in particular, employees are unlikely to have regular contact with board members or senior managers and are more likely to take their cultural cues, norms and mores from their immediate bosses. Consequently, supervisors are increasingly likely to assess whether middle management articulates and reinforces the firm's purpose, values and desired behaviours as a way, in turn, of testing the extent to which the culture articulated and set by the board is reflected in the day-to-day conduct, behaviours and attitudes of employees at the front line. In the UK, the FCA has spoken of the importance of business and function heads being able to reflect key messages from senior management. In that regard it has set out examples of good initiatives it has observed in its supervision of wholesale banks. These include the hosting of smaller 'townhall' events by desk or areas heads reflecting the fact that staff are generally most attentive to their immediate boss[13].

References

[13] FCA, 'Progress and challenges' – 5 Conduct Questions – Industry Feedback for 2018/19

New and emerging areas of focus

III. DIVERSITY AND INCLUSION

I'm not talking about optical diversity, where you simply set the table with people who look different. I mean true diversity, where you encourage new ideas and differences of opinion, and include them equally in the discussion.
Mary C. Daly, President and CEO, Federal Reserve Bank of San Francisco

This is an area of increasing prominence in supervisory thinking on culture, particularly in relation to supervisors' over-arching concerns about over-dominant individuals and group-think amongst board members. Supervisors are signalling, with increasing assertiveness, their wish to ensure that boards are not dominated by one or two individuals, ideas or perspectives and that key decisions are subject to rigorous collective debate and challenge and consideration of alternative analyses and options.

To guard against 'group think' firms are expected to ensure that the board and senior managers, together with the succession 'pipeline', are comprised of individuals from a range of backgrounds, experiences and outlooks. To this end, supervisors will assess whether diversity has been approached in a meaningful way beyond protected characteristics such that it delivers diversity of perspective and viewpoint. They will be particularly alert to any evidence of 'tokenism' in recent senior appointments and overall board and senior executive composition. In this regard, Christopher Woolard of the FCA has commented that genuine diversity and inclusion will not be achieved *'by employing the sisters of your existing board members'*[14]. Accordingly, supervisors will expect firms to have policies promoting diversity in its widest sense and will look for evidence that a firm has a long-term strategy to deliver enduring diversity at all levels of the organisation.

In the UK, the FCA considers diversity to be a relevant factor in its assessment of the fitness and propriety of senior managers.

The SMCR is key [...] in our judgement, the way a senior manager approaches issues around diversity may be relevant to our assessment of their competence and character.
Christopher Woolard, Executive Director of Strategy and Competition at the FCA

References

14 Christopher Woolard, The art of thinking independently together – why the regulator cares about diversity, 2017

New and emerging areas of focus

IV. PSYCHOLOGICAL SAFETY

Regulators have long expressed concern about 'good news' or 'fear' cultures in firms and the associated risk that mistakes or poor conduct are suppressed or covered up at lower levels, leaving boards in the dark as to what is really going on in the business and vulnerable to regulatory and reputational shocks as the problems belatedly emerge. As such, they increasingly emphasise the importance of creating a culture that encourages 'psychological safety'; that is, a culture where employees feel able to share opinions and ideas, or acknowledge errors, without fear of being penalised or of a disproportionate management response. In short, to speak up without fear.

> **Where a culture is open, risks are flagged, experiences are shared and decision-making is enhanced. But in a culture where colleagues are afraid to speak up, unethical behaviour can gain a foothold.**
> Christopher Woolard, Executive Director of Strategy and Competition at the FCA

For regulators, creating an environment where employees feel safe 'speaking up' results in more productive and innovative businesses and reduces the potential for inappropriate risk taking or behaviour which can result in harm to consumers and markets. In the absence of 'psychological safety', they will be concerned that risks and issues are not escalated sufficiently quickly and that the board and senior managers do not have an accurate picture of either the firm's culture or its operations.

The 2018/19 the BSB survey found that 40% of employees who spoke up at work said that they had not felt listened to or taken seriously, and a further 19% were unsure[15]. In this regard, the FCA in the UK has stated that where employees do speak up, the response of an organisation is key to determining whether it is cultivating a 'safe' environment[16]. To determine whether there exists an environment of adequate 'psychological safety' supervisors will seek tangible evidence that board members and senior managers monitor and analyse issues being raised by employees, and take credible action to address them.

In assessing the 'reasonable steps' senior individuals have taken to address misconduct and breaches, Mark Steward, the Director of Enforcement at the FCA, has indicated that poor escalation procedures and inadequate senior manager oversight over problems *'will be an issue'*[17]. This further highlights the importance, to senior managers, of ensuring that their teams feel safe to raise issues and concerns and that there are strong escalation protocols in place. As a distinct channel for escalating serious issues, supervisors are also focusing on the culture firms are establishing around whistleblowing as well as the formal whistleblowing policies and processes in place. They can be expected to test not only staff awareness of policies and processes, but also their practical level of confidence in them and specifically whether staff feel able to 'blow the whistle' without fear of reprisal.

References

15 Banking Standards Board, Annual Review 2018/19
16 FCA, Webpage: https://www.fca.org.uk/culture-and-governance/psychological-safety
17 Mark Steward, Partly contested cases, the pipeline and AML investigations

The supervision of culture in the UK: the FCA approach

In its Approach to Supervision document, the UK's FCA outlines the focus its risk assessment process places on business models and culture as the key causes of harm in firms.

The FCA defines culture as the habitual behaviours and mindsets that characterise an organisation. Whilst it acknowledges that it cannot assess mindsets and behaviours directly, the FCA focuses on four key drivers of culture within a firm:

- The firm's purpose (as it is understood by the employees)
- The attitude, behaviour, competence of the firm's leadership
- The approach to rewarding and managing people (e.g. staff compensation and incentives); and
- The firm's governance arrangements, controls and key processes.

The assessment of these drivers is central to the FCA's identification of harm for all firms and is underpinned by its firm assessment model. This sets out six questions against which the FCA assesses firms' culture.

These are:

- How effective is the firm's purpose in reducing the potential harm arising from the firm's business model?
- How effective is the firm's leadership in reducing the potential harm arising from the firm's business model?
- How effective are the firm's people policies in reducing the potential harm arising from the firm's business model?
- How effective is the firm's governance in reducing the potential harm arising from the firm's business model?
- How effective are the firm's systems and controls in reducing the potential harm arising from the firm's business model?
- How effective is the oversight of the business in reducing the potential harm arising from the firm's business model?

In its supervision of culture, the FCA pays particular regard to the role of senior managers who it sees as *'being responsible for the firm's culture and for preventing harm'* [18]. Under the SMCR, almost all employees are subject to conduct rules setting minimum standards of behaviour. However, senior managers, because they play an important role to play in decision-making and setting the culture of a firm, require approval and must have an agreed statement of responsibility setting out their accountabilities. The FCA's makes clear its willingness to hold senior managers to account for decisions and conduct that have a significant impact on the firm, stating it *'will purse individual accountability rigorously'* [19].

References

[18] FCA, Approach to Supervision, 2019

[19] FCA, Approach to Supervision, 2019

Management information on culture

With the increased public scrutiny on conduct and culture, and greater expectation for boards to be fully informed of and involved in such issues, ignorance is no longer an acceptable excuse [...] many directors are asking themselves "how do we really know?" and are putting in place measures for greater involvement and insights into the company culture.
G30, Banking Conduct and Culture – A Permanent Mindset Change

As supervisory scrutiny of firm culture becomes more searching and intrusive, boards and senior managers can expect supervisors to challenge them increasingly on how they assure themselves that their target culture is operating in practice and delivering acceptable outcomes, both from a regulatory and strategic, and commercial perspective.

Culture is inherently difficult to measure and almost all information can potentially provide an indication of a firm's culture. However, as our recent report *How do you know? Management Information for Conduct Risk* sets out, board members and senior managers can make a good start by evaluating whether the attitudes and behaviours demonstrated by staff reflect the firm's desired culture and values, and whether the firm is achieving positive outcomes for customers and the market. For example, boards could assess periodic reporting on behaviour such the timeliness of breach reporting to determine whether it indicates an underlying cultural issue or view product and service data (e.g. resolution times, queries, and call volumes) through a cultural lens to identify customer treatment and overall outcomes.

Conclusion

Whenever they address issues of firm culture, regulators will continue to emphasise the critical importance of establishing the right culture and mindset throughout an organisation; the responsibility of the board and senior management in that regard; and underpinning key roles of accountability, remuneration and incentives, and comprehensive MI. However, as supervisory scrutiny of culture becomes more intrusive and expansive, firms will also need, increasingly, to respond to the new areas of focus highlighted in this paper.

In particular, they will need to revisit their core purpose and business model to ensure that these put good outcomes for customers, the market and staff at the heart of decision-making. And they will need to stand ready to eliminate activities, products and services that are inconsistent with that purpose, even if they are profitable. Having expended considerable effort, over the course of the past few years, in setting the cultural tone at the top, firms now need to ensure it is transmitted it to all levels of the firm such that it has an enduring, and demonstrable, influence on the behaviour and mindset of all staff. Firms will also need to ensure that there is diversity of perspective, experience and knowledge amongst employees, starting with the board, and that accordingly their recruitment practices and succession plans are consistent with this objective. Furthermore, firms will need to establish an environment where staff feel safe and confident 'speaking up', sharing their ideas and expressing their concerns.

A necessary condition of achieving these goals is that firms treat their cultural transformation not as a one off exercise, however wide-ranging, but as continuously driven effort that is constantly re-evaluated and renewed. Moreover, the exercise should be informed by regular, insightful MI that enables progress to be rigorously measured and demonstrated.

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