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ANALYZING TWO APPROACHES OF SUPERVISING CULTURE  
IN BANKING

by Joe Brunk



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## **Abstract**

In light of the financial crisis and other culture-related scandals, regulators have recently begun to address the issues of toxic cultures plaguing banks. The US and the UK have attempted to address these issues using two slightly different top-down approaches. The purpose of this paper is to address the question of whether the US approach to supervising the culture of its banks is superior to the UK's approach to supervising the culture of its banks. Two case studies show that corporations and industries, even in the absence of government regulations, can create the proper institutional framework and incentives to change their culture. This paper argues that the US approach to supervising bank culture is superior because it is more likely to mitigate the unintended consequences associated with the knowledge problem, namely unethical behavior. Because of its less regimented and burdensome nature, the US approach fosters an environment where banks can adapt to changing circumstances or errors. This approach allows for more flexibility, variation, and competition in attempts to positively change banking culture.

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**Abbreviations**

<b>APR</b>	Approve Persons Regime
<b>BSB</b>	Banking Standards Board
<b>CR</b>	Certification Regime
<b>CRA</b>	Community Reinvestment Act
<b>CRO</b>	Chief Risk Officer
<b>ERP</b>	Economic Recovery Program
<b>FCIC</b>	Financial Crisis Inquiry Commission
<b>FCA</b>	Financial Conduct Authority
<b>FINRA</b>	Financial Industry Regulatory Authority
<b>FSA</b>	Financial Services Authority
<b>OCC</b>	Office of the Comptroller of the Currency
<b>SEC</b>	Securities & Exchange Commission
<b>NGO</b>	Nongovernmental Organization
<b>SMCR</b>	Senior Managers and Certification Regime
<b>SMR</b>	Senior Managers Regime
<b>US</b>	United States
<b>UK</b>	United Kingdom

## **I. Introduction**

The 2007-2008 global financial crisis sent shockwaves through the world economies and financial sectors. The crisis has sparked copious amounts of research examining its potential sources. However, ethics and toxic cultures in banks have been studied less than other factors that contributed to the crisis. In their report on the financial crisis, the Financial Crisis Inquiry Commission (FCIC) concluded that “there was a systemic breakdown in accountability and ethics” as well as “an erosion of standards of responsibility and ethics that exacerbated the financial crisis” (FCIC 2011, xxii).

Ethics in banks has been widely discussed by industry experts, public and private regulators, and banks to understand where culture has gone wrong and what can be done to improve it. Some analysts argue that the institutional environment and degradation of ethics played a role in the most recent global financial crisis (White 2008; Dudley 2013, 2014b; FCIC 2011). In a recent speech, Susan Dudley (2013) stated that there is an “apparent lack of respect for law, regulation and the public trust,” and he argued that “there is evidence of deep-seated cultural and ethical failures at many large financial institutions.” Even after the implementation of Dodd-Frank in 2010, some argued that toxic cultures and unethical behaviors still existed within banks and led to more culture-related scandals, most notably at Wells Fargo and involving Libor (Dudley 2013, 2014b; Federal Advisory Council 2015; Arnold 2016; Tayan 2016; Salz Review 2013). At Wells Fargo, wrongful sales practices permeated throughout the company. In order to meet their ambitious sales goals, employees deceived customers and took advantage of them by opening up millions of fraudulent accounts without their consent (Arnold 2016). In the Libor scandal, bank employees inflated and deflated their rates to falsely overstate their creditworthiness. The Libor is a benchmark of several interest rates, submitted through

confidential channels by major banks around the world, that they then use to borrow from each other. Employees were rigging the Libor rates, by asking employees at other banks to submit specific rates which significantly lowered the borrowing rates used between banks. This gave the perception that the financial system seemed safer than it really was (Salz Review 2013).

Governments have now involved themselves by providing solutions to remedy these unethical behaviors and unrelenting cultural problems.

Regulators have recently begun to address the issues of toxic cultures incessantly plaguing financial institutions. The US and the UK have attempted to address these issues using two slightly different top-down approaches to influence culture. The UK has taken an approach with more regimented processes and more formalized regulations (Financial Conduct Authority 2016, 2017, 2018). US regulators have taken a less heavy-handed approach by providing guidance to banks and urging the industry to address its issues on its own (Financial Industry Regulatory Authority 2016a, 2016b; Office of the Comptroller of the Currency 2014; Dudley 2013, 2014a, 2014b; Dahlgren 2014). The purpose of this paper is to address the question of whether the US approach to supervising the culture of its banks is superior to the UK's approach to supervising the culture of its banks in overcoming the challenges associated with the knowledge problem, namely, preventing unethical behaviors. The advantages and disadvantages are demonstrated through a comparison of the two different approaches taken by the US and UK.

The goal of this paper is to determine if the US approach to supervising the culture of its banks is superior to the approach implemented by the UK. To do this, I employ a case study approach of two firms to show that corporations and industries, even in the absence of burdensome government regulations, can create the proper institutional framework and incentives to change their culture. In Section II, I review the approaches employed by the UK

and US to illuminate their different regulatory approaches to banking. In Section III, I cover the theoretical arguments used for making the case that the US approach is superior in addressing unintended consequences associated with the knowledge problem. Section IV presents different case studies of cultural change that occurred in organizations in the past. Section V shows how individual banks and the financial services industry as a whole has begun, or has the ability, to take similar steps to lead a change of culture. Finally, in Section VI, the paper concludes with policy recommendations based on insights from the theoretical literature and the case study analysis.

## **II. A Review: US and UK Banking Culture Regulations**

Basic polls have shown that trust in the financial sector has been consistently low since the 2007-2008 global financial crisis and has even seen decreases in more recent years (Gallup 2016; Close 2016). In addition, banks have been facing heavy fines due to regulatory violations. According to a report from the Boston Consulting Group, fines from regulatory failures, such as money laundering, market manipulation, and terrorist financing, have amassed to about \$321 billion for financial institutions since the crisis (Grasshoff et al. 2017). Banks, faced with fines for improper behavior and a lack of public trust, will need to address these issues to permanently restore their reputation with the public. Instead of allowing banks to address this problem on their own, governments have started to craft regulations in order to prevent further issues of this nature from occurring.

Both the US and the UK have taken top-down approaches to supervising culture at financial institutions. Financial institutions are not in a position to address these issues freely and independently of government influence in either country. As I will outline below, the UK's

approach to supervising culture has more regimented processes compared to the US's less heavy-handed approach.

*i. The United Kingdom's Approach*

In 2013, the Financial Conduct Authority (FCA) was created to replace the Financial Services Authority (FSA). With the creation of a new regulatory body and in response to the 2007-2008 global financial crisis, rules from the FSA, such as the Approve Persons Regime (APR), were revisited and new rules were implemented to increase accountability in the financial sector. The APR required persons performing certain functions to be approved and labeled "fit and proper" by the FSA or FCA. By replacing the APR with the Senior Managers and Certification Regime (SMCR) in 2016, the FCA altered its approach to supervising culture. The FCA now supervises financial institutions' governance framework and require senior-level employees to identify and map out their responsibilities and assume responsibility for developing and embedding their firm's culture. These reforms were driven by the recommendations from a report titled "Changing Banking for Good," produced by the Parliamentary Commission on Banking Standards in 2013. The report concluded, among other things, that regulators should look to "make individual responsibility in banking a reality" by holding senior-level individuals fully accountable for their decisions (Report of the Parliamentary Commission on Banking Standards 2013, 8).

The SMCR consists of three major components, the Senior Managers Regime (SMR), the Certification Regime (CR), and conduct rules. The SMR is focused "on individuals who hold key roles and responsibilities," while the CR is focused on "other staff who could pose a risk of significant harm to the firm or any of its customers" (FCA 2016). A key difference between



these two components is that individuals under the SMR will be pre-approved by regulators, and individuals under the CR do not need to be pre-approved but are to be assessed by the firm annually. The CR also indicates that all relevant staff must be made aware of and are subject to the conduct rules. The conduct rules “set out a basic standard for behavior,” and apply if the specific employee falls under either of these two regimes (FCA 2016).

More specifically, the SMR requires senior managers to allocate and map out responsibilities through what the FCA calls their “statement of responsibilities.” This requires the senior managers to determine and explicitly state the areas in which they are responsible and accountable for (FCA 2017). Senior managers must also be responsible for “each of the firm’s business functions and activities,” which the FCA calls “overall responsibilities” (FCA 2017). To ensure that each department within the firm is covered, the FCA also requires each firm to provide a “responsibilities map,” that combines all the statements of responsibilities and creates an overview of the whole firm. The firms are also required to provide outlines of “their management and governance arrangements” (FCA 2017). The SMR has already been expanded since it went in to effect. As of May 2016, the SMR now covers all firms, not just banks, that are overseen by the FCA. This expansion is projected to cover an additional 60,000 firms. These firms include asset management, hedge funds, investment firms, and the insurance industry (FCA 2018).

## *ii. The United States’ Approach*

Alternatively, the US has focused on similar issues when supervising culture but has not implemented such a prescriptive rule as the UK’s SMR. The Federal Reserve and the Office of the Comptroller of the Currency (OCC) have been the main drivers of the regulatory push, but

the Securities & Exchange Commission (SEC) and Financial Industry Regulatory Authority (FINRA) have also begun to address these issues.

FINRA is a private corporation that is in charge of regulating their member firms and acts as a self-regulated organization overseen by the SEC. Initially, FINRA started to focus on culture in their priority letters to member firms. In their 2016 Regulatory and Examination Priorities Letter, FINRA stated that firm culture and ethics is (and remains) a top priority. The letter also addressed how FINRA “will formalize [their] assessment of firm culture” to understand the role it plays in compliance and risk management (FINRA 2016a, 1). FINRA also noted that they will “not seek to dictate firm culture, but rather to understand how it affects compliance and risk management practices at firms” (FINRA 2016a, 1). Soon after this first letter, FINRA issued a second follow up letter to publicize that they would meet with executive staff of firms to discuss and evaluate the importance of culture and how it develops and effects firms (FINRA 2016b). They also asked firms to submit specific information regarding these aspects of culture (FINRA 2016b). FINRA has not publicly released any findings, issued any guidance, or addressed any future plans since releasing these two letters.

Like FINRA, the OCC has also begun guiding the development of culture at financial institutions. The OCC issued revised “heightened standards” in 2014, which cover financial institutions with \$50 billion or more in average total assets, and established guidelines “to strengthen the governance and risk management practices” (OCC 2014). OCC standards focus on the risk culture at banks, and also force financial institutions to develop a “risk appetite statement” and define their “safe and sound” risk culture. These standards apply to a company’s governance framework and risk measurement.

The Federal Reserve Bank of New York has played a critical role in sparking the dialogue regarding banking culture and has helped focus in on what is and what is not working regarding supervising culture. They now hold an annual workshop on “Reforming Culture and Behavior in the Financial Services Industry,” which they started in 2014. These workshops bring together senior-level bank executives, senior regulatory officials, and other experts to discuss industry-led initiatives and spread ideas to address the issues of supervising culture. According to a 2014 speech given by Sarah Dahlgren, the Executive Vice President of the Financial Institution Supervision Group of the Federal Reserve Bank of New York, they also initiated a program of “enhanced engagement.” This initiative encourages more conversations to be held between regulators and bank employees, which has given regulators a closer look at issues surrounding supervising culture. Additionally, they released a report titled “Behavioral Risk Management in the Financial Services Industry: The Role of Culture, Governance,” and recently issued a white paper in December 2017 looking at “Misconduct Risk, Culture, and Supervision.”

The US government’s approach to supervising banking culture is similar to the UK’s in that it is top-down in nature. However, the US is giving the banks more authority and allowing them to attempt to address the issues themselves.

### **III. Theoretical Framework for Understanding the Supervision of Banking Culture**

Many scholars, government officials, and the media have concluded that a pervasive toxic culture is to blame in large part for the most recent financial crisis (see FCIC 2011; Salz Review 2013; Dudley 2013, 2014b; Federal Advisory Council 2015; Arnold 2016; Tayan 2016). NPR reported that a toxic sales culture led to Wells’ Fargo employees to “deceive customers and open unauthorized accounts” (Arnold 2016). The Federal Advisory Council (2015, 15), in the wake of

the LIBOR scandal, even admitted that the recent challenges have been “behavioral and cultural” and these more recent scandals “provide hard evidence that there remains work to be done.” Despite the implementation of regulations after the 2007-2008 global financial crisis, misconduct and culture-related scandals have still occurred in the financial services sector.

Scholars and regulators have identified that culture is an important issue to be addressed. However, some methods for correcting culture are likely more successful than others. The theoretical framework outlined below will aid in determining the approach most likely to lead to real cultural change in preventing unethical behaviors.

### *i. Culture*

While culture is often understudied in economics due to its ambiguity and tacit nature, Austrian economists have contributed to the research by combining culture and economic action. They place the focus on how and why people define meaning, emphasizing the importance of meaningful human action (Hayek 1952; Mises 1998). Culture gives actors informal norms and institutions in which to operate and creates an environment where they can reach their objectives.

To fully grasp its significance, we must first define culture. Starting generally, a definition of culture is paraphrased from John (2015) as a particular arrangement of meanings that is shared by a group of people, although they are never consciously aware of it and they did not design it. We see culture at work whenever members of the group are able to engage in consistent and predictable social interaction, and when they are able to delineate the acceptable from the unacceptable (John 2015, 232–233).

Everyone operates within the cultural framework of their environment. Culture plays a role in the development of markets and determining which opportunities are pursued and

ignored. Firms operate within this broader notion of culture and are also influenced by their own internal culture (or corporate culture). In this paper, corporate culture is defined in two different but cohesive ways as used by Kotter and Heskett (1992). The first definition of corporate culture is the “values that are shared by the people in a group and tend to persist over time even when group membership changes” (Kotter and Heskett 1992, 4). The second definition is “the behavior patterns or style of an organization that new employees are automatically encouraged to follow by their fellow employees” (Kotter and Heskett 1992, 4).

Quantitative analyses have established that firms with strong, well-defined corporate cultures often outperform firms with weak cultures (Kotter and Heskett 1992; Gordon and DiTomaso 1992; Burt et al. 1994; Sørensen 2002). For instance, Heskett (2012) concluded that firms with a strong corporate culture outperform “culturally unremarkable” firms by 20 to 30 percent.

In the same way corporate culture impacts individual firms, culture also plays a role in the success and activities of specific industries (or industry culture). When asked to provide a definition of banking culture in a 2014 speech, William Dudley, the previous president and CEO of the Federal Reserve Bank of New York, answered, “Culture relates to the implicit norms that guide behavior in the absence of regulations or compliance rules—and sometimes despite those explicit restraints [...] Culture reflects the prevailing attitudes and behaviors within a firm [...] Culture relates to what ‘should’ I do, and not to what ‘can’ I do” (Dudley 2014).

Recall that trust in the financial services industry is at an all-time low and has been for years (Gallup 2016; Close 2016). This phenomenon has caught the attention of both regulators and banks, who recognize a need for a change. As seen from all the definitions above, culture is hard to measure, which can make influencing or engineering culture difficult.

## *ii. The Knowledge Problem*

The concept of the knowledge problem, articulated by Hayek (1945), has long been discussed in economic literature. Hayek stated that knowledge “never exists in concentrated or integrated form but solely as the dispersed bits of incomplete and frequently contradictory knowledge ... the knowledge of the particular circumstances of time and place” (Hayek 1945, 519). Hayek succinctly described the knowledge problem as “a problem of the utilization of knowledge which is not given to anyone in its totality” (Hayek 1945, 520).

In *Collectivist Economic Planning*, Hayek combined his arguments with Ludwig Mises’ to show that central planning was an implausible economic system as it eliminated the role of prices, and eventually led to inefficient outcomes through irrational production (Hayek 1963; Mises [1990] 2012). Not being able to adequately access the knowledge of time and place proved to be a major roadblock in the success of central planning. In recent years this debate has continued, further detailing the failures that central planning faces when it comes to the coordination of production and prices (Lavoie 1981, 1985a, 1985b, 1986; Boettke 1990, 1993, 1994, 2001). However, the competitive market is able to make use of knowledge, even inarticulate knowledge, through property rights, monetary prices, and profit and loss signals (Hayek 1945; Mises [1990] 2012; Lavoie 1986). As Lavoie (1986, 9) explained, “the problem is rather that the relevant knowledge is inarticulate. The producers know more than they can explicitly communicate to others.” He then went on to argue that the market, “marshals this dispersed knowledge without requiring its articulation” (Lavoie 1986, 9).

This insight is key for a complex idea such as culture. Culture is tricky to define, and if it is hard to define, it will be even harder to command someone to change it in an effective way.

No individual, single firm, industry, or even government could possibly possess the knowledge necessary to make a firm work culturally. This means that no consumer, business owner, or government official can communicate or understand the cultural specifics that make the firm operate in a particular way.

The knowledge problem is even more relevant today as our world grows more complex. It continues to muddle policy prescriptions and their intended outcomes. The policy makers who attempt to regulate and engineer culture at financial institutions will inherently encounter the same knowledge problem that a centrally planned economy faces. When implementing cultural policy prescriptions at financial institutions, understanding the previous culture within the firm is vital to the success of the policy. Boettke et al. (2008) provide an example of how the knowledge problem impacts the success of broad economic development interventions. They contend that the formal rules must connect with the already existing, informal institutions to be successful for economic development. If the interventionist policies do not connect back to the existing, informal norms, then the changes are unlikely to hold, as Boettke et al. (2008) found in Bosnia and Russia. The same concept can be applied to prescriptive policies imposed on the banks to alter their culture. If the imposed policies do not link with the informal norms of the banks, they will most likely not lead to the intended change. Understanding the informal norms of large and complex firms such as a bank would prove to be problematic for any policymaker or governing body.

This hints at a specific issue stemming from the knowledge problem—the “man of system” mentality. The “man of system,” first articulated by Adam Smith in *Theory of Moral Sentiments*, is a type of mentality held by government regulators. When discussing the mentality’s influence on humanitarian aid, Coyne (2013, 62) defined it as the assumption that

“experts possess the relevant knowledge and information to use humanitarian resources in the best ways possible.” Hayek (1989, 3) also mentioned this issue when he argued against the “scientistic attitude” that many economists embrace when identifying all relevant variables and generating precise results proves too challenging. In a situation where the intended outcomes are hard to define and measure, adaptability is key to finding an efficient resource allocation and ultimately finding successful outcomes. Any successful government plan will need to adjust to changing circumstances, yet, due to the “man of systems” mentality and rigidity of policymaking, adaptability is unlikely.

In *Doing Bad by Doing Good*, Coyne (2013) examined the effectiveness of government and nongovernment organizations (NGOs) humanitarian aid. The government has drastically increased its involvement with humanitarian aid through its own programs as well as steering the NGOs efforts through government grants. The acceleration of state dominated humanitarian aid has led to adaptability issues that revolved around the feedback mechanisms and incentives present to the humanitarian aid actors. Coyne (2013, 62) provided an example of how “the man-of-the-humanitarian-system mentality” negatively impacted humanitarian aid efforts, and how it limited the adaptability of humanitarian aid programs by blocking feedback and incentive mechanisms. Feedback and incentives are particularly important in a setting where outcomes of the intervention are hard to find or even measure. Coyne (2013) went on to argue that when these issues are present, it is even more valuable to understand the theory behind the implications of policy.

In two papers, Chamlee-Wright (1993, 2002) examined two separate instances where a failure to recognize culture specificity led to failed attempts at stimulating economic development through bad policies in both Ghana and Zimbabwe. In the first example, corrupt



government leaders enacted policies that criminalized market activity as well as implemented price controls that made it difficult for local entrepreneurs to operate (Chamlee-Wright 1993). In order to restore control in the markets, the leaders lifted the price controls through the IMF's Economic Recovery Program (ERP), which helped the markets recover in the local economies. The markets were rebuilt but the recovery was not a total success because the government leaders, "could not rebuild the trust relationships which had developed over decades of face to face interaction among neighboring traders" (Chamlee-Wright 1993, 94). Prior to this, the entrepreneurs had developed relationships with their neighboring market stalls, and these relationships were critical to the success of the entrepreneurs. With the newly developed market system implemented by the IMF, all of the prior relationships were lost because the entrepreneurs did not have the same neighbors as before. In her conclusion Chamlee-Wright (1993, 99) stated, "We have missed opportunities for promoting economic development because we have ignored the cultural specificity in which institutions emerge," and then went on to say that "We are likely to meet with more success if we advocate policies which allow indigenous institutions to work to their full potential." In this case, the policies were intended to help the economy return to its prior state, before government influence, but they unintentionally stunted the economic recovery process.

In the second example, Chamlee-Wright (2002) examined a similar occurrence but this time in Harare, Zimbabwe. She compared the experiences of female entrepreneurs in Zimbabwe with those in Ghana. The cultural contexts in which these female entrepreneurs operated in were very distinct from one another, with a major difference being the way these entrepreneurs created and sought opportunities and entrepreneurial strategies. The Zimbabwean entrepreneurs faced a different culture, arguably more resistant to their success, than the Ghanaian entrepreneurs, but

they still found success through “a process in which entrepreneurs create strategies for responding to the cultural context in which they find themselves” (Chamlee-Wright 2002, 1002). Even though these Zimbabwean entrepreneurs faced many constraints pitted against them, they still found success by navigating through the tough culture they confronted. Some of these constraints consisted of segregationist policies that benefitted European businesses more than the Zimbabwean businesses, where many Zimbabwean entrepreneurs faced the threat of mass arrests. Zimbabwean woman also faced cultural obstacles such as their status in marriage and their larger familial groups that prevented their entrepreneurial success. Zimbabwean entrepreneurs adopted strategies to overcome these obstacles geared towards “saving and mutual assistance, investing, business diversification, and maintaining control over their resource” (Chamlee-Wright 2002, 990).

These two cases indicate the wide array of differences that can exist with two seemingly similar cultures. They are also examples of culture influencing the success of policies, unintentionally leading to failure. While these policies were implemented with good intentions, they led to undesirable results that undermined the stated goals.

The knowledge problem can also lead to other unintended and unintentional consequences that arise out of intentional government interference. Becker (1957) explained how discrimination may occur in markets where nonprice rationing occurs. Becker argued that free-market competition could eliminate nonprice discrimination and would force individuals and companies to make decisions based on price discrimination. One common, controversial form of government interference is price controls on housing. Price controls, while intended to protect consumers from unfair prices, usually lead to a misallocation of resources and even increase the use of discrimination based on non-price factors (Glaeser & Luttmer 2003; Gyourko &

Linneman 1989). The intentional interference implemented by governments leads to unintentional outcomes. These interventions actually incentivize people to act on their prejudices because they no longer have the incentive to make decisions based solely on price. Similar results occur with minimum wage laws (Williams 1984, 2010; Jardim et al. 2017). The Davis-Bacon Act, which is a prevailing wage law set for government construction projects, has also led to similar outcomes. Keyes (1982) and Katz and Kessler (2001) both found the Davis-Bacon Act to be detrimental to minorities and argued repeal may actually improve their wages and employment opportunity.

Government regulations that unintentionally promote unethical behaviors have also been a problem in the financial sector. In the late 1990s and early 2000s, government regulators tried to limit the amount of risk-taking by banks through various regulations (Basel Committee on Banking Supervision 2004; Sarbanes-Oxley Act of 2002). The Sarbanes Oxley Act of 2002 overhauled corporate governance, accounting and financial disclosure requirements to prevent firms from taking on too much risk. Additionally, the Basel Committee introduced Basel II, which altered the capital requirements for banks and also forced banks to change their financial disclosure practices (Basel Committee on Banking Supervision 2004). In response to these new regulations, banks started hiring more chief risk officers (CROs), who were in charge of monitoring risks at their bank. Pernell et al. (2017) found that with the introduction of CROs, banks started to take on more and more risk instead of reducing risk. They attributed this to two different causes. The first was that CROs promoted the use of derivatives because they allowed for more customized portfolios and increased flexibility and adaptability to market fluctuations, which helped them increase their returns (Pernell et al. 2017). Second, the authors argued that traders reduced their own monitoring of activities because they believed the CROs would

monitor their activities as well, which put more of the onus on the CROs (Pernell et al. 2017). In the end, CROs increased the amount of risk taken on by banks, ultimately influencing and exacerbating the financial crisis.

Risk management is not the only place where government regulations influenced the decisions banks made leading up to the financial crisis. In the early 1990s, the Clinton Administration reformed the Community Reinvestment Act (CRA) by changing the way banks offered mortgages to low income borrowers (see Wallison 2009; Tarr 2010; Ravier & Lewin 2012; Michel 2015). These changes forced banks to focus on their outcomes—loans made to low income borrowers—instead of the process in which they evaluated potential borrowers (Hossain 2014). And, Miller (2018) found that the Recourse Rule, which lowered capital requirements on highly rated mortgage-back securities, encouraged banks to hold more of these financial instruments that defaulted during the financial crisis. These examples show how government regulations can unintentionally promote unethical behaviors at firms.

With a “man of system” mentality present in bank regulators, they will not be able to take into account the preferences and social context in which any decisions are made. Most notably, the preferences of the employees working at individual banks, who have the knowledge of their specific time and place, cannot possibly be considered. Further, policies may accidentally encourage unethical behavior rather than promoting a more ethical culture. Fortunately, Hayek (1989) offered a solution or alternative to how this “man of system” or policymaker should behave. Hayek argued that the policymaker should act more like a gardener, who develops the appropriate environment for his plants to flourish, and less like a craftsman, who constructs each aspect his handiwork. If the policy maker acts more like a gardener, the environment would be more predisposed to allow adaptations to flourish.

These ideas play a role in both approaches for influencing banking culture. Both the UK and the US want to achieve the same end: a positive change in banking culture. The more regimented approach used by the UK is significantly more likely to succumb to these problems. The faults of the “man of system,” such as conceit and an inability to utilize dispersed and inarticulate knowledge, apply to the policymakers in charge of leading and implementing the regime in the UK. While US regulators will fall victim to these faults as well, the US approach allows for more flexibility, variation, and competition, relative to the UK. Because of this, the US may be more likely to cultivate a favorable environment for a change in culture at banks.

### *iii. Spontaneous Order and Evolution*

As we examined above, the complex nature of culture makes it immensely difficult to engineer specific, intended outcomes. The knowledge problem magnifies this inherent issue of complexity in the nature of culture. Any policymaker is then faced with the impossible task of effectively discerning all the information necessary to provide effective solutions for initiating a change in banking culture. As Lavoie and Chamlee-Wright (2003, 111) said, “As government regulation grows, business decisions will be increasingly made according to bureaucratic, not business principals. To add insult to injury, this increased bureaucratic control has little chance of actually advancing social ends.”

In order to address these compounding issues, an approach that allows for spontaneous order and evolution to take hold will lead to more efficient outcomes. Spontaneous order emerges out of combinations of human action, not human design. Horowitz (2001, 82) described spontaneous orders as the “practices, rules, institutions, and so forth that have developed not because human actors rationally foresaw their likely benefits and deliberately, consciously

constructed them, but rather because they are unintended consequences of various human actors' pursuit of their own purposes and plans."

Hayek (1945) argued that markets emerge even in the absence of any central planning. When addressing the market process and the price system, Hayek (1945, 527) argued that these ideas are not of human design yet lead individuals to "do desirable things" without any central plan or anyone knowing why they are desirable. Individuals are able to coordinate and plan efficiently as a result of property rights, the price system, and the feedback mechanisms of profit and loss. When applying this to the division of labor, Hayek (1945, 528) argued that "man has been able to develop division of labor on which our civilization is based because he happened to stumble upon a method which made it possible." Hayek (1960, 1973, 1991) ultimately argued for the effectiveness of spontaneously emergent orders and institutions.

Culture is a spontaneous order because it emerges out of unplanned human action. Just as markets and prices emerge without any central plan, culture also emerges and evolves spontaneously. When explaining this phenomenon, Lavoie and Chamlee-Wright (2003, 1) state that, "A flourishing market economy does not automatically arise from the ashes of a centrally planned economy the moment somebody declares the end of communism...It involves the emergence of alternative and more fragmented notions of 'authority'."

When discussing the criticisms of the free market, the most common stances are that markets and the businesses that operate within the market are amoral and make all their decisions on a profit-maximizing basis. These are based on faulty assumptions made about the real world. The perpetually changing and fragmented nature of markets allow actors to use discretion when making business decisions (Lavoie & Chamlee-Wright 2003). The existence of this discretion explains that there is no one-size-fits-all method to maximizing profits but there are a range of

options that lead to that same outcome. Within that range of options exists decisions that are more or less moral, allowing for business decision makers to make choices about being more or less socially responsible. This means socially responsible action and making responsible business decisions are not separate from one another, since it “is an inevitable consequence of the fact that business firms are part of the moral and political culture in which they arise” (Lavoie & Chamlee-Wright 2003, 120). Responsible decision making in a business environment will include socially responsible, or moral decisions, if the surrounding institutions support and incentivize them. Lavoie and Chamlee-Wright (2003, 122, 126) summarized this idea well when they stated that, “The market can be an effective vehicle for intentional, socially responsible behavior” and “sometimes the market is the most effective vehicle by which to initiate social transformation.”

Culture is critical to not only the success of banks but also the whole financial services industry, thus a change is desperately needed. Cultural change within markets does not necessarily need to come from a top-down directive. Indeed, top-down directives are less likely to overcome the knowledge problem and may lead to unintended and potentially unethical outcomes. However, effective outcomes may be reached more efficiently from the bottom-up. In the following section, I will examine a few instances where successful cultural shifts occurred in business environments without any government directives. These cases will help illustrate lessons for reforming banking culture.

#### **IV. Case Study Analysis**

In this section, we will examine two case studies of firms that underwent cultural shifts organically, rather than prompted from a government regulation. Both Starbucks and Alcoa

successfully underwent a culture change that led to long-term successful growth. These examples show that a) culture and incentives matter and b) positive results can occur spontaneously without any direct planning involved.

*i. Starbucks*

In the midst of the 2007-2008 financial crisis, Howard Schultz returned to being CEO of Starbucks after stepping down in 2000 to become chairman. Prior to 2007, Starbucks, an international chain of coffee houses, had rampant growth. In 2007 growth faltered, and their sales and profits tumbled. Due to the ongoing digital revolution, erratic economic conditions, shift in consumer behaviors, and increased competition, Starbucks entered a time of crisis. Schultz tells the story in his book of how he turned the company around, despite the chaotic circumstances (Schultz and Gordon 2011).<sup>1</sup> Through a myriad of actions, Schultz led the transformation of Starbucks' culture and influenced the success of the company.

To initiate culture change at any organization, the leader or CEO is tasked with leading the charge or leading by example. The “tone from the top” is vital in setting the organizations guiding principles and goals. Within 45 minutes of publicly announcing his decision to return as CEO, Schultz gathered more than 1,000 of Starbucks employees (called partners) in an open forum to announce his return (Schultz and Gordon 2011). This forum was also broadcast to offices and roasting plants around the world with the goal to “to ensure that people understood that Starbucks' very survival was at stake, while at the same time helping them feel safe” (Schultz and Gordon 2011, 59). Schultz also emailed a companywide memo titled “The Transformation of Starbucks,” sent a voice message to every partner, and posted a letter to all

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<sup>1</sup> Unless noted otherwise, all information is sourced from this book.



customers on their website. The initial tone from the top laid out by Schultz set the stage for all progress going forward. Schultz's tone built a companywide sense of openness between all employees which helped develop transparency throughout the company.

These communications continued past the initial stages of Schultz's plan. He wrote more than ten memos in the first few months back as CEO and reinstated more open forums to formally involve their partners (Schultz and Gordon 2011). Schultz also invited people to email him directly and received about 5,600 emails in the first month alone.

Schultz also hosted a leadership conference in 2008 in New Orleans for their 8,000 US store managers and 2,000 partners with the intention to re-instill confidence in their employees and infuse them "with the emotional capital they so desperately needed to reconnect with the company" (Schultz and Gordon 2011, 78). Each participant engaged in a range of activities, such as education sessions and panel discussions, including a large closing session; interactive exhibits on the mission and values of Starbucks; community volunteering activities; and a street fair with food and entertainment. Schultz received hundreds of emails from reinvigorated partners following the leadership conference (Schultz and Gordon 2011).

Additionally, Starbucks began to implement several training programs. A Lean<sup>2</sup> program was established at some of its stores, with the aim of "involving employees by asking for their opinions about how to improve their own work and environment" (Schultz and Gordon 2011, 281). Schultz visited a handful of stores to see this concept in practice. When Schultz visited the stores, the partners were open and candid with him about the improvements they instituted in

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<sup>2</sup> Which they defined as "a generic term for a nontraditional way of managing and working that claims to reduce redundancies and waste while making conditions easier for employees and improving product and service quality for customers" (Schultz and Gordon 2011: 281).

their stores through Lean. The partners also took initiative in sharing these practices with other stores experiencing similar issues.

Starbucks also provided store managers and baristas with specialized training programs. These were programs designed to “inspire and improve performance” (Schultz and Gordon 2011, 77). The first of such training programs was called “Espresso Excellence Training.” Starbucks closed all of their US stores for one day to take time to retrain 135,000 baristas to give them “more tools and knowledge to do their jobs well” which “would improve the experience for them as well as customers” (Schultz and Gordon 2011, 78).

With a combination of training programs and the open transparent work environment established by Schultz’s tone from the top, led to a comfortability of speaking up and raising issues to address beneficial changes to production and customer satisfaction. Indeed, many Starbucks stores improved their customer satisfaction and quality scores (Schultz and Gordon 2011).

## *ii. Alcoa*

Alcoa, the Aluminum Company of America, was one of the first and one of the largest industrial aluminum manufacturing companies in the world. The company saw a lot of success until the 1980s, when leadership made a number of irresponsible missteps by expanding into new product lines. In a chapter of his book, Charles Duhigg (2012) detailed the story of Alcoa hiring a new CEO and the ensuing transformation.<sup>3</sup> Paul O’Neill took over as CEO of Alcoa in the fall of 1987. Just as Schultz had done with Starbucks, O’Neill fostered an environment for cultural change and business success.

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<sup>3</sup> Unless noted otherwise, all information is sourced from this chapter.

In his first appearance as CEO, O'Neill focused solely on Alcoa's safety standards when he spoke to a room full of investors. Even when asked about profits, growth, and production, O'Neill turned the conversation back to safety and stated, "If you want to understand how Alcoa is doing, you need to look at our workplace safety figures" (Duhigg 2012, 98). After his initial speech, O'Neill continued preaching safety by visiting Alcoa's facilities in the US as well as 32 other countries.

To ensure that safety was taken seriously at Alcoa, O'Neill did more than just preach about it to his employees, he followed through with his actions. Whenever someone was injured, the person in charge "had to report it to O'Neill within twenty-four hours and present a plan for making sure the injury never happened again" (Duhigg 2012, 105). To make sure that the immediate communications were possible, Alcoa overhauled its whole organizational structure. Each facility had to establish new communication systems that efficiently relayed the information from the lowest level worker all the way up the management chain. During a time when computer networks and the internet were only beginning to emerge, O'Neill ordered Alcoa's offices to adapt technology that allowed easy sharing of information. O'Neill intended this to be used to share safety suggestions but employees started sharing other information as they became more comfortable with the process, leading to other efficiency and productivity gains.

In another attempt to improve safety, O'Neill and Alcoa's managers encouraged their workers to suggest ideas that could help their safety protocols improve. While most of the suggestions did not involve safety solutions, workers suggested a number of other great ideas. For example, "a low-level employee made a suggestion that quickly worked its way up to the general manager," which resulted in doubled profits in that product line (Duhigg 2012, 116).

The environment and direct lines of communication allowed workers to not only be comfortable escalating any issues with safety and ideas for increased production, but also allowed these ideas to quickly spread to the management level. This focus led to results: lost workday incidents (accidents per 100 employees that lead to days lost from work) reduced from 1.86 to 0.2 (Lagace 2002). The tone and initiatives O'Neill set helped shape the culture from the outset of his time at the organization.

Both Starbucks and Alcoa changed their cultures organically achieve long-term growth. These two case studies demonstrate that culture can successfully change within a firm without prompts from government regulation. Banks will need to reach similar results to overcome their low public trust, high misconduct related fines, and poor public reputation. In the next section, I will illustrate various ways in which banks have already started to address their misconduct and culture-related issues.

## **V. Current Bottom-up Attempts to Changing Banking Culture**

To help restore public trust and their reputation, banks have an incentive to improve their culture. Banks in the both US and UK have started to address their culture. There have also been various annual industry conferences and events hosted by both regulators and independent advocacy organizations dedicated to cultural change. For example, in 2015, JPMorgan Chase started a global initiative to establish a “Culture and Conduct” program. In its 2015 annual report, JPMorgan Chase stated the purpose of the initiative was to reinforce their business principles and “to hear first-hand what drives their behavior and to better understand how to motivate people to do the right thing” (JPMorgan Chase 2015, 55). In addition to this, JPMorgan also has a number of other training programs designed to help their employees prepare for management roles and to

take on more leadership opportunities within their firm. As JPMorgan Chase (2014, 20) stated, it uses these programs “to build a strong culture of doing the right thing and doing first-class business in a first-class way.”

Another bank, Barclays, also initiated a culture reform. As a result of the recent LIBOR scandal, Barclays announced a formal plan to change their culture. Initially, Barclays implemented a Compliance Career Academy in partnership with Cambridge Judge Business School, where they implemented technical and behavioral training focused on helping decision-making geared towards “achieving success in the right way” (Barclays 2014). In its 2016 Annual report, Barclays reported, “We have placed continued focus on the importance of a values-based culture and with that in mind, conduct, culture and values were established as part of our key strategic priorities for the year” (Barclays 2017, 42). Although this only existed in the annual report, this statement helped set the tone from the top relaying the importance of their culture to all employees. Barclays also emphasized the importance of creating an open and transparent work environment. It did so by implementing two different programs such as their “Conversation Framework and Empathy Diagnostic,” and their ‘Let’s talk about how’ performance management campaign (Barclays 2017, 42–43). These programs are designed to help improve customer relationships and outcomes as well as reinforce their values-based culture to all their employees.

HSBC, another bank involved in the LIBOR scandal, also made a commitment to a cultural change within the firm. When outlining its plan, HSBC stated in their 2016 Annual Report, “The plans emphasise enabling a speak-up culture, principles-based judgement and other behaviours that are key to supporting the Group’s strategic objectives such as managing financial crime risk” (HSBC 2017, 26). To enable a speak-up culture, HSBC emphasized the importance

of making sure the bank had an effective whistleblower program. Its annual report stated that the bank had combined all of its whistleblowing channels into one streamlined platform called HSBC Confidential (HSBC 2017, 24). In addition to this, HSBC also implemented an online tool titled “At Our Best.” This recognition tool allows employees to recognize “colleagues around the world who bring our values to life in the way they think and act” and if an employee receives enough recognition, they are awarded gifts and benefits (HSBC 2015, 38, 286). HSBC also finished a three-year program of “values-led leadership training for all employees” (HSBC 2015, 38).

PNC is another bank that has taken steps to reform its culture even though they have not been at the center of the more recent scandals. PNC has a customer-first culture which is established by their ‘Office of the Customer,’ which is in charge of introducing programs geared towards customer benefit. One of the first programs introduced was CARES, which is described as “PNC’s enterprise-wide customer interaction model” and provides “guidance as to how employees can best serve customers, specifically by connecting and empathizing with them and by taking full ownership of their experience” (PNC 2016, 21). Another program of note implemented by PNC is their ‘Just Fix It!’ Program. This program is intended for employees to have a forum to recommend solutions to some of the problems that only specific employees experience. PNC explained the goals of this program as “to hear firsthand from our employees about which barriers get in the way of delivering an exceptional service every time for every customer” (PNC 2016, 22).

These are all examples of how each bank inculcated the cultures at their banks through different training events, programs and strategic missions. Banks started to address these issues themselves, free of any government regulation, to limit the unethical decisions made by their

employees. Much of what is written above aligns with the actions taken in the two case studies above. Banks have started to create a more open and transparent environment that allows employees to speak up when they think something is wrong or when they see a fix to a solution that will help their business in the long run. These programs allow for more spontaneous order and evolution to occur within the firm. They have also devoted more time in providing more meaningful training opportunities where employees can reacquaint themselves with their company's values and vision.

Furthermore, banks and regulators must be able to learn and share knowledge with each other. They must share past experiences in changing culture and be able to articulate the best practices that have worked for them. As demonstrated by the examples above, banks can and will inculcate culture internally. They will also do it in coordination with governments, but this is separate and distinct from government planning and top-down regulation. In addition to the steps taken by banks to fix their culture issues, they will also face a combination of social pressure and soft law dedicated to solving these issues.

Soft law refers to rules that are not directly enforceable but legal action can be brought to punish breaches of the rules. Soft law also refers to codes of conduct or guidelines geared towards influencing standards of conduct. According to Thierer (2016), social pressures, which inherently arise from the bottom up, can also lead to changes and are often driven by advocacy organizations. Some advocacy organizations have been successful in influencing decisions in the rapidly advancing technology sector, more specifically in media, television content and safety (Thierer 2016, 76). Emerging technologies have also seen an abundance of soft law arise to govern these companies and will continue to do so as the pace of innovation will far outpace the evolution of hard law (Thierer, Hagemann & Skees 2018). Technology companies, advocacy

groups and governments have already been working together through various mechanisms, including soft law, to help create governance frameworks that regulate emerging technology companies (Thierer 2016). All the parties involved recognize the issues with emerging technology companies and are willing to work with government and advocacy organizations to implement soft law. Just as there is a lot of fear in the technology industry, there is also a lot of fear, mistrust, and uncertainty involving banks and the actions they take. The technology industry has developed a model to address these issues and demonstrates that is already being done successfully. The financial services sector has taken steps to create their own unique model to initiate the learning and sharing of knowledge with the goal to solve their own industry issues. The approach of the United States and the heavy fines they have issued can be classified as an approach using soft law. In the UK, the Banking Standards Board (BSB), an independent body, began in 2015 to “promote high standards of behaviour and competence across UK banks and building societies” (BSB). Although the UK’s approach makes use of hard law, there are still examples of soft law, like the BSB.

In addition to the evolution of soft law and advocacy organizations, there have been a number of conferences and workshops geared towards the purpose of sharing knowledge between banks and regulators. One of the most prominent advocacy organizations is the BSB, an industry driven initiative designed to repair the industry’s reputation through restoring trust. It provides “impartial and objective assessments of the industry’s progress” (BSB). One of the unique things that the BSB has done, is provide an assessment report based on survey results and qualitative analyses of their member banks (BSB, Assessment Results). This assessment provides a general overview of the industry and helps identify ways to improve for the future. The report is “intended to provide member firms with the evidence, support and challenge to



help them achieve and maintain high standards of behaviour and competence, individually and collectively” (BSB, Assessment Results). They also hold events such as their Annual Culture and Conduct Forum geared towards discussing the most relevant issues with culture and conduct at banks as well as providing an update on the real time progress of what banks are doing themselves to address these issues. The BSB has held three annual forums on culture and conduct in addition to other small events throughout the year (BSB, Events Programme).

The BSB is not the only organization beginning to hold conferences on culture and conduct in the financial services industry in the UK. City & Financial Global recently started addressing the issue of culture and conduct in the financial services sector. An “independent, research-based conference organizer” that organizes around forty-five high level events a year covering a wide range of topics (City & Financial Global, About Us), City & Financial Global has held numerous conferences specifically about the UK’s SMCR, hosted forums on personal accountability and the evolution of regulatory technology in addition to three culture and conduct forums they have held begun to hold annually (City & Financial Global, Past Conferences).

While the UK has a more robust environment of advocacy organizations dedicated to culture, there are a number of government and private company-run events that have served the same function in the US. The New York Fed has held six workshops in the last four years geared towards reforming corporate governance and culture. Thomson Reuters led the charge in organizing forums and events where regulators and bank executives can meet and share their experiences in attempting to reform their culture. Thomson Reuters hosted their fourth workshop in spring of 2017 aimed at examining the impacts that behavior science can have on banking reform.

In addition to these conferences and workshops, banks are also addressing cultural and misconduct issues themselves. In Citi's 2017 Proxy statement (2017, 36) they note that they have had board members and senior management participate in every New York Federal Reserve workshop on culture and behavior in the financial services industry. Citi (2017, 36) and six other banks organized a one-day symposium to discuss the dynamics of culture at financial institutions. The continued increase in the number of events related to culture will give banks and regulators more opportunities to collaborate and discuss positive ideas and experiences they have found that limited the amount of unethical behavior.

## **VI. Conclusion and Policy Recommendations**

Through the evidence presented above, this paper shows the US approach to supervising bank culture is superior to the approach implemented by the UK because it is more likely to stem the unintended consequences associated with the knowledge problem. The US approach fosters an environment where banks can adapt to changing circumstances or errors, such as the proliferation of unethical behavior. By contrast, the UK approach to influencing banking culture is more prescriptive and regimented, and succumbs to many of the problems addressed in the theoretical section, despite taking measured steps to increase accountability.

The US is taking an approach that is arguably less prescriptive and allows for more spontaneous order and evolution to occur. The US approach allows firms more flexibility, variation, and competition when navigating the regulatory structure and attempting to change their culture. Firms have undergone cultural shifts in the absence of a government mandate to make cultural changes. Shifts have occurred out of the competitive environment and were necessary for the firms in question to survive. If banks failed to adapt their cultures to address

cultural issues, they risk losing customers. The competitive environment forces these banks to adapt individually and as an industry. Many banks around the world have started to address their culture issues internally and much of it aligns with what the US is pushing for. It has yet to be seen which approach may yield better outcomes. This paper provides a framework to demonstrate how, when compared to the UK's approach, the US approach may lead to better outcomes in terms of fostering an environment that results in positive culture change.

Although the UK's SMCR will likely not be repealed or replaced in the near future, this paper identifies some of the places where prescriptive regulation usually fails. This paper shows the UK should not expand their SMCR to be more prescriptive but should leave more room for the banks to develop and change their own cultures internally. The US should maintain their approach and should think twice about instituting more prescriptive regulations dealing with banking culture. When attempting to influence culture within banks, the US approach provides banks with more flexibility, variation, and competition. Moving forward more generally, both countries should attempt to create an environment where spontaneous evolution can occur to help address the problem of toxic cultures that promote unethical decisions.

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