MAY 2022

Culture & Conduct Risk in the Banking Sector

Why it matters and what the industry is doing to address it

starling

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Starling Trust Sciences LLC

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Lawrence, Cameron, Research Director

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ABOUT STARLING

Starling enables management through foresight, so organizations can optimize performance before opportunity is lost and mitigate culture and conduct related risks before they cascade into crises. A pioneer in applying computational social science methodologies to management challenges, Starling marries behavioral science to AI and organizational network analytics to generate Real-time Operational Insights. Delivered across our customizable Predictive Behavioral Analytics platform, these allow users to anticipate and shape performance among teams, business units, and corporate functions. Starling brings speed, scale and efficiency to management initiatives aimed at creating, preserving, and restoring value.

AUTHORS

Stephen Scott is the Founder & CEO of Starling. A risk management expert, he has led successful engagements in over 50 countries and has lived and worked in New York, Washington, London, Frankfurt, Madrid and Shanghai. Stephen served as the lead international investigator for a US Senate inquiry into espionage and corruption during the 1996 Presidential election. He later led a forensic inquiry into the collapse of the largest banking group in a Caribbean nation, amidst a multi-billion dollar corruption scandal, as a condition of that nation's continued receipt of IMF support. Thereafter, he built and led the China operations of the restructuring firm that wound down Lehman Brothers. Stephen holds degrees from Cornell University, the London School of Economics, and dual-MBA degrees from Columbia and the London Business School.

Cameron Lawrence is Starling's Director of Research. A past software developer in the financial services industry, Cam received his Bachelor's degree in Electrical Engineering from Villanova University, where his studies focused on cognitive science and machine learning, and where he served as Copy Desk Chief for the University's paper of record, *The Villanovan*.

Stephen Leacock is the award-winning graphic designer and illustrator who has handled the layout and design of Starling's *Compendium* since its inception (2018), shaping it in to the enjoyable and easy-to-use reference that it has become. Learn more about him at leacockdesign.com.

Our continued thanks go to those who helped to craft past issues of this annual report, **Jeff Kupfer**, **Anne Chiou**, **Grigory McKain** and **Klien Hilliard**, without whom this series of reports would not have become what it is. And kudos to Starling co-founder **Erich Hoefer** for the thought-provoking graph that appears on ▸ **p. 197**.

Our greatest appreciation goes to the many deeply-informed industry experts who were kind enough to review draft material in the preparation of this report — it is substantially improved by their input: **Kah Fai Lee** (MAS, Singapore); **Helen Gale** (FRC, UK); **Sasha Heizmann** (NAB, Australia); **Stephen Hewitt** (RBC, Canada); **Brock Kruger** (OSFI, Canada); **Caesar Lack** (UBS, Switzerland); **Ted MacDonald** (FMSB, UK); **Mathilde Mesnard** (OECD, France); **Pei Hong Mok** (MAS); **Thomas Noone** (NY Fed, US); **Matthew Phillips** (FRC, UK); **Thomas Probst** (UBS); **Tamara Scicluna** (Rhizome Advisory, Australia); **Ronald Sin** (MAS); **Kershia Singh** (FSCA, South Africa); **Peter Smith** (DFSA, Dubai); **Ciaran Walker** (Evershed Sutherland, Ireland); **Jocelyn Yiew** (MAS)

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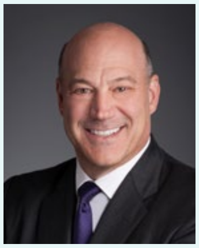
Our Advisors

FINANCIAL INDUSTRY ADVISORS



GARY COHN

Gary Cohn is Vice Chairman of IBM and Co-Chairman of Cohn Robbins Holding Corp. Prior to serving as Director of the US National Economic Council (2017-18) he was President and Chief Operating Officer of Goldman Sachs.

"We need reliable forward-looking metrics for non-financial risk governance, allowing for more meaningful horizontal reviews. That capability becomes all the more important in light of the current pandemic, which has dislocated our workforce, made the future of work less clear, and which makes misconduct within firms all the more damaging."

MARK COOKE

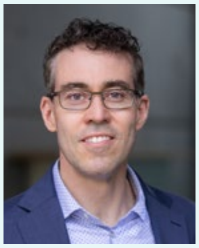
Mark Cooke joined HSBC in 2014 serving as Group Head of Operational Risk, before taking a sabbatical in 2020. He also served as Chairman of ORX, the financial services industry association for Operational Risk Management.

"An over-reliance on surveillance & monitoring and systems of record has not resulted in desired non-financial risk management outcomes. It is clear that new approaches are needed, and this makes Starling's annual Compendium *a must read for operational risk managers — in financial services or any sector struggling with behavioral risk."*

SIEW KAI CHOY

Siew Kai Choy was a Managing Director at Singapore's sovereign wealth fund (GIC) where he was Director of the Data & Analytics Department, Head of Governance and IT in the Public Markets Group, and founder of GIC Innovation Labs.

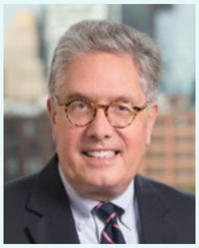
"Regtech firms have shown it is possible to distill signal from standard company data sets that tie to mission critical outcomes — including risk and governance related outcomes that are of key concern to boards, shareholders, and supervisors. This is sure to be of interest to anyone looking to better address the issues outlined in this report."



JAMES H. FREIS, JR.

Jim Freis was the longest-serving Director of the US Financial Crimes Enforcement Network (FinCEN) and, subsequently, Chief Compliance Officer and Anti-Money Laundering chief for the Deutsche Börse Group.

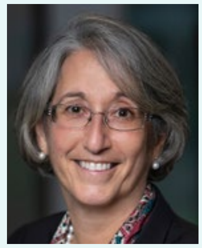
"To promote the integrity of financial institutions and markets, three things are critical: appropriate governance structures, the right people, and a readiness to leverage insights made available through evolving technologies. Summarizing global trends in this direction, Starling's annual Compendium *is a valuable industry resource."*



THOMAS CURRY

Thomas Curry was US Comptroller of the Currency and served as ex-officio member of the Board of Directors of the Federal Deposit Insurance Corporation (FDIC) and the Financial Stability Oversight Council.

"Managing the operational risk associated with culture and conduct remains an ongoing area of concern to bank management and their supervisors. For both constituencies, Starling's Compendium *is a valuable resource, offering ideas and capturing emerging best practices for those working to better assess and mitigate such risks."*



BARBARA NOVICK

Barbara G. Novick was a co-founder of BlackRock in 1988. She transitioned from Vice Chairman to Senior Advisor as of February 2021.

"Corporate governance and corporate culture are critical to the long-term value of companies. Too often, short-sighted decisions result in the negative outcomes that affect customers, employees, and the broader community, and in turn destroy shareholder value. Starling's Compendium *provides valuable insights into ways companies might mitigate these risks proactively, through the use of behavioral and data science."*

RICHARD KETCHUM

Richard Ketchum served as Chairman & CEO of FINRA, CEO of NYSE Regulation, Chief Regulatory Officer of the NYSE, President at both the NASDAQ and NASD, and Director of the Division of Market Regulation at the SEC.

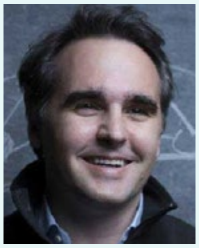
"The emphasis a firm's leadership places on measuring compliance with their proclaimed cultural values tells you a lot about whether they're committed to assuring that employee behavioral norms are consistent with the proverbial tone-from-the-top. Starling's Compendium *outlines good guidance for those seeking to move beyond mere window-dressing."*

ACADEMIC & SCIENCE ADVISORS

JOHN SEELY BROWN

"JSB" was Chief Scientist at Xerox and director of its renowned Palo Alto Research Center (PARC). He has served on the boards of Amazon, In-Q-Tel, and the MacArthur Foundation. JSB has published over a hundred scientific papers, nine books, and holds 11 honorary degrees.

"Invisible networks of social ties within organizations facilitate the flow of critical but intangible dynamics, like trust, identity, and social capital. These dynamics shape how we think, what we believe, and how we behave. By making such forces visible and actionable, we may work proactively to optimize organizational performance and mitigate risks."



DAMON CENTOLA

Damon Centola is the Elihu Katz Professor of Communication, Sociology and Engineering at the University of Pennsylvania, where he is Director of the Network Dynamics Group. Also a fellow at Stanford's Center for Advanced Study in the Behavioral Sciences, his research centers on social networks and behavior change.

"Computational social science has ushered in unparalleled opportunities to improve strategies for management, governance and behavior change within firms, and allows for the most advanced scientific understanding of strategic decision-making and organizational culture. These tools will shape the future of risk management in every industry, perhaps most immediately in the financial sector."

NICHOLAS A. CHRISTAKIS

Nicholas A. Christakis is the Sterling Professor of Social and Natural Science at Yale University, where he directs the Human Nature Lab and Co-Directs the Yale Institute for Network Science. He is widely known for his research in social networks and public health, and is author of *Blueprint: The Evolutionary Origins of a Good Society*.

"People are connected, and so their behaviors are connected. This fundamental fact has tremendous relevance for diverse management challenges, as both good and bad behaviors spread contagion-like within and between organizations. Combining these ideas with the right data sets, computational social science tools allow us to forecast 'epidemics of behavior.'"

KAREN COOK

Karen Cook is the Ray Lyman Wilbur Professor of Sociology at Stanford University, where she directs the Institute for Research in the Social Sciences and researches social networks and trust. For the Russell Sage Foundation Trust Series, she edited *Trust in Society* and *Trust and Distrust in Organizations*.

"The move away from hierarchical forms of authority to more horizontal and networked ways of managing businesses makes trust ever more central to their success. The trust of clients or customers is rarely seen when trust is lacking internally. And because internal trust dynamics shape performance outcomes materially, they warrant management tools and attention."

AMY EDMONDSON

Amy Edmondson is the Novartis Professor of Leadership and Management at the Harvard Business School. A widely influential and oft-cited thinker, her most recent book, *The Fearless Organization: Creating Psychological Safety in the Workplace for Learning, Innovation and Growth,* has been translated into 11 languages.

"Psychological safety is present when colleagues trust and respect each other and feel able — even obligated — to be candid. A psychologically safe workspace encourages staff to speak up about concerns and to offer their best ideas, making it highly relevant to the culture and conduct risk supervisory agenda summarized in Starling's Compendium."

BETSY LEVY PALUCK

Elizabeth Levy Paluck is a professor in the department of psychology and at the Princeton School of Public and International Affairs at Princeton University, where she also serves as deputy director of the Center for Behavioral Science & Policy. She is known for her work on social norms and social change, for which she won the 2017 MacArthur "Genius Grant."

"Research has demonstrated that we are profoundly influenced by the many social networks within which we reside: among friends and family, work colleagues, civic and voluntary organizations, churches and temples. Those networks shape our beliefs and our behaviors — and those networks can be managed with a view to shaping intentional behavior change for the better."

THOMAS MALONE

Thomas Malone is the Patrick J. McGovern Professor of Management at the MIT Sloan School, founding director of its Center for Collective Intelligence, and founding co-director of the MIT Initiative on "Inventing the Organizations of the 21st Century." His acclaimed book *Superminds* summarizes decades of his essential research.

"What I call 'superminds' are very powerful in shaping the cultures of firms. A kind of collective intelligence, they go unrecognized in most management circles. But superminds not only exist, they are observable and measurable, which implies that they may also be managed meaningfully. This may be of particular value in the culture and conduct risk management context."

TOM READER

Tom Reader is an Associate Professor of Organizational Psychology at the London School of Economics & Political Science, where he directs a Masters degree program in Organizational and Social Psychology. He studies the cultural norms and practices critical to averting accidents and risk management failures in teams and organizations.

"As in aviation, healthcare, nuclear power, and other critical industries, it is essential that financial institutions deploy a forward-defense to guard against risk governance failures. This requires a company culture that allows firms to anticipate and respond to emerging risks proactively — predicting and preventing bad outcomes rather than merely detecting and correcting for them after harm is done."

CONTRIBUTORS

In the production of this annual report, we strive to curate and present information without imposing our own views on such — except in those sections cleverly entitled **Our View**.

Despite best efforts to be neutral observers and reporters, bias will inevitably intrude in any such reporting exercise, if only in the choices we make about what to include and exclude from this report. In an effort to mitigate such bias, we solicit direct input from those whose views we seek to convey.

This we do in two ways:

- First, by forwarding a questionnaire ▸ **APPENDIX P. 484** to relevant figures in all major global financial centers, to better assure that we capture their views as fully and accurately as possible; and
- Second, by inviting their specific remarks, appearing throughout the report, and more fulsome contributed commentary and interviews that appear in the many **In Focus** segments herein.

For this, our fifth annual *Compendium*, we made a concerted effort to include voices that were not as well-heard in our earlier reports as we would have liked. We are delighted that this year's report includes contributions from Canada, The Bahamas and Dubai, for instance. And we are particularly proud to have had contributions from so many women.

We hope that this 2022 update to our annual report will help to prompt further informed discussion among banking industry executives, regulators and supervisors, central bankers and international standard setters, among other stakeholders. We are proud that so many of them have trusted us with the curation of this important dialogue and our sincerest thanks go to all those who have taken the time to offer views for inclusion here to the benefit of their peers.

As always, we welcome any questions, comments, or criticisms, along with suggestions as to how we may improve next year's report. Please reach us at info@starlingtrust.com.

Contributors

PREAMBLE

Framing the report

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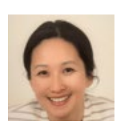

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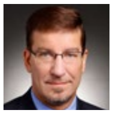
PEER PERSPECTIVES

leadership lessons from other sectors



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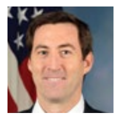

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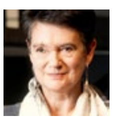
THE ACADEMY

with world-renowned scholars



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OUR VIEW

perspectives from our world-class advisors

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Co-founder and past Vice Chairman of BlackRock

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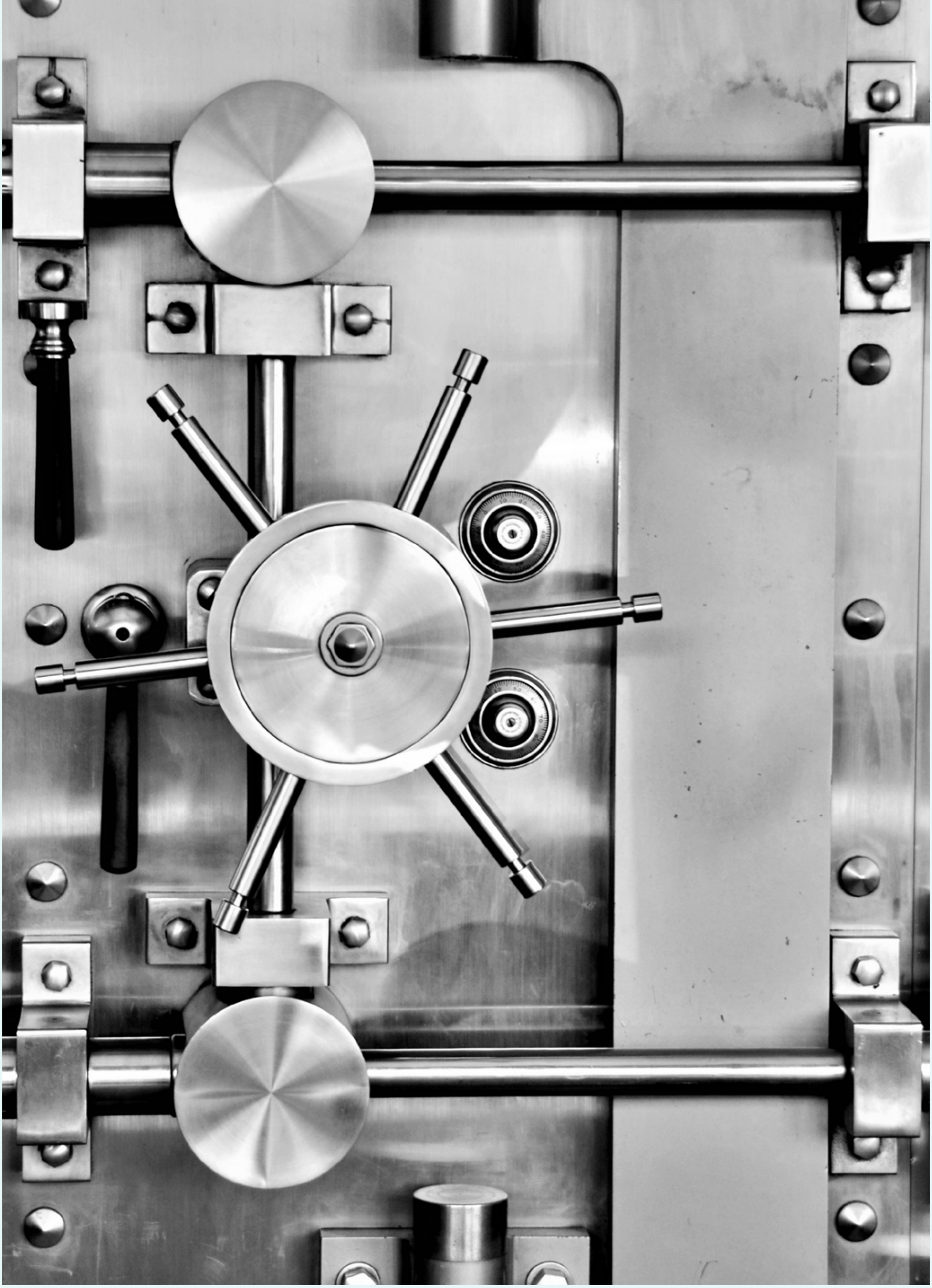
London School of Economics, Associate Professor of Organisational Psychology

CLOSING COMMENTS

where to from here?

KLAAS KNOT

Chair, Financial Stability Board, President, *De Nederlandsche Bank* and Member, European Systemic Risk Board



2022 Key Takeaways

1 Financial sector integrity is a national security interest — The extraordinary sanctions regime put in place by a majority of those nations that host the world's deepest financial markets, upon initiation of the current conflict in Russia-Ukraine, demonstrates that the global financial system plays a critical role in national security affairs. The integrity of that system is thus seen to be a national security priority.

2 Social concerns are business concerns — Past distinctions between 'society' and 'the market' are blurred in ways that present new challenges. Customers, employees, and investors raise an increasingly loud voice, insisting that firms and their leaders take concrete steps towards alleviating social tensions and imbalances — both those predating and those exacerbated throughout the covid pandemic.

3 Culture and conduct challenges are governance issues — Culture is consistently seen as culprit amidst continuing risk governance failures among firms, as well as in troubling lapses on the part of the auditors and regulators relied upon to assure market integrity. Culture is thus considered to be a critical governance priority — for private and public entities equally — and particularly so in the financial sector.

4 The Era of Accountability — As customers, employees, and regulators increasingly look to hold business leaders to personal account for damaging misconduct, in the wake of perceived oversight failures, industry overseers themselves are now facing heightened scrutiny from injured consumers, aggrieved investors, and irate legislators. Leaders confront a new era of personal accountability.

5 Speaking-Up and Speaking-Out — Regulators are prioritizing firm cultures marked by psychological safety, with a view to creating conditions that promote 'speak up' behaviors among staff who witness questionable acts and decision-making. Firms failing in this will contend with employees increasingly ready to 'speak out' — externally — when speaking up internally appears unwelcome or untenable.

6 Voting with their time — The "Great Resignation" shows employees to be seeking jobs offering three essentials: meaning, agency, and purpose. Meaning is found in work that allows for personal growth and connection with admired peers. Agency demands that employees feel directly able to effect change and outcomes. And purpose requires close alignment of personal and business goals and values — culture.

7 Predict & Prevent — Reliance on surveillance and monitoring to detect and correct for misconduct is no longer viewed as an adequate standard of care; firms must demonstrate a reliable capacity to predict and prevent stakeholder harm. Firms are looking to AI to achieve "predictive alignment" between values and operations, so that their brand is burnished rather than tarnished in each stakeholder engagement.

8 Business 'resilience' requires stable cultural girders — Disruptions to businesses and their supply-chains, triggered by the covid pandemic and now geopolitics, have placed a premium on firms' ability to achieve and demonstrate 'resiliency.' This includes the resiliency that is contingent upon firm culture and human capital management, for which new formal disclosure requirements are being contemplated.

9 "G is Key" — Environmental, Social and Governance (ESG) considerations have moved to the center of investment deliberations, reshaping markets and demanding of firms new priorities and related disclosures. While the E and S aspects get most press attention, a majority of institutional investors prioritize the G element, prompting demand for more predictively reliable risk governance metrics.

10 Pricing non-financial risk — So long as the costs associated with non-financial risk are recognized retroactively, they can be waived off as "costs of doing business." However, as firms adopt cultural and behavioral metrics to price non-financial risk proactively, expectations will shift to forecasting and mitigating them, to the benefit of investors, insurers, regulators, and other stakeholders.

Contents

Opening Letter

At a conference on "Reforming Culture and Behavior in the Financial Services Industry," hosted by the Federal Reserve Bank of New York in late October of 2016, I struck up conversation with a data scientist who worked at what was then known as the UK's Banking Standards Board (now the Financial Services Culture Board). Bank regulators around the world had begun to discuss culture in the industry as a matter of potential supervisory concern, we observed, but there was no available summary of what was being considered in the various global markets. We thought the industry would benefit by some shared resource that identified relevant trends, outlined emerging consensus views, and noted key points of departure.

Curious to learn more, Starling began a research effort in 2017, which culminated in the release of a report in the spring 2018 entitled, "Culture & Conduct Risk in the Banking Sector: why it matters and what regulators are doing to address it." This "*Compendium*," as we dubbed it, was well-received. So, we continued our research and began to solicit input directly from industry figures involved in the supervision and governance of culture and conduct related risks. Our 2019 report included several such contributions. Our 2020 report offered many more. Our 2021 report featured more still.

In this, our 5th annual *Compendium*, we are immensely pleased to have received contributions from some 60 global leaders representing: bank boards and executives; regulators, supervisors, central bankers and policy-makers; industry standard setting bodies and associations; renowned scholars working in fields as diverse as economics, law, finance, management, evolutionary biology, anthropology, and social psychology; and prominent figures from outside the financial sector, who have their own relevant wisdom and experience to share and were kind enough to do so.

We are humbled by this collective generosity and hope that our 2022 *Compendium* will serve as a valued industry resource.

Our 2018 inaugural report centered on a discussion of culture as something argued to be of relevance to a firm's performance, its non-financial risk profile and governance capabilities. That report also addressed the suggestion that culture was therefore something to which regulators should attend.

Our 2019 report began by discussing the importance of trust in the financial sector, the erosion of such since the financial crisis, and suggestions that behavioral science might offer new means by which to manage and supervise misconduct risk, thus helping to restore trust in the industry.

With an opening Preamble from the Dutch Central Bank — a pioneer in the application of behavioral science to culture and conduct supervision — our 2020 report continued in this same direction. That report closed with a discussion of social capital and its importance to economies and societies — particularly when set against the backdrop of the covid pandemic, which had just reordered all expectations and presumptions of what the years ahead might hold.

This discussion was at the fore in our 2021 report, opening with a piece from then Bank of England Chief Economist Andy Haldane, on the economic importance of social capital. Throughout last year's report, this theme was sounded in connection with the increased prioritization of ESG concerns. Debate regarding culture as a possibly important driver of conduct was by then fully resolved, as were questions as to whether culture was a matter that warranted supervisory attention. The challenge — for firms, their boards, their supervisors, and their investors — was how such risk governance concerns might lend themselves to reliable measurement — ideally proactively, so that harm might be staved off.

Carolyn Rogers, then Secretary General of the Basel Committee on Banking Supervision, closed our 2021 report. She noted that the financial crisis — and the "too big to fail problem" — led to a flurry of macroprudential policymaking aimed at reducing financial risk and maintaining resilient bank balance sheets. Looking ahead, she expected macroprudential attention would shift to assessing *non-financial* risks with greater rigor — conduct risk among them — and to ensuring resilient bank cultures, with a view to the "too big to manage" problem.

Our report this year picks up on all those foregoing themes. The main body of the report — "the *Compendium* proper" — discusses relevant events and priorities in evidence across the world's major markets over the course of the past year. This central reference is significantly enriched by the more detailed insights offered by regulators, supervisors, central bankers, and international standard setters who generously contributed to the **In Focus** series of inserts that featured also in our past reports. And continuing from past practice, we have included here a number of essays and interviews featuring several of our industry and academic advisors, who express **Our View** on topics central to the report.

Last year we introduced two additional series of contributed remarks: **The Academy**, featuring essays and interviews from renowned scholars; and **Ground Breakers**, profiling leading industry executives who have brought new approaches to culture and conduct risk governance. Those series continue here.

We also introduced last year a series of **Deeper Dive** pieces, affording greater study of the themes heard throughout that report. Space precludes inclusion of such this year, but several supplements will be released later in the year, providing detailed supplements to the material collated here.

In addition, this year, we are delighted to introduce two new series of contributions: **Good Counsel**, capturing the well-informed views of legal scholars and practicing lawyers; and **Peer Perspectives**, featuring relevant views offered by leaders outside the financial industry, who have also contended with culture and conduct risk issues, and whose experience may be helpful to those addressing these governance and supervision challenges in banking.

The In Focus series is found within the *Compendium* proper, aligned with the relevant sub-sections for the regions, countries, and authorities we cover. For ease of reference, Good Counsel, The Academy, Ground Breakers, Peer Perspectives, and Our View inserts are set apart in separate 'chapters' herein.

I believe it fair to say that our *Compendium* has become one of the principal platforms across which the industry addresses itself with regard to culture and conduct risk in the banking sector, why it matters — *and what the industry is doing to address it*. We are grateful to have been entrusted with the curation of such an important global discourse.

Stephen Scott
Founder & CEO, Starling
15 May 2022

I can calculate the motion of heavenly bodies,
but not the madness of people.

ISAAC NEWTON [1720]

Most of the time, members of our civilization
conform to unconscious patterns of conduct.

FRIEDRICH HAYEK [1960]

Preamble

From Tunnel Vision to Lateral Vision

by GILLIAN TETT

Gillian Tett

When Russia invaded Ukraine in February 2022, Western business leaders and policy makers reacted with shock. But Jeff Sonnenfeld, a business professor at Yale University, got busy: within a couple of days, his students had created a webpage that tracked which Western companies were withdrawing from Russia — and those which did not. It quickly expanded and campaigners started to use the data to demand that recalcitrant companies withdraw. Nestle was a case in point: after the Yale list revealed that it was still operating in Russia, activist hackers launched cyber protests, prompting Nestle to withdraw. "When this list was first published the week of February 28, only several dozen companies had announced their departure," Sonnenfeld explained on the site, in early May. "[But] we are humbled that our list helped galvanize 1000 companies to withdraw." Transparency, in other words, had a snowballing effect.

There is a bigger lesson about cultural change here that corporate leaders should note. On one level, this tale is a case study in Western anger about the Russian invasion of Ukraine. On a broader level, however, it also illustrates two crucial points: radical transparency is changing the social contract between companies and society; and this, in turn, is forcing business leaders to become more sensitive to shifts in the wider social zeitgeist.

The cultural, political and environmental context of business matters more than ever.

It is hard to overstate what a subtle-but-significant shift this represents compared to the second half of the 20th century. Fifty years ago, when the economist Milton Friedman developed his vision of shareholder-first capitalism, ordinary citizens had little way of keeping track of what companies were (or were not) doing. The main sources of information were official statements or shareholder reports, usually issued after a time lag. Even governments struggled to know what companies were doing.

Radical transparency is changing the social contract between companies and society.

No longer. Today platforms such as Glassdoor or social media sites are increasingly offering real-time insights into companies' internal affairs; when Boeing tumbled into scandal a couple of years ago around safety standards on its 737 planes, a pilots' social media chat room became a vital source of information for critics.

Environmental, social and governance activists are becoming adept at scraping data from other information sources about a company's environmental footprint. Former Vice President Al Gore is overseeing a public mapping and data visualization project that aims to reveal carbon emissions with so much granular precision that they can potentially be attributed to individual entities. And that Yale website provides another example of digital scrutiny. Investors do not need to wait until an Annual General Meeting to ask about corporate strategy on contentious issues (like operating in Russia); it is being tracked in real time.

Hence the importance of a second key point: tracking the social zeitgeist and seeing how business fits into the wider cultural context. When Friedman developed his "shareholder first" concepts, company leaders felt little need to tackle tough social issues, since there was a wider societal assumption that this could be outsourced to governments (and citizens did not know what companies were doing anyway).

Today, however, consumers are increasingly demanding that companies "act responsibly" — and businesses are under pressure to respond. The campaign around Russia is one dramatic example of this. But protest movements such as #MeToo or Black Lives Matter have shown how social attitudes can shift in other fields too, and activists such as Greta Thurnberg have contributed to a shifting social zeitgeist around environmental issues. The concept of "sustainability" has taken center stage, along with the idea that "stakeholderism" should replace Friedman's vision of "shareholder first" capitalism.

So how should company leaders and policymakers respond?

One oft-ignored set of ideas can be found in the discipline that I hail from: cultural anthropology, or the study of cultural and social systems. This is not a field that business executives usually know much about. It has an exotic, dusty image, since its adherents used to do their research in far-flung locations that seemed alien to Western onlookers (America's most famous anthropologist, Margaret Mead, studied in Samoa, for instance). Moreover, late 20th century business has tended to emphasize quantitative analysis, not qualitative (or "soft") research.

However, in today's world, there is a burning need to combine hard and soft sciences — mixing Big Data and artificial intelligence with some cultural analysis capability. And what most non-anthropologists do not know is that, today, anthropologists study Western cultures as much as non-Western ones. Indeed, there is a flourishing field of corporate "ethnography" whose practitioners have worked in places ranging from Intel to JPMorgan and the Bank of England.

Most important of all, the methodology of anthropology contains three ideas that any executive could learn from, particularly if they are seeking to understand cultural context.

First, anthropologists know that although humans always assume that the way they look at the world is natural, inevitable and unchanging, it never is: assumptions about what is "normal" vary between cultures, and shift stealthily over time.

Second, it is hard for anyone inside a culture to get a dispassionate view of their surroundings unless they periodically jump out of their world and look back, as a stranger in their own mental land. A fish cannot see water, as the Chinese proverb goes, unless it leaves its fishbowl and/or talks to other fish.

Third, to understand what makes a culture tick, you must not only look at what people are openly talking about, but what they are *not* discussing — because it is embedded in topics that seem obvious, or taboo or embarrassing. The topics that fall between the cracks of our classification systems are important; social silences matter.

Thus when anthropologists study a society, they try to take a holistic, bottom-up approach to studying its culture, usually by living with people, watching them and trying to develop empathy for their perspective. Anthropology is all about taking the worms' eye view, not just the birds' eye view; about looking at the gap between what people say and do — and what they do not say or do — and studying context.

Above all else, anthropologists try to use lateral vision, not tunnel vision, to make sense of the world.

This might sound abstract. But it should challenge any business executives who try to navigate the world from the safety of their offices, using intellectual tools beset by tunnel vision. Relying on economic models alone, for example, is dangerous since these are only as good as the parameters which are included in the model. So too with corporate balance sheets: if you just look at companies in terms of profits and loss, you will only get a partial perspective of what is happening, since what is excluded can be vitally important. A couple of decades ago, after all, issues such as medical risk, climate change or gender policies were viewed as "externalities": to the economic models, or footnotes in the accounts. Today, such issues are turning economic models and balance sheets upside down.

What leaders need today is lateral vision of how the environment around them is shifting. And they also need a willingness to embrace different perspectives. Both are at the core of anthropology.

Many corporate leaders already instinctively recognise the need for this shift, and view it in terms of new buzz words like "sustainability" or "stakeholderism". What the Environmental, Social and Governance movement does, after all, is encourage companies to look at their wider footprint in the world, using lateral vision, not Friedman's tunnel vision. However, a rigid box-ticking version of ESG does not provide true lateral vision. After all, the zeitgeist around ESG keeps changing too.

In today's world there is a burning need to combine hard and soft sciences.

Just think, once again, about Ukraine. Before February 2022, many Russian companies sat inside ESG baskets because they were embracing decarbonization policies. After the invasion, however, they became taboo. Similarly, gas companies and defense stocks used to be shunned by ESG. Today, as issues of national security and energy independence are becoming crucial, there is a new focus on so-called "friend-shoring", to use the term coined by Treasury Secretary Janet Yellen, extolling the merits of putting supply chains into seemingly friendly countries such as Mexico (rather than Russia or China).

Companies are now expected to collaborate with government in sensitive industries in a manner that was commonplace in the early 20th century but became unfashionable in recent years.

Ideas of ethics are shifting. So the crucial point is this: nobody can hope to navigate the world just by using cultural analysis; numbers matter too. But ignoring culture carries costs. Or to put it another way, if an executive today tries to create strategy just by using traditional economic models or corporate balance sheets, they will be like someone walking through a wood with a compass. Nobody would tell them to toss that compass away; economic models or big data sets are useful. But if you only stare down at a compass dial, without raising your eyes, you risk walking into a tree — no matter how technologically brilliant that compass might be.

Cultural context matters deeply, particularly when that context is shifting, which is why a business world that has embraced artificial intelligence needs to adopt another type of AI — Anthropology Insight — if they are to thrive and create a truly sustainable future.

***Gillian Tett** is chair of the editorial board and editor-at-large (US) of the* Financial Times*. She writes weekly columns, covering a range of economic, financial, political and social issues, and is co-founder of the FT's* Moral Money*: a twice weekly newsletter that tracks the ESG revolution in business and finance.*

In 2014, Tett was named Columnist of the Year in the British Press Awards, and was the first recipient of the Royal Anthropological Institute Marsh Award. In June 2009 her book Fool's Gold *won Financial Book of the Year at the inaugural Spear's Book Awards. June 2021 saw publication of her* Anthro-vision: A New Way to See in Business and Life *in which she draws on her own training in anthropology to illustrate the many ways in which the discipline may contribute essential insights to management decision-making.*

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Comments & Contributions

"What we have before us are breathtaking opportunities disguised as insoluble problems."[1]

Sounding a note of optimism in the Preamble to our 2021 report, the Bank of England's Andy Haldane argued that, for all the collateral damage they cause, crises like the covid pandemic allow for, "a re-evaluation, a rethink and a refresh in many of our behaviours and practices, whether as individuals, businesses, communities, or nation states." This reset and re-evaluation, he suggested, has prompted a reorientation of our working, business, and policy practices, and provided a nudge towards putting co-operation, trusting relationships, and well-being at the center of our discussions, decision-making, and deeds. Our badly frayed "social fabric," Haldane suggested, was being, "rewoven from the bottom-up."

What is this "fraying" of the social fabric? Perhaps the best discussion of this we have seen was offered by Jonathan Haidt, a social psychologist and professor of ethical leadership at New York University's Stern School of Business.[2] Haidt looks to the fall of the Tower of Babel, recounted in the Book of Genesis, and marshals it brilliantly as a metaphor for the social and civic rancor of the last decade. In the aftermath of the tower's destruction, the people of Babel were left "wandering amid the ruins, unable to communicate, condemned to mutual incomprehension." Though Haidt takes the United States as his focus, the metaphor serves well to describe a broadly distributed sense of disorientation that has been experienced globally — or at least in 'the West' — in recent years. During that time, we've ceased to view one another as brethren: discord, disregard and distrust have come to characterize our interactions. “We are cut off from one another and from the past,” Haidt laments, collapsing into ever smaller, like-minded tribes, ensconced in pervasive and corrosive social media ‘filter-bubbles’ that render us further entrenched in our hostile stance towards ‘others.’

But Haidt also notes that, historically, “civilizations have relied on shared blood, gods, and enemies to counteract the tendency to split apart.” As we go to print, the unconscionable Russian aggression in Ukraine is perhaps serving to pull some of us back together. To further abuse a term overworked since the start of the covid pandemic, the international sanctions regime imposed against Russia — by governments in every major financial center — is truly ‘unprecedented.’

And perhaps that affords some room to join in Haldane’s optimism? While it may be that a ‘shared enemy’ precipitated current collective endeavors to choke off war through economic means, that action itself evidences shared aspirations. “During this difficult time,” wrote JP Morgan chief Jamie Dimon in his most recent letter to shareholders, “we have a moment to put aside our differences, offer solutions and work with others in the Western world to come together in defense of democracy and essential freedoms.”[3] As we join in collaboration towards these common goods, perhaps this will help us to reweave our social fabric at an accelerated pace?

All together now

Russia’s Internet Research Agency, a propaganda arm of the government, has endeavored to sow distrust and discord among Americans, and between America and her allies, with alarming success.[4] Through its aggression in Ukraine, however, Russia has inadvertently provided us with a common and binding threat. Pulling together to successfully face down that threat is a national security imperative. And, therefore, so too is overcoming past distrust and discord.

“The war in Ukraine represents a rupture in the system of rules that governed global stability,” Monetary Authority of Singapore Chairman Tharman Shanmugaratnam stated, in a March 2022 speech. “It will be a rupture with many ramifications.”[5]

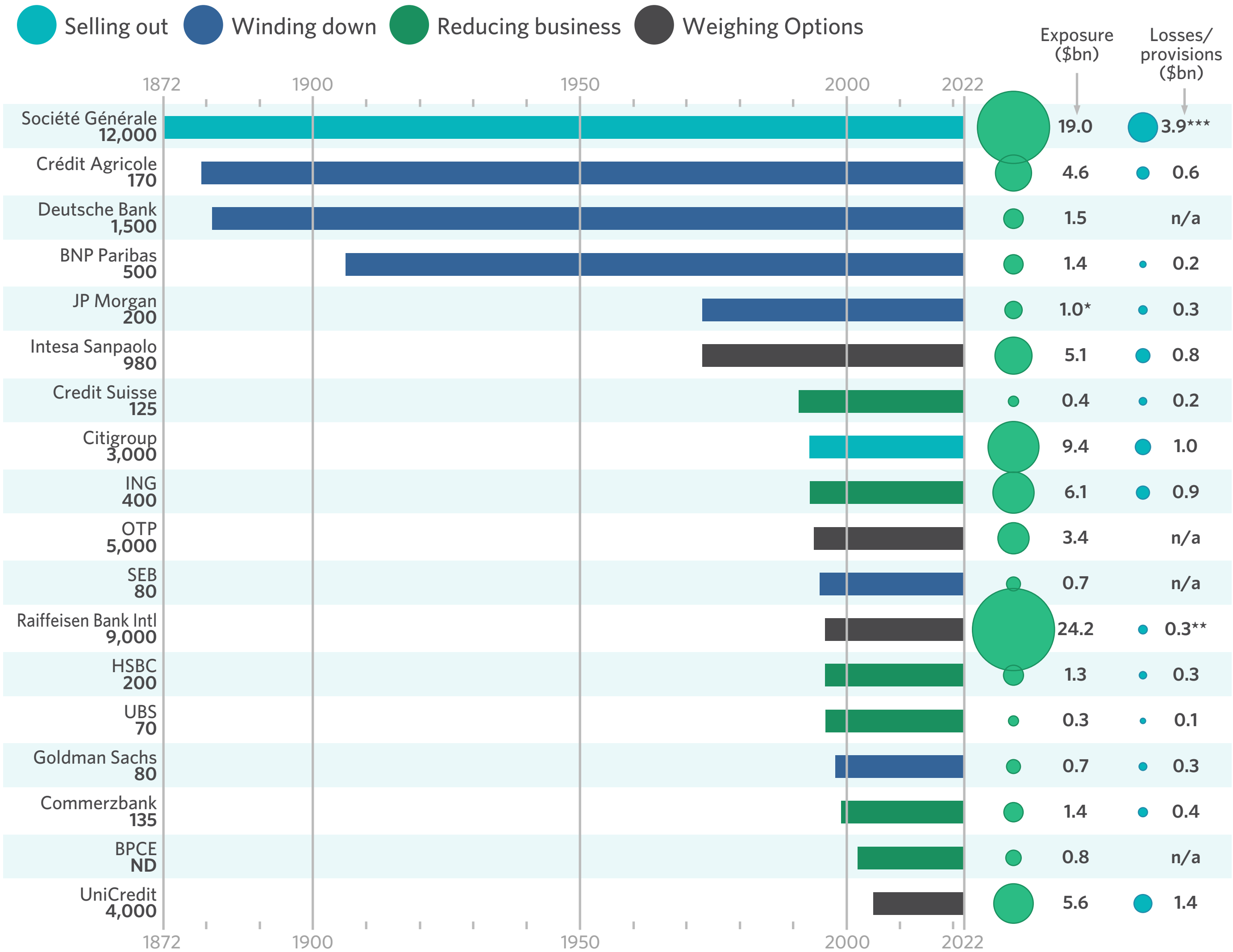
> The war in Ukraine represents a rupture in the system of rules that governed global stability.
>
> **MONETARY AUTHORITY OF SINGAPORE CHAIRMAN THARMAN SHANMUGARATNAM**

The next day, Goldman Sachs and JP Morgan joined hundreds of businesses in other industries that had decided to wind down their Russian operations.[6] A day later, Deutsche Bank announced that it would shutter its Russian business.[7] BNY Mellon announced that it would take a $100 million hit to quarterly revenue due to its own decision to pull back from Russia.[8] Later in the month, BNP Paribas and Crédit Agricole elected to sever their ties with the Russian market.[9] Though UniCredit, Société Générale, Raiffeisen and Citigroup disclosed a combined Russian exposure of over $57 billion, all felt pressured to abandon their Russian interests.[10] Citigroup, which had already begun to pull back from Russia before the Ukraine invasion, announced in mid-March that it would accelerate its withdrawal, and anticipated having to absorb significant losses as consequence.[11] In April, Société Générale announced it would take a €3.1 billion hit after agreeing to exit Russia by selling its interests in Rosbank,[12] raising pressure on other firms to follow suit.[13] In total, western banks are estimated to have some $86 billion exposure to events in Russia, with some $10 billion of that provisioned as expected losses.[14]

In early March, the US Treasury Department’s Financial Crimes Enforcement Network (FinCEN) advised US financial institutions to exercise added vigilance regarding potential efforts to evade the

Foreign Banks in Russia

Year bank first entered Russian market and staff numbers in Russia



Visual journalism: Steven Bernard & Patrick Mathurin
Source: FT research *potential losses **mostly attributable to Ukraine war ***€3.1bn loss on sale of business plus €561mn provision mostly tied to war
©FT

sanctions imposed on Russia, and identified a number of red flags indicative of such activity.[15] The House Financial Services Committee in Congress has since sought to obtain detailed information regarding those businesses that have decided *not* to withdraw from the Russian market, with particular focus on financial firms.[16] Those failing to curtail their Russian dealings may find themselves called to testify before the Committee.[17]

In mid-March, the US Departments of the Treasury and Justice launched a Russian Elites, Proxies, and Oligarchs (REPO) multilateral task force, with participation at ministerial level, across numerous allied nations.[18] This adds to the tasks — and risks of noncompliance — that now confront banks, which have been pressed into targeting "blacklisted" Russian individuals and assets.[19] After reports that Credit Suisse had instructed hedge funds and other investors to "destroy and permanently erase" documents relating to loans backed by "jets, yachts, real estate and/or financial assets" owned by any sanctioned Russian oligarchs,[20] the House Committee on Oversight and Reform and the Subcommittee on National Security in the US Congress launched investigations into the firm.[21]

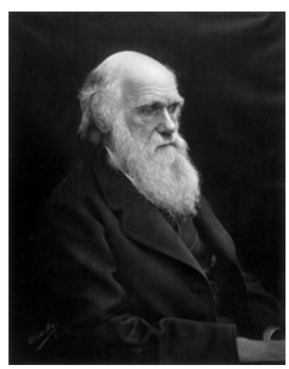
This level of corporate participation in geopolitics, and the speed with which such collective action was achieved, has never before been seen.[22] The sanction's impact on Russian banks was immediate. Its two largest firms, Sberbank and VTB, account for about half of the country's banking market. Predominantly owned by the government, VTB has been central to Russia's economic development. At the start of the year, Sberbank was second only to HSBC in market value among European banks. Both Sberbank and VTB were mortally imperiled by the sanctions regime and made reliant upon the support of Russia's Central Bank.[23] In April, the US escalated sanctions targeting Sberbank and Russia's Alfa-bank, after President Biden decried "major war crimes" committed by Russia. "Responsible nations have to come together to hold these perpetrators accountable," he said.[24] The US government has since begun sharing intelligence with foreign banks.[25]

Efforts to cut Russian banks out of the SWIFT international payments system continue to mount. This month, European Commission President Ursula von der Leyen announced the EU would take measures to, "hit banks that are systemically critical to the Russian financial system and Putin's ability to wage destruction."[26] UK financial regulators have insisted that banks go further than refusing to do business with Russian individuals and firms. They are investigating how Russian money is moved around the world, and the Financial Conduct Authority has warned that it would bring its "full toolkit" to bear in this regard.[27]

Though it did not pull out of Russia, the UK's largest financial firm, HSBC, said it would step up scrutiny of its Russian clients.[28] In what was perceived by some as adopting too soft a stance, HSBC removed reference to "war" in its reports to analysts,[29] referring instead to a "conflict" in Ukraine.[30] Thereafter, trustees of the UK Parliament's pension fund agreed to sell all investments linked to Russia[31] — to include its investment in HSBC.[32] Some have speculated that HSBC finds itself caught between its interests in China and those in its western markets.[33] Notably, China has refused to refer to Russian aggression as an "invasion,"[34] and has rejected calls to join the sanctions regime.[35] As we go to print, China's Ping An Insurance, HSBC's largest shareholder, is pushing for its break up.[36]

It is unclear how this 'weaponization of finance'[37] will continue to impact firms' operational and non-financial risk governance, and how it may expand potential exposure to regulatory sanctions or other liabilities. What is clear, however, is that banks now face increasingly complex and uncertain governance, risk and, compliance tasks,[38] which will underscore the importance of maintaining resilient cultures and effective conduct risk management capabilities.

"I do not think that there is any evidence that man ever existed as a non-social animal."



Thus wrote Charles Darwin in an 1871 letter.[39] That same year saw the publication of William Stanley Jevon's *Theory of Political Economy*, one of the first books to present economics as a mathematical science and to emphasize the maximization of 'utility.'[40] "The theory which follows is entirely based on a calculus of pleasure and pain," Jevons wrote, "and the object of Economics is to maximise happiness by purchasing pleasure, as it were, at the lowest cost of pain." Of the two, it was Jevon's ideas that took hold in management science. Today, however, Darwin is in the ascendent.

"The cultural, political and environmental context of business matters more than ever," writes Gillian Tett, Chair of the Editorial Board at the *Financial Times*, in her **Preamble** to this year's report. ▸PAGE 5 In the late 20th century, as economist Milton Friedman's shareholder-first view of capitalism took hold, business information was scarce, of questionable veracity, and available only after considerable time-lag. Today, "radical transparency is changing the social contract between companies and society," Tett observes. As "sustainability" and "stakeholderism" have taken center stage, businesses are under pressure to demonstrate that they act "responsibly."

The cultural, political and environmental context of business matters more than ever.

Responding to the current *Zeitgeist* successfully confronts management with new challenges that the orthodox training in management science largely fails to contemplate. "Just as adding salt to food binds the ingredients and enhances flavor," Tett writes, in *Anthro-vision: A New Way to See in Business and Life*, "adding anthropological ideas to disciplines such as economics, data science, law, or medicine creates a deeper, richer analysis."[41] The methodology of anthropology offers three key management lessons: first, that which is viewed as 'normal' and fixed is in fact contextual and fluid; second, it is difficult to step outside from presumed day-to-day 'realities,' to consider assumptions afresh and with some degree of objectivity; and, third, to understand what makes a culture tick involves studying not only what people say and do, but also what they refrain from saying and doing. "Social silences matter," Tett writes.

When anthropologists study any given society, Tett explains, they adopt a holistic and bottom-up approach to studying its culture. Managers would be well advised to do likewise as they consider how to optimize the performance of their businesses, and mitigate attendant operational and behavioral risks. "Above all else," Tett emphasizes, "anthropologists try to use lateral vision, not tunnel vision, to make sense of the world." Achieving lateral vision in an organizational context means deploying new management tools. "Blending computing and social science should be a priority today," Tett argues in *Anthro-vision*. "Computer science needs social science if you want to make sense of data." As business makes ever greater use of artificial intelligence, Tett urges them to adopt a companion AI: "Anthropology Insight."

In one of a series of contributions from **The Academy**, Cambridge economist **Diane Coyle** extends Tett's views, criticizing the "methodological individualism" that characterizes traditional economics.[42] ▸PAGE 355 "What I take from the literatures in psychology and biology," Coyle notes, "is that we have a lot yet to learn about the way people take decisions, and how our internal wiring for making decisions and the external context interact." Anthropology, she contends, is a "natural companion discipline" to the economic orthodoxy that holds way in most policy-making deliberations. In *Cogs and Monsters: What Economics Is, and What It Should Be*,[43] Coyle asks provocatively, "Why is there no Chief Government Anthropologist?"

This perspective is echoed by criminologist **Adam Fine** of Arizona State University and legal scholar **Benjamin Rooij** at the University of Amsterdam, who contribute to the series of essays that feature in our report this year labeled **Good Counsel**. ▸PAGE 143 Fine and Rooij discuss what they refer to as the "Behavioral Code," exploring what behavioral science may teach us about compliance. Challenging the prevailing view that legal incentives (and disincentives) drive human behavior, they argue that, "compliance is not just a matter of motivation, but also of context." Humans take decisions and action based on "motivational and situational processes" which the law, and compliance regimes, tend to ignore. We should not be surprised, therefore, when these regimes fail to deliver desired outcomes.

In continued **Good Counsel**, **Brandon Garrett** (Duke University School of Law) and **Greg Mitchell** (University of Virginia School of Law) take this argument a step further. Garrett and Mitchell are critical of what they call a "compliance trap," born of misplaced hope and fear. ▸**PAGE 161** "A large compliance industry exists to identify and implement practices that have shown promise in some settings and, most importantly, have satisfied regulators," they note. Why not hope the adopted approach will produce better outcomes going forward, despite repeated past failures? Particularly given fears that testing to see whether these practices work as intended, "poses the substantial risk of creating evidence that the measures are not in fact mitigating risks." Expanding on arguments offered in their paper entitled "Testing Compliance,"[44] Garrett and Mitchell see this combination of hope and fear resulting in what they term a "rational ignorance" about the true effectiveness of current standard compliance programs.

Overcoming such ignorance requires that we de-emphasize today's over-reliance on systems of surveillance and monitoring, aimed at catching-out bad actors, argues Yale Professor of Law and Psychology **Tom Tyler**, in further **Good Counsel**. ▸**PAGE 147** Expanding on arguments made in *Why People Cooperate: The Role of Social Motivations,*[45] Tyler argues that surveillance, "fails to capture the powerful influence of social motivations that exists within most populations." This is true also of sanctions-based approaches to regulation. Tyler argues that a better approach would start by recognizing that employees want their voices to be heard, that they care about fairness and respect, and that they want to believe that management and regulatory authorities are acting out of trustworthy motives. When these conditions go unmet, compliance and regulatory regimes are seen to be lacking in legitimacy and "procedural justice," consequently failing to shape behavior in desired directions.

"I'm convinced that we need a permanent culture change in banking, and across corporations more generally," says **Axel Weber**, until quite recently Chairman of UBS. ▸**PAGE 71** Among the **Ground Breakers** we feature this year — leaders who have brought some of these more human-centric approaches to the governance of culture and conduct risks within their organizations — Weber describes a Corporate Culture and Responsibility Committee he created and chaired at UBS, with a focus on instilling a long-term oriented culture. This long-term mindedness ties directly to the interests of the firm's clients, Weber argues, and to responsibilities UBS has adopted with regard to ESG interests.

I'm convinced that we need a permanent culture change in banking, and across corporations more generally.

Weber decries a top-down and *post facto* "audit-centric" approach to culture and risk governance. Rather than prioritize a "culture of compliance," he urges, a firm's leaders must seek to maintain a culture that prioritizes the delivery of good quality outcomes for clients. Moreover, "banks have to understand that they are part of society." With war raging in Europe, "this link between banking and society has never been as clear as it is today," Weber emphasizes.

Included among the **Peer Perspectives** offered this year is a discussion regarding the current sanctions regime imposed against Russian interests, joined by **Richard Spencer**, former Secretary of the US Navy and a past partner at Goldman Sachs, **Owen West**, Assistant Secretary of Defense for Special Operations from 2017-2019 and a former partner and energy trader with Goldman Sachs, and **Timothy O'Neill**, currently a Senior Counselor in the firm's Executive Office. ▸PAGE 417 Capital has long been deployed (or withheld) in service of geopolitical aims, O'Neill reminds. "What we're seeing now is the tactical application of these tools in a very different way," Spencer offers. "The magnitude of it is unsurpassed and I think that's a key difference." But, as West points out, the ruble is now trading higher than its pre-invasion levels, NATO allies struggle to agree on the entities and individuals to sanction, and some companies continue to pay in rubles. "Western banks have been unwilling to take on a leadership role in the sanctions context akin to the way they've led on social change issues and best practices in corporate governance," West concludes.

These circumstances highlight the importance of culture and risk management in the financial sector. "The cleverest frauds are all analog," O'Neill observes. "They involve human beings interacting with one another." Spencer argues that we should seek to become more proactive in managing these risks. With AI and machine learning tools, he notes, banks have been highly predictive in managing financial risks. "Why aren't we applying those sorts of tools more commonly to our internal and operational risks?", Spencer asks. "That old comment, that culture eats strategy for breakfast, is just so true," he adds, tying this to the growing attention to ESG interests that prioritize setting good culture and governance standards. "As we get more data on causality rather than correlation," O'Neill suggests, "ESG may be the ultimate value factor in stock selection." West emphasizes that testing for good risk governance requires, "a core set of business principles that are reinforced from the C-suite, down through the ranks, and back up again." Regulators, investors, boards, employees, and customers are increasingly watching for this.

Trust and Total Factor Productivity

$$Y = A \times K^{\alpha} \times L^{\beta}$$

Economists employ the term Total Factor Productivity (TFP) to explain that portion of economic output that cannot be explained by capital (K) and labor (L) inputs to production alone.[46] In essence, when we get more output (Y) than our economic models can readily explain, we fudge the numbers, crediting the excess productivity to some mysterious factor, TFP (A). But what is this actually measuring?

TFP, "has been shown to be the main driver of economic performance," economists Christian Bjørnskov and Pierre-Guillaume Méon note in a fascinating paper.[47] Their research suggests that TFP is, in fact, a measure of what they term "the productivity of trust." Moreover, the evidence implies that the effect of trust on productivity operates through legal and regulatory governance mechanisms. Establishing "a clear and robust association between levels of TFP and social trust," Bjørnskov and Méon go on to show, "a clear and robust relation between social trust and the growth of TFP." These trust effects on TFP, in turn, depend heavily on quality of formal institutions.

It is therefore a worry when the quality of our institutions deteriorates. In its 2022 *Trust Barometer*,[48] Edelman finds that almost two-thirds of people are inclined to distrust organizations today. This complicates and may undermine our ability to collaborate successfully. Confronting challenges posed by the covid pandemic offers a case in point.[49] With regard to pandemic response efforts, heading into 2022, Bill Gates pointed to collapsing trust as one of his primary concerns.[50]

Singapore has managed the pandemic more successfully than many other nations. In this connection, Prime Minister Lee Hsien Loong has pointed to trust in government and leadership as the city-state's "most precious resource."[51] The banking sector is perhaps uniquely vulnerable to a loss in trust.[52] Indeed, some have suggested that a decline in trust in traditional financial firms has spurred growth of fintech and digital 'neobanks.'[53] Mindful of its importance, the Association of Banks in Singapore has worked with Edelman to study trust in the local industry closely in recent years.[54]

"When people lose trust in institutions," Jonathan Haidt observes, they also lose faith in the claims that leaders of those institutions make. "When citizens lose trust in elected leaders, health authorities, the courts, the police, universities, and the integrity of elections," he continues, "every decision becomes contested; every election becomes a life-and-death struggle to save the country from the other side."[55] And because trust is more difficult to measure than other forms of capital, its loss is often *felt* long before it is *seen* in any standard metrics.[56]

More than an abstract concept, trust is a tangible measure of performance that should be managed proactively.

What is true at the macro-level of societies and economies is true also at the micro-level of individual firms and organizations. The military has long recognized the importance of trust to mission command and success.[57] A meta-analysis of relevant academic research papers finds intra-team trust to be positively correlated to team performance.[58] "More than an abstract concept," Deloitte has argued, "trust is a tangible measure of performance that should be managed proactively."[59] But how are we to make trust 'actionable' in a practical management context?

With Andy Haldane, and others who point to social capital's economic value, Cambridge economist Sir Partha Dasgupta defines such capital in terms of, "interpersonal networks whose members develop and maintain trust in one another."[60] The mutual enforcement of behavioral norms that promote such trust *among group members* is key here, rather than reliance on some form of external enforcement. "If we want to work for better outcomes," economist Paul Seabright suggests, "we should forget about trying to change human nature, and concentrate instead on changing the conditions under which people interact."[61] And if we want to understand what shapes our social networks, trust relationships, and interaction patterns, then we're well-advised to set aside economic theory and start by considering humans at a far more fundamental level.

Oxford anthropologist and evolutionary psychologist **Robin Dunbar** joins those from **The Academy** writing herein. ▸PAGE 347 "We are apt to forget that, as a species, we have only lived in settlements of any size for around 8000 years," Dunbar reminds. "Beyond the tribe, the world was largely anonymous and rather menacing. Our psychology is designed for this small-scale world." Evolution has left us predisposed towards collaboration in small groups, Dunbar has demonstrated, mounting in size from 5 to 15 to 50 and 150. As we move outward from the center of our social worlds, trust declines and emotional distance increases. "We typically devote 40% of our total social time to just five people," Dunbar's studies have found, "and around 60% to just 15 people." Limits in our ability to scale trust in turn limits the size of the groups with which we are inclined to collaborate, and with whom we do so successfully.

There's tremendous plasticity to behavior, conditioned on social factors that can be studied

This has management implications. As they are human creations, organizations — and firms — are necessarily social in nature and operation. "The internal dynamics of any business is subject to the same stresses of scale as those that threaten to destabilise our social networks," Dunbar argues. "When both get too large, they start to fracture and fall apart." As such, it is common to find that people in organizations tend to cluster into small-scale collaborative peer groups, bound by mutual trust ties.

A study recently reported in the *Harvard Business Review*[62] looked at the impact of trust in relationships between survey participants and (1) their workplace teammates, (2) their team leaders, and (3) senior leaders. Those reporting high levels of trust for people in two of the three categories were three times more likely to be fully engaged at work and to be "highly resilient" employees. Those reporting high levels of trust among all three categories were *fifteen* times more likely to be fully engaged and highly resilient.

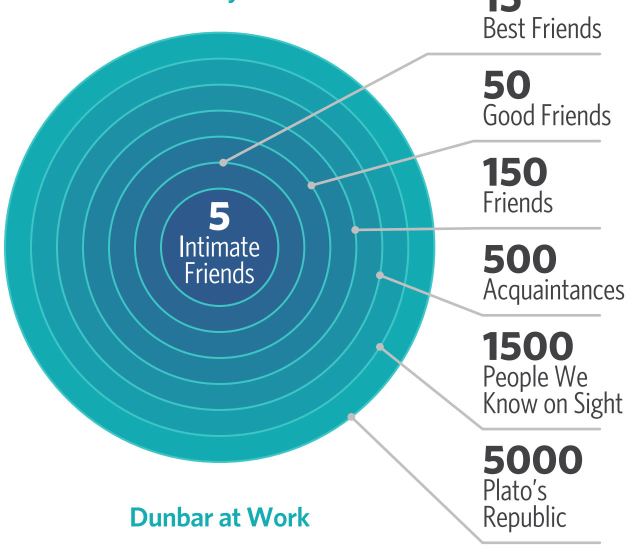
Sharing **Our View**, an illustrative discussion of these behavioral predilections, and how they play out in the workplace, can be found in an interview with **Betsy Levy Paluck**, Acting-Chair of the Psychology Department at Princeton and Deputy Director of its Kahneman-Treisman Center for Behavioral Science & Public Policy, and **Damon Centola**, Director of the Network Dynamics Group and professor of Communication, Sociology & Engineering at the University of Pennsylvania. ▸PAGE 445

"There's tremendous plasticity to behavior," Centola says, "conditioned on social factors that can be studied." Our behaviors, he argues, are in many ways dictated by heretofore invisible social forces that science has now made visible and operable. He draws a sharp distinction between "simple contagions" — like the spread of a disease, moving from one to the next via mere exposure — and "complex contagions," such as the spread of a behavioral norm. The former is well suited to *information* transfer, Centola explains, but the latter is necessary for *knowledge* transfer. He also points to a distinction between thoughtful *collaboration* efforts as contrasted with the more instinctual ways by which we approach *coordination* efforts. The latter is perhaps more interesting to study, Centola argues, if only because, on surface, it appears trivial. In fact, however, most of our behavior within organizations is shaped by unconscious efforts to simply coordinate effectively, and this implies conforming to peer norms and expected behaviors in our day-to-day activities.

"When those who have to answer for the effects of some particular organizational culture think about trying to change that culture," Paluck notes, "they most often think about top-down processes." Her research focuses on what she calls "networks of attention," and her findings are that we are far more likely to attend to those *around* us rather than those above us. This comports with Dunbar's observation that our stock of social energy is devoted to a small core group of intimates. "For anyone interested in culture change, it's important to know what networks of trust are at work in the organization," Paluck recommends. Those to whom we attend more readily in the workplace may not always be those whom we trust most deeply, but it's likely the case most often.

And those who receive much peer attention, "have an outsized influence on our ideas about what's expected in any given organization," Paluck explains. "And, to me, that's what culture is really about."

Dunbar Dynamics



Dunbar at Work

"The top-down management approach fails in cases where people are being asked to innovate, or to shift norms in ways that are uncomfortable or different," Centola argues. "That's because it ignores the realities of day-to-day work in an office, where we are not only coordinating with peers, but we're also entrenched in ways of doing things that have been successful." Behavior change initiatives will only be sustainably successful if driven from the bottom-up, with peer confirmation — or 'social proof' — in ready and abundant evidence. This does not mean that driving culture or behavior change cannot be intentionally achieved, however. "We're at the point in our science where we have an understanding of networks and of norms such that, if we're going to invest in culture change, we know where to look," Paluck contends. "We have really good ideas about where and how to intervene to drive change."

We're at the point in our science where we have an understanding of networks and of norms such that we have really good ideas about where and how to intervene to drive change.

Here we go again

Business Law and Ethics Professor **Todd Haugh** (Indiana University's Kelley School of Business) joins those offering **Good Counsel** herein. ▶PAGE 153 Haugh observes that, "approximately once a decade, a highly publicized corporate scandal occurs, there is public outcry, then a broad legislative response, and finally a compliance boom." But this has not resulted in any less misconduct. Behavioral studies have found that there are "systematic and predictable ways" in which individuals make moral decisions, and these are often contrary to what intuition would suggest. Ethical behaviors spread across social networks much like health-related behaviors, Haugh contends, arguing with Dunbar, Centola, and Paluck. Social network dynamics, and the theories underlying them, have been used in public health to model the spread of disease, Haugh writes. And they can also be used, "to better understand how corporate crime and organizational noncompliance occurs, is fostered, and spreads within companies and across industries." Haugh encourages us to employ such behavioral science insights in a "public health model" of compliance.

In an **In Focus** interview this year, former Secretary General of the Basel Committee on Banking Supervision, **Bill Coen**, discusses his years of experience confronting financial crises. ▸PAGE 323 Research suggests that a major crisis can be expected once in about every seven years. Among all of those that Coen has witnessed, "an element of deficient corporate governance" was evident. And although each crisis imparted lessons and triggered after-the-fact corrective measures, these most often wind up fostering a false sense of security regarding future resilience, however unintended.

Coen warns of complacency risk, reminding that, "if you can't measure it, you can't manage it." And if firms cannot measure or effectively manage a risk themselves, he adds, regulators will struggle as well. Firms and their supervisors must therefore work in concert to devise a means of assessing non-financial risks proactively. Ideally, firms would see it in their own self-interest to 'stress-test' their risk governance capabilities, Coen says. But he expects the industry will likely need prompting in this direction from regulators. As their level of culture and conduct risk supervision increases, he adds, this may prove to be "effective and enduring in providing the necessary impetus."

In another contribution from **The Academy**, Oxford economist **Sir John Kay** takes issue with tying misconduct to the notion of the firm as a "legal person," operating through some identifiable "directing mind and will." ▸PAGE 349 "All organisations need some hierarchy," Kay allows. "People need to know when decisions have been taken and what they are." But he challenges the presumption that organizations operate through 'command and control' structures. Were such an effective means of large-scale economic organization, Kay observes wryly, "the Soviet Union would have been a rip-roaring success." Indeed, in a landmark case brought against Barclays,[63] the courts found no such controlling mind to be in evidence. The case failed, Kay notes, because allegedly fraudulent acts were made "by and on behalf of the bank, rather than by any particular individuals." Picking up on themes discussed in *Greed is Dead: Politics After Individualism,*[64] Kay applauds the UK's Senior Managers and Certification Regime (SMCR) as an effort to hold individuals accountable for misconduct that takes place at the firms they lead.

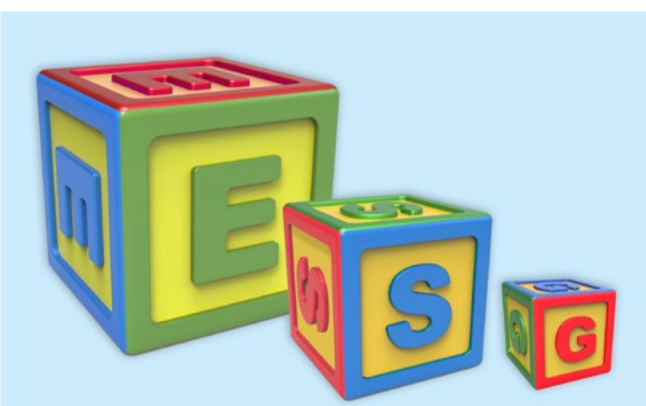
Adding to the **Good Counsel** offered herein, **Ciaran Walker** of Eversheds discusses the efficacy of such "new individual accountability regimes." ▸PAGE 179 Closely examining experience had to date in the UK, Australia, and his native Ireland, Walker reminds us that the SMCR followed from the recommendation of a UK Parliamentary Commission on Banking Standards, set forth in a 2013 report, "Changing Banking for Good."[65] A core factor giving rise to misconduct in the industry, that report found, was a "striking limitation on the sense of personal responsibility and accountability of the leaders within the industry for the widespread failings and abuses over which they presided."

A feature of all these accountability regimes, Walker notes, is the requirement that firms specify who is responsible for what at senior levels across the organization, in a documented Statement of Responsibilities. But while firms may specify individuals accountable for meeting certain responsibilities, it is nevertheless difficult to prove that these individuals were in fact negligent in their duties after some mishap. As such, if these accountability regimes are to be judged on the basis of the number of successful enforcement actions taken against senior executives, "the evidence to date might suggest that they have not been a success," Walker concludes.[66]

Who delivers the post to the postman?

Misconduct often occurs, as Kay notes, without any obvious 'controlling mind' that can be held culpable. And because regulators will not typically direct firms in how they are to manage their conduct risk governance — firms are expected to work out the details themselves — this can leave regulators casting about for information without knowing what they should be seeking, or where precisely it is to be had. Firms, meanwhile, struggle to evidence that their risk governance efforts should be seen as adequate, not knowing what metrics regulators will find compelling.

In an **Our View** piece, this dilemma is the focus of in an interview with **Gary Cohn**, past-President and COO of Goldman Sachs and now Vice Chairman at IBM, **Keith Noreika**, a past Acting Comptroller of the Currency who now advises firms on regulatory matters at Simpson Thacher & Bartlett LLP, and **Barbara Novick**, a founder, past Vice Chairman, and now Senior Advisor to the leadership of Blackrock. ▶PAGE 427 What comes through clearly in that discussion is uncertainty as to who, in any company, ultimately 'owns' responsibility for assuring the efficacy of risk governance infrastructures.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Opening the discussion, Novick emphasizes the role of the board in assuring effective risk management, tying that to the G in ESG. The lion's share of attention is focused on E and S, she notes, "and that's unfortunate, because G is the most important," Novick adds. She points to the 737 Max crashes at Boeing, 'Dieselgate' at Volkswagen, repeated dam collapses at Vale, and the false accounts scandal at Wells Fargo. In all instances, the same problem appears evident. "Where was the board in terms of the oversight of these risks?"

> "G is key."
>
> BARBARA NOVICK

"G is key," Novick concludes. After the Vale mine disasters, the company agreed to compensation payments for 'socio-economic' and 'socio-environmental' harm. "So, that's the S and the E in ESG," Novick adds. "But what was really at play here was an underlying governance issue: whether or not the board was overseeing risk properly by challenging management's risk assessment." In March last year, the US Securities and Exchange Commission (SEC) formed an Enforcement Task Force Focused on Climate and ESG Issues.[67] Notably, the SEC recently charged the Brazilian mining company with misleading investors — pointing specifically to representations made in its ESG disclosures with regard to the company's safety measures and risk governance.[68]

Rather than look to boards, Cohn argues, we should look to senior management. "A board can't be expected to run the day-to-day governance, or culture and conduct of these large organizations, whatever industry you may be in," Cohn says. He notes, however, that senior management is only as good as the data it has to work with. "It is unquestionable that bank leaders want to get off the back foot around non-financial risk in a similar fashion to how we've done so for financial risk," he contends. "The question is, how?"

The most vital information regarding these risk issues tends to reside deep in the bowels of an organization, Cohn says. And as that information makes its way up to senior management, it gets filtered and watered-down so that key information is lost or altered such that it no longer reflects operational reality. "Is there a way to bring the day-to-day operational insights in the core of the organization up to those at the top who are trying to drive it in the right direction?" Cohn asks. "The G piece of ESG has never really been addressed through data in the same way as the E and the S," he observes, calling for data technologies that will work "to put the G on equal footing."

> Is there a way to bring the day-to-day operational insights in the core of the organization up to those at the top who are trying to drive it in the right direction?
>
> **GARY COHN**

"The board and management collectively have their reputation and the company's reputation on the line," Noreika says. Governance is the task of managing complexity and credibility effectively, he argues. "You only can go into a regulator and say, 'we're complying with the laws,' if in fact you have a governance structure that does that," he says. "And you can only go to a shareholder's meeting and say, 'our product/business is safe, reliable, etc.,' if you have a governance program that ensures that." Many of the regulatory reforms that followed from the financial crisis were targeted at such governance questions, Noreika points out. But governance capabilities need constant upgrading. "What you're doing today as best practice is not necessarily what's good tomorrow, because technology advances, thinking advances."

> You only can go into a regulator and say, 'we're complying with the laws,' if in fact you have a governance structure that does that.
>
> **KEITH NOREIKA**

With Cohn, Noreika points here to the importance of new technologies: "tools that can help to bring more information from the bottom of the pyramid up to the main decision makers." Management and boards alike need these tools, he says. The regulatory aspect of governance is important in this connection. Regulators must be able to ask whether firms are obtaining the risk information that is critical, so that such can be reported up to them in a way that is practical. Culture and conduct risk management is a community endeavor to which multiple constitutents must contribute.

This has direct bearing on the discussion of trends towards 'stakeholder capitalism' appearing in our report last year.

Writing in the *Financial Times*, Mervyn King, former Governor of the Bank of England and Chairman of the International Integrated Reporting Council, asserts that there are four critical outcomes external stakeholders should expect from a company's corporate governance: "ethical culture with effective leadership; trust and confidence in the company by the community where the company operates; adequate and effective controls inside the company; and value creation in a sustainable manner."[69] Some discuss these governance priorities in terms of aligning "corporate purpose"[70] with broader societal objectives. And it is increasingly argued that, rather than legal abstracts, firms should be regarded as social creatures, comprised of a complex web of relationships with stakeholders who share in and enliven that purpose.[71]

Former Unilever chief Paul Polman urges firms to take a long-term view with regard to these stakeholders' interests, marrying discussion of corporate purpose to the increasingly prominent ESG agenda.[72] Gallup reports that, in the United States, people prefer capitalism (60%) over socialism (38%).[73] But critics on the right decry the sort of overtly political "woke capitalism" that they see in the ascendant.[74] Blackrock's Larry

Fink responded to such arguments in his 2022 letter to CEOs, entitled *The Power of Capitalism*.[75] "Stakeholder capitalism is not about politics," he writes. "It is not a social or ideological agenda. It is not 'woke'. It is capitalism, driven by mutually beneficial relationships between you and the employees, customers, suppliers and communities your company relies on to prosper." But critics on the left view such statements as a form of false piety, noting that many of the CEOs who have publicly signed on to the stakeholder capitalism agenda nevertheless act to prioritize shareholder interests — their own included.[76] Some argue that this injures workers more than other stakeholders.[77] And if this is correct, it is not likely to be sustainable.

The 'future of work'

The covid pandemic has produced countless studies, initiatives, academic programs, consultancy offerings, and management musings regarding "the future of work." Placing primacy on workers' interests is perhaps the one thing that all have in common. And the pandemic has highlighted that their interests are shifting rapidly.

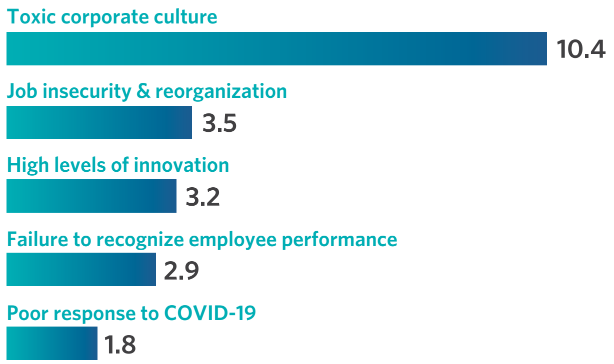
This is perhaps most evident in a preference for working from home.[78] While many in management worry that remote working may result in 'culture crises' at their firms,[79] auditors and regulators are more concerned that these work arrangements make it more difficult to detect fraud.[80] For bank executives, this has resulted in acute risk management concerns.[81] For many, an initial instinct was to devote greater resources towards surveillance and monitoring capabilities.[82] But increased efforts to monitor employees working from their homes has triggered privacy concerns.[83]

Similar efforts, on the part of bank regulators and supervisors, have rattled some. "Firms must prove an appropriate culture can be put in place and maintained in a remote working environment and that the firm's activities do not require the presence of an office location," the UK's Financial Conduct Authority indicated in October 2021, announcing intent to test such remote working arrangements.[84] Concern that bank regulators might begin to make home visits led some UK bank employees to investigate what privacy protections might be available to them through legal action.[85]

As noted in our 2021 report, firms have taken various and shifting stances on return-to-office policies. This continued throughout the year and remains unsettled now. Many firms had initially indicated intent to require workers to return to the office — and then the appearance of the Omicron strain of the virus scuttled plans.[86] In late December 2021, as covid cases reached a peak in New York, Goldman Sachs announced that it would make obtaining covid vaccine 'booster' shots compulsory, in order to help assuage concerns about its insistence that employees return to the office.[87] By January, Goldman had joined Citi and JP Morgan in pushing out their intended return-to-office dates.[88] Wells Fargo, which had postponed a return to the office indefinitely late last year, has since adopted a hybrid model, taking effect in March this year, that sets an expectation that employees will spend at least three days a week in office.[89] Continued uncertainty around the health risks posed by covid has led some firms to stop offering projected return-to-work dates altogether.[90]

Others have embraced hybrid working as a new — and perhaps desirable — reality. "We believe a hybrid approach will allow our people to have a better work/life balance," wrote UBS CEO Ralph Hammers, "making us a more attractive employer, appealing to a more diverse pool of applicants."[91] Even some among the new 'challenger banks' are offering paid sabbaticals to staff in order to promote a more appealing work/life balance.[92]

Importance relative to compensation



Source: https://sloanreview-mit-edu.cdn.ampproject.org/c/s/sloanreview.mit.edu/article/toxic-culture-is-driving-the-great-resignation/amp

As firms struggle to contend with covid-driven disruptions, they also confront more palpable generational shifts that give prominence to younger employees and their priorities.[93] "We are seeing a multi-trillion [dollar] transfer of wealth," to a younger generation with different priorities, observed one group managing director with UBS at a November 2021 'Culture and Conduct Forum.'[94] "Culture is an aspect of work particularly important to Gen Z," a late 2021 *Harvard Business Review* article reads, "as well as social and political injustices around the world."[95] Younger employees appear more ready to leave employers who do not embrace these values, or who fail to act upon them with conviction.[96]

This has played a significant role in what has been termed the 'Great Resignation,' and again places a premium on corporate culture. "In general, corporate culture is a much more reliable predictor of industry-adjusted attrition than how employees assess their compensation," a recent MIT study reports, with a "toxic corporate culture" appearing to be ten-times more powerful than poor compensation in driving employees away.[97]

The leading elements contributing to toxic cultures, this analysis found, included: failure to promote diversity, equity, and inclusion; workers feeling disrespected; and unethical behavior.

"It is not just the regulator who cares about the culture within your organization," one British consultancy notes, with reference to the UK's Financial Conduct Authority (FCA).[98] "Increasingly, it's the individual employees who are taking stock of where companies are excelling and failing to meet expectations."

The financial sector is not immune to these trends.[99] A recent McKinsey study finds that, of those who left the workforce during the pandemic, nearly half are unlikely to return.[100] In the UK, this appears to be more likely among more experienced professionals: those aged over 50.[101] In a 'Dear CEO' letter last March, the FCA raised particular concern regarding turnover of risk and compliance personnel.[102] These trends appear set to continue.[103]

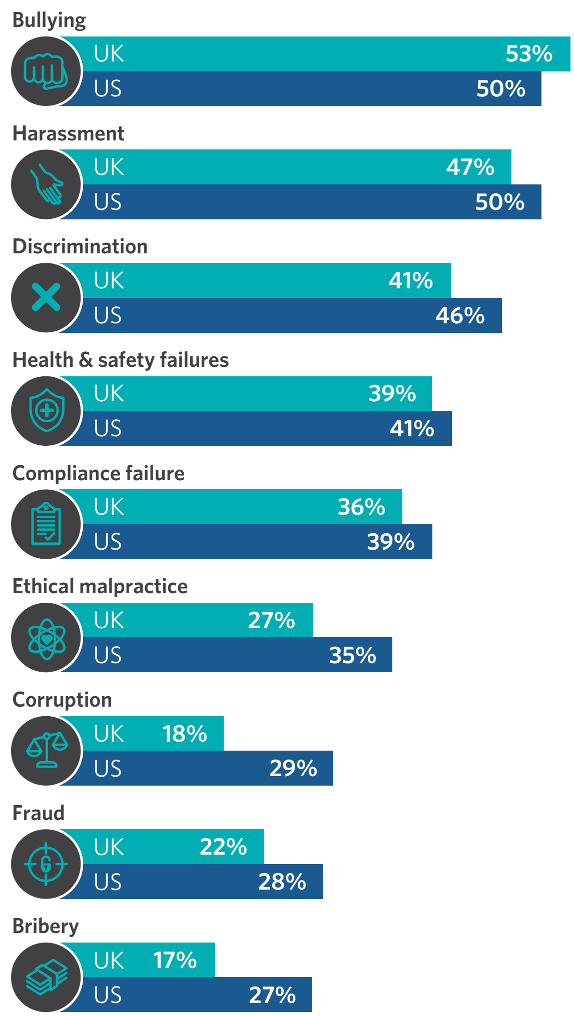
A Social License, Common Prosperity, and Society 5.0

Offering his own **Good Counsel**, Freshfield's **David Rouch** extends arguments made in *The Social Licence for Financial Markets*.[104] ▶PAGE 165 "At one level, a firm's success is defined by its goals — what outcomes the firm values," Rouch writes. But such success can be achieved only within a wider reality. "Those who pursue goals that ignore social and natural reality eventually fail," Rouch contends. Changes in workplace expectations, investor priorities, and regulatory demands form part of the social and natural reality within which firms must operate. This raises a thorny management challenge: "what is the balance between financial goals and goals related to the wellbeing of others?" Rouch asks.

Banks and other financial firms need to engage with both sorts of goals, and their associated motivations, in their work on culture and risk governance. Demonstrating genuine and consistent care for 'people and planet' has become essential to recruiting and retaining staff, Rouch advises, a majority of whom appear to share such values. This must inform a firm's work on culture, purpose, sustainability. Some may attempt to give lip-service to these values and goals, while sustaining cultures of short-termism and self-dealing, and while operating with scant regard to stakeholder interests. These firms risk losing their "social licence" to exist, Rouch warns.

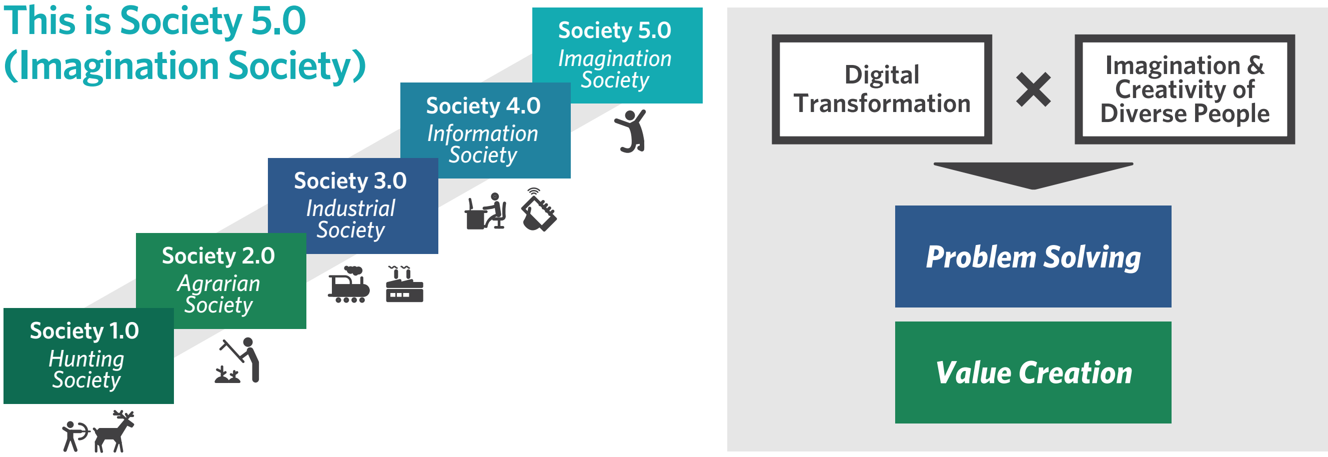
A recent article appearing in the *Economist* argues that such trends are pressuring us towards the era of "the bossy state."[105] At the 10th meeting of the Central Committee for Financial and Economic Affairs, in August 2021, China's Xi Jinping outlined his goal of achieving "Common Prosperity," a phrase first used by Mao Zedong decades earlier. We discuss this with **Charles Li**, CEO of Hong Kong Exchanges

Percentage of employees who have witnessed or been a victim of misconduct, by type:



Source: https://www.radicalcompliance.com/2021/10/19/gloomy-stats-on-workplace-misconduct/

This is Society 5.0 (Imagination Society)



Source: https://digital.thecatcompanyinc.com/b20magazine/tokyo-2019/society-5-0-updates-on-japanese-business-and-economy/

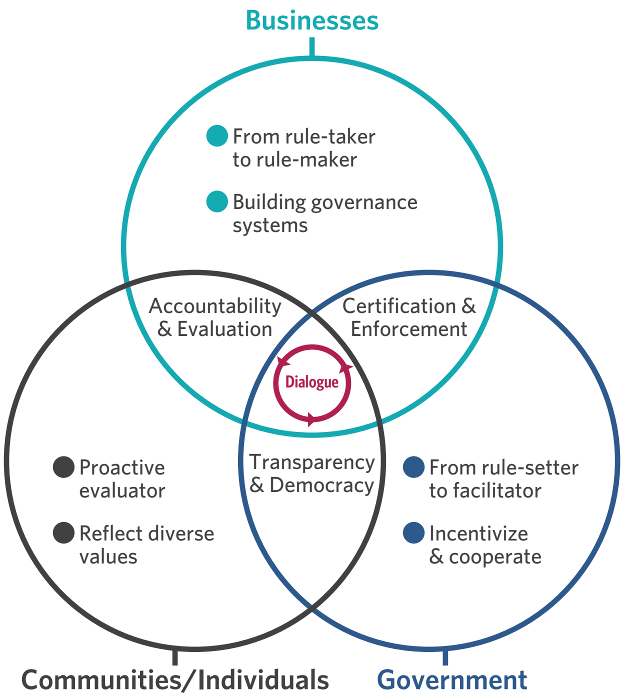
and Clearing Limited (HKEX) from 2010 to 2021, in a **Ground Breakers** interview. ▸PAGE 129 China is capable of producing wealth more quickly than many others but is perhaps less adept at making sure such wealth is distributed equitably, Li suggests. Xi's push for Common Prosperity seeks to address this.

"The fundamental logic behind Mr. Xi's pronouncements on Common Prosperity is clear," Li states. "What is not clear is how the government agencies charged with the tasks are planning to execute them." Uncertain implementation of this policy priority has produced disruptions, both within China's home market and throughout global markets. "Obviously, we've seen some negatives and some extremes that have occurred," Li notes, although he argues that the media has overplayed suggestions of a "chilling effect" on innovation.

Whereas, 20-years ago, officials on the Chinese mainland may have looked to Hong Kong regulators for guidance, Li believes that, today, the reverse is true. "When it comes to conduct risk and regulatory compliance," Li says, "you have China on the one hand and the US on the other, with Hong Kong sort of in the middle." Where a balance supportive of Common Prosperity is to be found is, at present, unclear.

"In 2016, the Japanese government introduced the concept of 'Society 5.0' and positioned it as the future vision of Japan," writes **Hiroki Habuka**, a Specially Appointed Professor at the University of Kyoto Center for Interdisciplinary Studies of Law and Policy, in a **Good Counsel** interview piece. ▸PAGE 173 The goal of subsequent initiatives, he says, is a close and productive interplay between cyberspace and physical space, with a view to assuring that this "works to promote economic development and to solve societal problems." Akin to the 'stakeholder capitalism' movement in the West, and China's goal of Common Prosperity, Japan's Society 5.0 goals aspire towards a 'new capitalism' for corporate Japan.[106] "Society 5.0 aims to transform not only industry but also society as a whole, through the power of digital technology," Habuka explains.

Roles of stakeholders in the new governance model



Realizing these goals will require innovation, he notes, and such innovation, "often conflicts with existing rules." Overcoming the related challenges is a governance priority. "These changes impose difficulties on the traditional governance model," Habuka argues, "based on the belief that the objectives of governance can be accomplished by regulators, who define certain rules in advance, and by citizens who comply with those rules."

Habuka outlines an alternative, "agile governance" model, designed to meet the goals of Society 5.0. "A decentralized governance model that emphasizes horizontal relationships among stakeholders is necessary," he suggests, "to include businesses, individuals, and communities."

A global body, comprised of economic and financial leaders from the public and private sectors and academia, the Group of 30 (G30) aims to deepen understanding of economic and financial issues.[107] Research conducted by the G30 makes clear that the conduct and culture journey in the financial sector is never over. "It is an ongoing, evolving, shifting process," Executive Director **Stuart Mackintosh** writes in an **In Focus** essay here. ▶PAGE 341 "Vigilance against bad behavior and toxic cultural developments in major firms (both banking and non-banking) cannot let up," he argues, "because failures still occur, and material fines, reputational damage, and fallout result."

Mackintosh sees opportunities to bolster stakeholder capitalism in the 'green transition' — the E in ESG. This cannot be about box ticking, however, or goals will be missed, he warns. "As the ESG wave rises and rises, and as the great asset transfer from baby boomers to millennials and young Generation X & Y investors gets underway, pressure on firms to make the leap on green conduct and culture will build," Mackintosh argues. That wave will "swamp" those who fail to acknowledge and act upon the "greening of conduct and cultural norms that is part of the evolution of banking and its place in society."

Meaning, agency, purpose — and *belonging*

"If the past 18 months have taught us anything," McKinsey argues, "it's that employees crave investment in the *human* aspects of work."[108] Employees are looking to their jobs for meaning, agency, and purpose. Central to all three is a palpable sense of belonging. And fostering such a sense of belonging is made more difficult given hybrid working norms.[109]

"A tribe is defined both by who is in it and who is left out," the *Financial Times*' Gillian Tett writes in a recent column.[110] She cites research from Harvard Business School, Johns Hopkins University and Microsoft, exploring the interaction patterns revealed in more than 360 billion Microsoft Outlook emails, sent by 1.4 billion corporate employees, among 4,000 companies worldwide, Microsoft among them.[111] The email data covers a 24-month period that extends both before and after the start of the covid pandemic. Eschewing communications content, the researchers instead investigated 'modularity patterns' — the degree to which these electronic communications were clustered into self-contained "tribes." As covid-driven work-from-home protocols became entrenched, the study finds, organizations became more siloed.

Who Americans Spend their Time With
(2003-2015)

Source: American Times Use Survey - www.kaggle.com/datasets/bls/american-time-use-survey
Graphs by Henrick Lindberg - mymodernmet.com/who-americans-spend-time-with

This resonates with Robin Dunbar's theories regarding our primal tendency to cluster in small groups bound by close trust ties. Such tribalism is not necessarily all bad. "Acting in a tribal way," Sebastian Junger argues in *Tribe: On Homecoming and Belonging*,[112] "simply means being willing to make a substantive sacrifice for your community — be that your neighborhood, your workplace, or your entire country." For managers, the challenge presented by changing work norms is how to increase the size of workplace tribes.

Among the top three factors employees cited as reasons for quitting, a McKinsey study finds, are not feeling valued by their organizations (54 percent), by their managers (52 percent), or because they didn't feel a sense of belonging at work among their peers more generally (51 percent). Firms should perhaps focus less on "Diversity, Equity and Inclusion," McKinsey suggests, and attend instead to what it dubs "DIB": Diversity, Inclusion and Belonging.[113]

Financial sector regulators have taken greater interest in diversity in the last years. "Without inclusion and a sense of belonging," Acting Comptroller of the Currency Michael Hsu cautioned in an October 2021 speech, "diversity over time becomes a box to be checked, not a value to be upheld."[114]

Some have joined with a growing number of firms, exchanges, and investors calling for quotas. Those sounding such calls regularly refer to studies that appear to demonstrate positive effects that flow from diversity — improved financial performance and reduced conduct risk principal among them.[115] Most visibly, such activism is aimed at creating greater gender diversity.

In 2003, Norway became the first country to set a quota (40%) for the number of women firms must appoint to board roles.[116] "There are reports documenting a positive correlation between female directors and corporate performance," notes **Karin Thorburn**, Research Chair Professor of Finance at NHH Norwegian School of Economics, and Adjunct Full Professor of Finance at The Wharton School, in an interview appearing in our series from **The Academy**. ▸PAGE 371 "However, this correlation does not imply causality," she adds. With a quota imposed, however, causal direction is made clear: forced change in the board prompts a potential change in performance, and this can be studied.

After researching the effects of the Norwegian quota, Thorburn reports that the forced appointment of female directors to the previously all-male boards had no valuation impact. "I am in favor of more diversity in the corporate world," Thorburn makes clear. "However, it is important to remember that it is not about investment performance but, rather, social policy," she adds. "The argument that diversity is good corporate governance has no support in the research," Thorburn concludes. This is not to suggest that diversity is not a worthy goal, in and of itself, but rather suggests that we need not look to justify it by appealing to presupposed economic benefits that appear not to be in evidence.

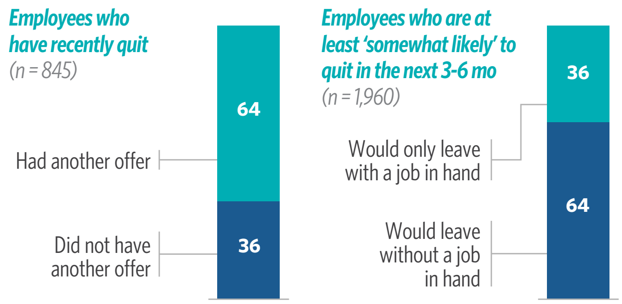
The office: here, there, everywhere

As the set of charts on the preceding page demonstrate, at least among Americans, the time we spend with our families and friends drops off precipitously as we enter our professional lives. Focus shifts to partners and children, thereafter, as might be expected. But our time is devoted almost equally so to our colleagues and co-workers throughout adulthood — and then increasingly spent alone as we age. Little wonder that work relationships play such an important role in our lives, and that the loneliness some experience in remote working is such a growing concern.[117]

Perhaps it is this that drives many of the current trends seen in the workplace. Economics will play a role, as ever, but it does seem that, during the covid pandemic, people have opted to re-prioritize time spent with those whom they care about most: those at the center of their 'Dunbar circles.' Time spent in commuting was never popular. Today it is intolerable. Difficulties in finding work/life balance has long meant excessive time away from loved ones. This is no longer acceptable. Perhaps better to leave the workforce altogether than to suffer in jobs that fail to provide a sense of meaning, agency, purpose, and belonging — or that afford scant opportunity for time with those we care for most?

Once organizations recognize that most behaviors are caught, not taught, they can fully leverage the more organic, network patterns driven approach towards shifting culture.

Attrition may accelerate, as people are willing to quit without another job lined up.
Share of respondents, %



Source: https://www.mckinsey.com/business-functions/people-and-organizational-performance/our-insights/great-attrition-or-great-attraction-the-choice-is-yours

If such reasoning in fact lies behind current trends — such as an increasing readiness to leave jobs without first having another one lined up — then it is all the more important that management attend to a 'core versus periphery' issue that may characterize remote working.[118] The UK's Financial Conduct Authority warns of the potential for hybrid work arrangements to lead to development of an in crowd and an out crowd.[119] "There is a danger that social capital becomes the preserve of those who can and want to work in offices," the UK's Financial Services Culture Board warns.[120] "This has potential long-term implications for diversity and inclusion." Notably, early investigations suggest that there are significant differences between the expectations of men and women as regards return-to-office norms.[121]

Remote and asynchronous working conditions place a yet greater significance on trust relationships in the workplace.[122] "Throughout the pandemic, as many have been forced to work virtually, most organizations have morphed from relatively cohesive network structures that are broadly diffused, to socially disconnected neighborhood structures more dependent on a limited set of local interactions," writes **Michael Arena**, Vice President of Talent & Development at Amazon Web Services, joining those offering **Peer Perspectives** herein.[123] "As more distinct clusters emerge, these groups become more detached from one another and from the broader organizational purpose," Arena writes, with Babson College Professor of Global Leadership **Rob Cross**. ▸PAGE 403

"By understanding the network dynamics of culture," they suggest, "we can better enable the shifting of culture." But the "natural interplay" between culture and organizational networks does not often feature in culture change initiatives. "We tend to believe that organizational culture is pushed down from the top of the organization through rigorous change programs, and is uniformly adopted across the organization," Arena and Cross observe. In fact, however, "these behaviors tend to cluster in various discernable pockets throughout the organization, based on their value to a given group." The traditional top-down, hierarchical view of an organization is thus less important than a bottom-up perspective, and this is also the case for 'inside-out' management presumptions considered against the 'outside-in' reality of hybrid working conditions.

Arena and Cross advise that management should attend more closely to the network structures that shape workplace realities and organizational outcomes — structures important both before and during the covid pandemic. Behavioral predispositions among employees are set amidst these networks, with contagious effect. "Once organizations recognize that most behaviors are caught, not taught, they can fully leverage the more organic, network patterns driven approach towards shifting culture," they conclude. This awareness is critical in the context of managing non-financial risks within organizations, and to creating and sustaining resiliency — a term much on the minds of bank supervisors of late.[124]

Resilience required

"Ensuring the UK financial sector is operationally resilient is important for consumers, firms and financial markets," reads a recent policy statement issued jointly by the UK's Prudential Regulation Authority, its Financial Conduct Authority, and the Bank of England. "The disruption caused by coronavirus (Covid-19) has shown why it is critically important for firms to understand the services they provide and invest in their resilience," they added.[125] "We expect firms to perform mapping and testing so they are able to demonstrate their ability to stay within their impact tolerances," Bank of England Executive Director David Bailey said in a late April 2022 speech, with reference to events that may impair operational resilience.[126]

A recent report[127] issued by the International Organization of Securities Commissions (IOSCO) outlines key lessons regarding operational resilience learnt during the pandemic. Among them, IOSCO asserts that, "operational resilience means more than just technological solutions." It depends equally so on the resilience of a firm's "processes, premises and personnel." It is the role of regulators and supervisors to test firms' operational integrity and organizational resilience. Their relevant examinations most often focus on the *mechanics* of execution, within firms and across the financial system. But perhaps it is as important to consider the integrity of a firm's purpose, as lived out in day-to-day employee behavior? Would it not be helpful if supervisors had insights into how risk governance was aligned with company values, with a view both to what this implies for its operational resilience as well as its operational risk profile?

Suggesting this is so, McKinsey urges firms to adopt a more "holistic" risk management approach,[128] to involve risk culture diagnostics. This would allow leaders to better appreciate how each part of their organization embeds risk awareness into its common work practices, and to prioritize risk efforts organizationally. Such capabilities are made all the more imperative by changing workplace structures and norms, due to hybrid working and the impact this has had on traditional management hierarchies.[129] Recent research suggests that groups working remotely often demonstrate the same "collective intelligence" as do co-located teams, but only if the right collaboration processes are in place.[130] Establishing those practices is now a management priority.

The "scientific management" proposed by Fredrick Winslow Taylor was conceived of when a significant amount of work took place in factories, BCG observes. While this may have been a powerful approach for optimizing physical production and minimizing unpredictable human aspects of work, BCG argues, the theory loses force when applied to work where these human elements are critical.[131] "What would it take to inspire people's best efforts without compulsion?" BCG asks. "To engage their curiosity and imagination to awaken higher aspirations?" Prompted by high profile toxic culture issues,[132] risk management failures,[133] and outright misconduct,[134] many firms are turning attention to such questions and have concluded that it is in their interest to obtain insights into "the human element" of their operations.

Gradually, then suddenly

While fines for misconduct have fallen from post-financial crisis highs,[135] the US Department of Justice has said it would step up prosecution of white-collar crime,[136] and Wall Street banks entered their most recent earnings season under a cloud of rising costs,[137] much of that associated with increasingly complex governance, risk, and compliance tasks.[138]

Over the course of the past year, Credit Suisse has generated greater attention to the importance of the human element in connection with governance, risk and compliance. In March 2021, the firm faced a $5.5 billion loss arising from its dealings with Archegos Capital Management. In the same time period as its exposure to Archegos grew, many peer institutions required that Archegos put up more capital to offset what was taken to be an excessively risky and overly concentrated portfolio. With a view to short-term returns, Credit Suisse instead allowed Archegos to take money off the table.[139] The bank made $17.5 million in fees from its dealings with Archegos in 2020.[140]

The Archegos debacle is a prime example of how prioritizing profit in the short term — especially at the expense of Risk — is a recipe for disaster in the long-term.

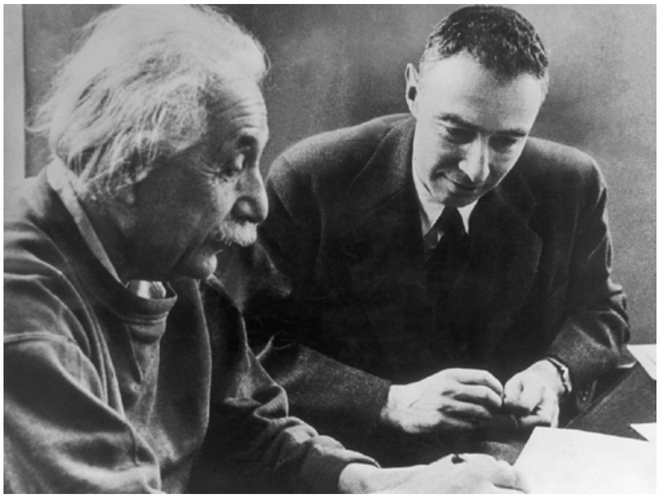
This led many to question the bank's risk management processes. Though an April 2020 audit found risk management deficiencies that likely contributed to the Archegos failure, this appears to have gone without redress.[141] In July 2021, the Credit Suisse board published a 165-page independent investigative study it commissioned, examining the bank's relationship with Archegos and the risk management lapses that led to such extraordinary losses.[142] The investigation found no evidence of fraud in the firm's dealings, but did highlight many severe deficiencies in risk management and risk escalation. "For its part, Risk failed to push back on the business or to impose deadlines for the business to eliminate limit breaches and to right-size the risk posed by Archegos," the report explains. "While loss responsibility ultimately lies with the business, Risk enabled the business's indulgent orientation toward Archegos, and adopted the business's justifications for Archegos's breaches and margin accommodations."

As Hemingway might style it, risk governance failures tend to become evident, "gradually, then suddenly."

Brad Karp is Chairman of US law firm, Paul, Weiss, Rifkind, Wharton & Garrison, and lead author of the report the firm was commissioned to prepare after its internal investigation into events at Credit Suisse. Karp provides relevant **Good Counsel** here. ▶PAGE 137

By the end of the week of March 22, 2021, he recounts, Archegos had defaulted on margin calls from Goldman Sachs, Morgan Stanley, Credit Suisse, Nomura, and UBS, among others. Overall losses of more than $10 billion raised questions as to how these sophisticated firms incurred such enormous exposures to Archegos's positions, and whether adequate risk-reducing mechanisms were in place. Karp's team found multiple causes and related red-flags that went unheeded. "The Archegos debacle is a prime example of how prioritizing profit in the short term — especially at the expense of Risk — is a recipe for disaster in the long-term," Karp writes.

Although senior managers across Wall Street had information showing that Archegos's risks were mounting, they did not prioritize reducing such risk. Overly focused on revenue generation, risk personnel failed to keep the business in check. Senior management often seeks to avoid confrontation, instead adopting a "lackadaisical and overly business-friendly attitude," Karp continues. He warns that merely implementing "the right risk architecture" is insufficient; a strong risk culture is central to assuring that risk managers, "are not only empowered to critically evaluate counterparty risk and escalate matters of concern to executive management or the Board of Directors, but that they do so."



Serving as 10th Director of the Los Alamos National Laboratory — home to the Manhattan Project that ushered in the nuclear age[143] — **Dr. Charles F. McMillan** offers a highly relevant **Peer Perspective** in an interview captured here. ▶PAGE 409 The phrase "safe, secure, and reliable" is a mantra at the lab, McMillan says. As part of the nation's nuclear Stockpile Stewardship Program, Congress established an accompanying Annual Assessment Process, through which the Directors of the Lawrence Livermore, Sandia and Los Alamos nuclear labs — together with the commander of US Strategic Command — must each write a letter to the President, annually, offering their candid evaluations regarding the state of the nation's nuclear deterrent. Having prepared seven such letters during his tenure, McMillan highlights the importance of having an independent voice that reaches the top of command — and the equal importance attached to providing the same independence of voice to those who had reported up to him.

Central to their risk evaluation was something McMillan calls "QMU" — the Quantification of Margins and Uncertainties. "The essence of my letter to the President was about how our margins were kept much larger than the inevitable uncertainties," he explains.

Careful people make mistakes, McMillan allows. The mechanics of safety controls — "engineered systems" — are insufficient without equal attention to the processes by which risk is meant to be contained. And this, in turn, is reliant upon the culture of the lab. "One of my fears was that there was a problem out there, and an engineer or a physicist knew about the issue but was afraid to bring it up for whatever reason," McMillan shares.

McMillan also highlights the importance of an organization's mission, or purpose. "The majority of our people see themselves as contributing to the security of the nation and helping to stabilize the globe," he says. "That sense of purpose is what drew them to the laboratory environment." That in turn prompted and facilitated a shared commitment to acting with integrity in day-to-day lab operations. This lesson, he suggests, should be heeded by those in the financial sector. "If I'm right that the financial system exists for an important purpose," McMillan concludes, "then society needs to be able to expect that integrity."

"Engineered systems" — are insufficient without equal attention to the processes by which risk is meant to be contained.

A shift in the wind

"My view, for a long time, has been that most professionals in the securities industry work hard to get it right," says **Susan Axelrod** in a **Ground Breakers** interview recorded here. ▸PAGE 111 Now Chief Supervisory Officer for Merrill Lynch Wealth Management, Axelrod served previously as Executive Vice President of Regulatory Operations at the Financial Industry Regulatory Authority (FINRA), tasked by Congress with protecting investors by making sure the broker-dealer industry operates fairly and honestly. "Focusing on conduct and culture, and holding individuals accountable," Axelrod says, "can send the message that — regardless of who you are, the revenue you bring in, or the role you play — misconduct can be career ending, or at least career-limiting."

Axelrod observes that, traditionally, culture and conduct issues received attention only after-the-fact, when they had already led to terminations and disciplinary actions. "The after-the-fact approach has not been demonstrably successful in decreasing enforcement actions," she notes. "Being more proactive, in a behaviorally predictive manner," Axelrod argues, "can have the benefit of freeing financial institutions to spend their time and energy on higher-risk matters." Responsibility for achieving this, she maintains, rests with those in first line risk management functions. "How can predictive modeling and a focus on behavioral science help to cut down on issues of misconduct in the industry?" Axelrod wonders. "These are all questions we need to continue to ask."

Now a partner with McKinsey, **Sarah Dahlgren** served earlier as head of supervision with the Federal Reserve Bank of New York (FRBNY). In another of our **Ground Breakers** series, Dahlgren discusses the impact of covid-driven work-from-home protocols and the shift to hybrid working conditions. ▸PAGE 115 "Most control environments didn't anticipate that so many people would be working full-time from somewhere other than an office," Dahlgren notes, "where simple things like your boss looking over your shoulder, or simply having a lot of people around, served as a deterrent" to misconduct. "One of the lessons from the 2008 Financial Crisis that I learned during my days at the FRBNY was that we didn't have sufficient engagement between supervisory staff and senior management of firms," she adds. "I worry that this problem may repeat itself if we don't make a concerted effort to reengage in person."

How can predictive modeling and a focus on behavioral science help to cut down on issues of misconduct in the industry?

Dahlgren emphasizes the importance of operational resilience as we go forward. "In the same way that regulators were able to identify weaknesses in financial resilience — both quantitatively and qualitatively — and ensure that financial capacity was reinforced to withstand the stresses over the past couple of years," she suggests, "now would be a good time to focus attention on a similar approach to non-financial risks." We must develop a reliable means of checking on culture, "as something that is critical to ensuring that we are achieving what we set out to achieve," she concludes.

Royal Bank of Canada (RBC) Chair, **Kathleen Taylor**, agrees on the importance of culture to performance outcomes. During an interview among our **Ground Breakers** series, ▸PAGE 61 Taylor discusses her time as CEO of the storied Four Seasons Hotels and Resorts. "Every time you engage with a customer, employee, partner, or investor, your brand is either burnished or tarnished," she says. It is notable that Taylor includes employees and work partners in this brand management guidance. "It's been a longstanding belief of mine that there's an inextricable link between a company's purpose, its strategy and its plans for how it's going to execute on that strategy," she notes. "And one of things that fuels all of that, of course, is its culture," Taylor makes explicit. "So, from a governance perspective, it's no surprise that relevant oversight and stewardship of culture should be seen as a core responsibility of the board of directors."

Every time you engage with a customer, employee, partner, or investor, your brand is either burnished or tarnished

Taylor describes the purpose of RBC as helping clients to thrive and communities to prosper. "I think it is incredibly important to recognize that organizations of all shapes and sizes participating in the economy are, by definition, also participating in society," Taylor argues. She ties these ideas to the ESG discussion, which she sees as "central" to the board's role. "That includes governance around risk management," Taylor adds, which in turn calls for a mix of competence, curiosity, courage, and a culture of collegiality. It is part of the board's mandate to assure that this mix is found in the leadership and day-to-day operations of the firm.

You've got to bake culture considerations into your ways of operating.

Serving as Group Chief Operating Officer at the National Australia Bank (NAB), significant responsibility for these day-to-day operations rests with **Les Matheson**, who joins our **Ground Breakers** series though an interview recounted here. ▸PAGE 103 Australia's Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (the "Hayne Commission") demonstrated that change was needed — "And not just in the way that companies operate," Matheson says, "but also for regulators and, in some cases, we needed changes to the law." In many parts of the world, he argues, those in financial services became overly focused on shareholders and attended insufficiently to the interests of customers. As the Hayne Commission demonstrated, this required a reset; financial industry leaders needed to rethink how they assure that their organizations are set up to enable employees to deliver on what customers truly need.

For instance, he suggests, "we can and should be using some of our monitoring systems to make sure that customers are using products in the right way." Matheson argues that firms need to make better use of their data and improve their communications with customers, helping them to make proactive change in connection with the products and services they pay for. NAB has established several such monitoring mechanisms. Among them, it has created a board-level Customer Committee and appointed an independent Customer Advocate reporting to the board on NAB's performance with customers. It has also established a Group Product Improvement and Governance Team, reporting directly to Matheson, tasked with improving on how NAB designs, manages, distributes and governs its products and services in a manner that drives continuous improvement in the value NAB's customers enjoy through their business with the firm.

This is central to managing culture and conduct risk at NAB. "The Board needs to ensure that the culture of any bank is managed," Matheson agrees with RBC's Taylor, pointing to the creation of the UK's Banking Standards Board (now the Financial Services

Culture Board) as an example of what is helpful here. By running an annual survey into employee's reported experience of cultural norms and conduct outcomes across the UK banking sector, boards are provided with a tool to measure relative performance among peer institutions. But, while the responsibility for assuring that a firm's culture is being managed properly sits with the board, it is management's responsibility to execute on that effectively.

We must take steps to proactively shape the work environment so it makes it less likely for misconduct to occur in the first place.

And if culture is to be managed, Matheson emphasizes, it must first be measured. "There are a lot of ways in which culture is set and there are good indicators in that regard," Matheson contends. Formal purpose and values statements, while important, provide little differentiation in what different firms espouse. "So, the difference ends up being in execution," Matheson argues. "You've got to bake culture considerations into your ways of operating."

Antoine Ferrère, Global Head of Behavioral & Data Science at Novartis, offers a relevant **Peer Perspective** here. ▸PAGE 397 "We often hear that using behavioural science helps us to 'go with the grain' of human behavior," Ferrère writes, but we then sometimes fail to apply this advice to ourselves." Ferrère discusses the initiation of a new Code of Ethics program at Novartis. "We knew very well that a policy — in itself — does little to drive what people actually do on a day-to-day basis," Ferrère confides. He explains that his team therefore worked to convey how the improved Code would produce demonstrable operational impact, which helped to promote internal attention to the initiative.

"Most corporate misconduct happens not because of one or two bad apples," Ferrère adds. "How the barrel allows apples to rot is more important: good people end up doing the wrong thing." A team of behavioral scientists at Novartis worked with the company's Ethics, Risk and Compliance functions to review decades of experimental evidence regarding what makes it more or less likely that someone will decide to do the wrong thing. Working with a custom-built survey instrument, Novartis "dug deeper into elements of the work environment in which our people operated," Ferrère explains. "We must take steps to proactively shape the work environment so it makes it less likely for misconduct to occur in the first place," he concludes. "We are seeking innovative, technology-driven ways of putting these insights in the hands of local and market decision-makers," he adds, with a view to the future goals of the initiative.

Nancy Harrington Jones is Chief Culture & Conduct Officer for the Americas at Société Générale. She contributes to our **Ground Breakers** series with an interview in which she discusses the creation of her role. ▸PAGE 81 On the heels of a high-profile rogue trading scandal ("The Kerviel Affair"), management knew it needed to make changes. Firms were being pressed to improve culture, both by their regulators, and through shifting societal expectations. Mindful of the influential Group of Thirty paper on culture reform in banking,[144] and believing the firm to have strong cultural cornerstones with which to work, Harrington Jones — then Chief Human Resources Officer — worked with the firm's Chief Compliance Officer to outline a new culture-focused executive role.

Culture and conduct considerations are the catalyst for raising the bar and remaining relevant in the long term.

Harrington Jones makes clear that this new role was not to be another compliance function. Nor was it desired to be some specialized HR appendage. To have heft, the role needed to report directly to the CEO and operate with true independence. "We envisioned the role as managing the infrastructure of the house and ensuring that all the right bricks were in place and that any cracks in the mortar were fixed,” she explains. The CEO agreed, and Harrington Jones was appointed to the new leadership role. “For us, having this as part of the CEO Office — sponsored by the entire management committee and therefore all lines of defense — is what we felt was best.”

Working through a newly formed group of “Culture and Conduct Champions,” with a focus on corporate governance, her team set out to establish a new “Target Operating Model,” to be continuously updated as learnings were achieved and as market demands might prompt. Staff across the firm adopted the Model, “to create behavioral objectives that are meaningful to them in their specific roles,” she explains. “Culture and conduct considerations are the catalyst for raising the bar and remaining relevant in the long term,” Harrington Jones concludes.

In another of our **Ground Breakers** series, **Alexandra Chesterfield**, Head of Behavioural Risk within Group Internal Audit at NatWest, explains how her team was established to help avoid, “unwanted, unanticipated and undesirable outcomes.” ▶PAGE 87 She starts with a sobering figure: six in ten survey respondents across 28 markets report believing that capitalism is doing more harm than good. “Business is no longer seen as a distinct and separate domain,” Chesterfield writes, “but part of the social fabric.” As expectations of business shift to demand that firms take public stances on matters of social concern, what does this mean for those in a firm’s audit function, she asks. “If value is about outcomes, how can we bring a more ‘human’ lens to assessing risk, looking precisely at the customer and wider stakeholder outcomes we drive through the way we behave?”

The explosion of textual data left behind by all of us provides social scientists with new ways to understand micro-interactions, emotional tone, group dynamics, and cultural shifts.

“History tells us that when organisations or systems fail — be it the financial crisis, oil rig disasters, aeroplane crashes, scandals, [or] political crises,” Chesterfield writes, “the root cause is often, at least partly, due to a human component.” Recognizing this, NatWest’s Internal Audit function established a Behavioural Risk team — an industry first, Chesterfield tells us. She defines behavioral risk, broadly, as the risk of, “poor outcomes for an organisation, customers, markets and society more widely.” Chesterfield emphasizes that the work she leads is forward-looking, “pinpointing and surfacing potential vulnerabilities and their root causes,” rather than operating as a policing function, “detecting problems that have already happened.”

Achieving this requires that the behavioral risk team: enjoys broad reach across an organization; can evidence the credibility of the insights it imparts; that it experiments with new methods of demonstrating cause and effect; operates in a multi-disciplinary manner; partners with academics and peers; and tracks its success through data. “The explosion of textual data left behind by all of us provides social scientists with new ways to understand micro-interactions, emotional tone, group dynamics, and cultural shifts," Chesterfield notes in closing, pointing to a future in which such data can be brought to bear to avoid harms proactively.

Joining our **Ground Breakers**, Global Head of its Centre of Expertise for Behaviour, Ethics & Learning, **Wies Wagenaar**, describes her own journey in establishing a new function at ABN AMRO. ▶PAGE 91 "Some futurists have predicted that the next banking crisis will be a crisis of ethics," she warns. Mindful of this, ABN AMRO conducts a root-cause analyses after any troubling incident, with a focus organizational culture. "These root cause analyses seek to ferret out obstacles to acting ethically and, by the same token, any unintended or unrecognized incentives to act unethically," Wagenaar explains. Behavioral science offers insights into why it is that good people sometimes make, and are able to justify, decisions to engage in bad acts. "From the scientific research and lessons learned through corporate incidents," Wagenaar writes, "we know that the behavior of employees is influenced by the context in which they find themselves."

The behavior of employees is influenced by the context in which they find themselves.

Rather than focus on catching bad actors in the act, Wagenaar looks to identify obstacles to behaving ethically, and any unintended incentives to behave unethically. "It's a matter, not of a few bad apples, but of bad barrels," she reminds, echoing Antoine Ferrère at Novartis. She describes two misconduct crises at ABN AMRO that illustrate such obstacles, and the perverse incentives found to have been at work in those circumstances, drawing on behavioral science research in some detail to help explain how such misconduct flows from a predilection towards conformity with group norms.

The firm has since established "integrity management systems" to help guard against such predispositions. "If employees feel that any procedures they are required to follow pose a behavioral risk," she notes, "or that they are not in keeping with our goals or with the client's best interests, they know they can speak up without feeling they're sticking their neck out."

In another essay from **The Academy**, MIT professor emeritus, **Ed Schein**, recounts his years of experience in trying to apprehend and successfully shape corporate cultures so they supported desired ends. ▶PAGE 383 It is hard to over-state the influence Schein has had in much of the thinking about culture and conduct risk supervision that has been espoused by many in the banking sector in recent years, industry overseers most particularly. A pioneer in applying behavioral science to conduct supervision, the Dutch Central Bank (*De Nederlandsche Bank*) points directly to Schein's work[145] in its influential, *Supervision of Behaviour and Culture: Foundations, Practice & Future Developments*.[146] Here, Schein begins by urging us to recognize that, "a detailed analysis of how to reduce risk and improve organizational safety is, in fact, also the best way to achieve the conditions necessary for long range excellent performance." Managing culture is not just about risk mitigation — a cost. It can also promote performance optimization — a revenue enhancer.

A detailed analysis of how to reduce risk and improve organizational safety is, in fact, also the best way to achieve the conditions necessary for long range excellent performance.

Leaders must contend with a range of general as well as industry-specific risks and accommodate different preferences typical of the 'macro-cultures' in which they operate. The former helps to prioritize resource applications. The latter can help to avoid squandering them. And leaders needn't confront these challenges alone: describing his experience in the nuclear industry, Schein encourages us to collaborate in

WHY PEOPLE DON'T COMPLY WITH SAFETY RULES, FOLLOW SAFETY PROCEDURES OR REPORT UNSAFE CONDITIONS

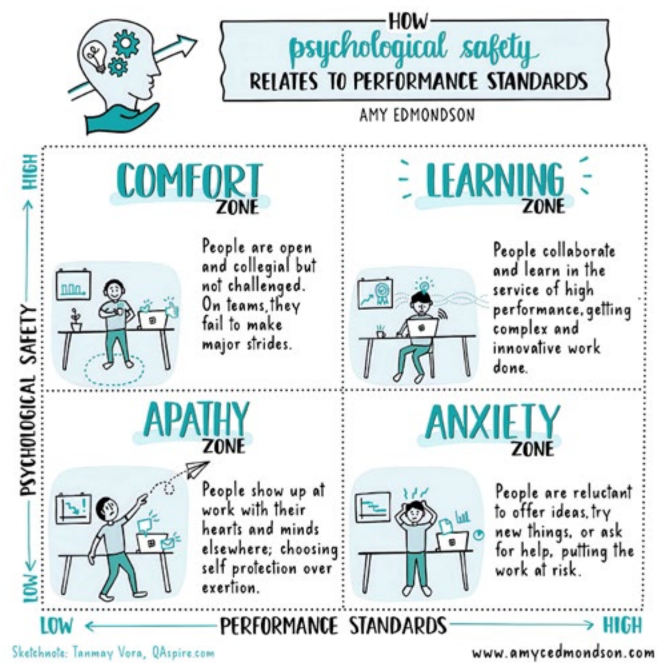
Type	In the Field Manifestations	Remedy
Lack of knowledge, skill, know-how or experience	"I didn't know this was a hazard" "I didn't know what to do because the reality was different from what I learned in training"	Formal education and training Practice, on the job training, coaching by more experienced workers
Overconfidence	"Nothing bad ever happened to me before doing it this way, so why worry now?" "I've been in the field long enough to know how things really work and what shortcuts are ok and make work easier"	Credible stories from close calls or actual incidents Personal accounts of lessons learned from credible sources, trusted coworkers
Macho Self-image	"I can do this job in spite of the hazards" "I can be a hero and others will respect me for it" "Only sissies or novices do it the standard way"	Personal counseling and coaching Employees examining and redefining the norm of what is heroic
"Practical Drift"	Confidence in short-cuts that have been invented, have been found to be ok, make work easier, and have been passed on by old timers to newcomers	Regular review by trained staff of how work is actually being done Adoption of methods that are better Retraining in correct procedures Appropriate discipline for compliance failure after retraining
Social Norms	"We all do it, no one ever said anything about it, why make a big deal about it all of a sudden" "I know its not by the procedure in the book, but that's how we do it around here. Do you want to fit in and do it our way or do you want to cause trouble for all of us"	Norms only change when the employees who hold them get involved in the change Process and decide on a new norm Acceptable risky behavior has to be defined as highly risky and unacceptable
Mistrust of Authority	"They lied to us before about what was safe or unsafe so how do I know they are telling us the truth now?" "I tried to tell them about what was not safe but they did not listen (or did not act or respond)"	Training of supervisors in listening, responding and conflict resolution Training supervisors to communicate clearly with managers
Mixed or Unclear Incentives	"My boss tells me to comply with all the safety procedures but he still wants the job done and let's me skip steps" "My boss (or co-workers) don't like it when I slow the job down because of some safety issue"	Re-examine middle management incentives and discipline to determine whether productivity pressures outweigh safety concerns Change incentives and back up with extensive training

Type	In the Field Manifestations	Remedy
Work Group or Work Peers Self-esteem	Not wanting to embarrass one's own group or work peers. To protect collective "face" Reluctance to "rat out" a fellow worker who is not complying with a rule	Clear and consistent messages from all levels of management that safety and open communication is a top priority, reinforced by close monitoring of immediate subordinates to insure that incentives are appropriate
The Ultimate Reason	"If I comply with the procedures I can't get the job done"	Ask the employees with genuine humble inquiry why they are not following procedure, listen, and then either retrain or change the procedure

establishing industry-oriented self-monitoring and training capabilities. "In the nuclear industry, there is a positive emphasis on what is viewed as a well-run nuclear plant, not just what is seen to be a safe one," Schein emphasizes.

Arguing with others here, Schein believes that the board and C-suite must be engaged in establishing effective risk and safety measures. But he warns that management has a tendency, "to make up the rules and announce them — without really investigating whether those rules will in fact produce greater safety." Here, Schein encourages us to adopt "Humble Inquiry"[147] techniques that he has developed, to better assure that our measures will be fit for purpose. This is especially important in the context of promoting a 'speak-up culture,' Schein advises.

"Paradoxically," he notes, "insisting the staff adopt a speak-up mindset puts the burden on the employee, who may well feel that it is not actually safe to speak up." Creating conditions of psychological safety is a management responsibility. Success or failure in meeting that responsibility rests ultimately with C-suite executives and their boards.



Schein also points to the importance of interpersonal trust relationships in the workplace, arguing that reducing "professional distance" and fostering more personal rather than transactional relationships should be a central management concern. Again, he points to the top of the house in this connection. "Organizations will become adaptive enough to maintain excellent performance in a rapidly changing technology and social environment only when senior management — and the board — recognize the need for more personal relationships, across hierarchical lines, as a prerequisite for building openness and trust."

In closing, Schein cautions us regarding "practical drift" — a term of art in safety management, which we discussed in our report last year with reference to "the normalization of deviance," a term coined by Diane Vaughan in the course of her inquiry into the causes of the space shuttle *Challenger* disaster.[148] "Standard procedures are forgotten until an accident reminds us that unhelpful variations became routine and accepted, though they were never sanctioned," Schein warns. He closes with a list of reasons that practical drift can occur ▸**ABOVE**. "The important thing for management to recognize is that safety and productivity can lead to conflicting principles pertaining to some of those rules," Schein advises, "and that the over-arching curative principle is open communications and the development of trust."

Mind the gap

Recent years have seen a steady encroachment of new technologies in the financial services space, leading many to re-think where the 'regulatory perimeter' lies. Last summer, the UK's FCA announced that it was "not capable" of properly supervising crypto-marketplace Binance.[149] "The problem here is not just that regulation needs to catch up with new technology," the editorial board of the *Financial Times* offered. "It is that new technology may be able to circumvent regulation altogether."[150] New crypto-exchanges, neo-banks, and other fintech innovators may seek to disrupt or disintermediate traditional financial institutions, but they cannot function fully without some level of engagement with those same firms, where regulatory oversight responsibilities are well established.[151] As such, regulators cannot avoid being drawn in to new and unfamiliar terrain. "Finance is about trust, ultimately," the SEC's Gary Gensler commented during an August 2021 interview.[152] It is the regulators' job to assure that such trust — and trustworthiness — is seen.

Profound forces are reshaping financial services.

This is made all the more challenging in an era of 'DeFi' — decentralized finance — which has sparked fears around anti-money laundering (AML) and Know-Your-Customer (KYC) capabilities.[153] Such concerns are steadily increasing.[154] "Fintech is not merely turbo-charging financial trading and expanding the financial universe," wrote Saule Omorova, nominated unsuccessfully to the helm of the US Office of the Comptroller of the Currency by President Biden, "It is also fundamentally reshaping our collective understanding of the financial system as little more than a particular form of applied information technology and computer science." Her remarks, in a paper entitled "Technology v. Technocracy: Fintech as a Regulatory Challenge,"[155] appeared under the sub-header: "The Trust/Power Challenge."

"To start, we must acknowledge the interconnectedness of the future of banking and the future of bank supervision," Federal Reserve Board Governor Michelle Bowman began a September 2021 speech.[156] In the mid-2010s, regulators sought to stimulate financial innovation, creating 'sandboxes' within which new products could be trialed, Acting Comptroller of the Currency, Michael Hsu, observed in an early November speech.[157] Today, a "rebundling" of banking services, and the fragmented supervision of crypto firms, "pose significant medium- to long-term risks to consumers, businesses, and financial stability," Hsu warned. "In my opinion, the most damaging thing from the 2008 financial crisis was the widespread loss of trust that resulted," Hsu remarked in another speech two weeks later. "It is one thing to lose one's money. It is another thing to lose one's faith in the system."[158]

"Profound forces are reshaping financial services," the FCA offered in its *2020/2021 Perimeter Report*.[159] "Our remit is large and it's growing." The regulator has vowed to make better use of digital technologies in a bid to become more adaptive in the face of these new demands.[160] The FCA is planning to draw up a new set of rules specifically targeting the challenges posed by "problem firms" in the crypto-space.[161] The UK's Prudential Regulation Authority is raising additional monies to support the hiring of 100 new staff to help it to keep pace with the innovations reshaping the industry.[162] In today's fast-changing environment, achieving regulatory certainty may not be possible, former FCA chief Chris Woolard remarked in a January 2022 LinkedIn post, accompanying the launch of consultancy EY's *2022 Global Regulatory Outlook* report.[163]

It will of course be necessary to attend to evolving company culture norms and the expected conduct of these new market participants.

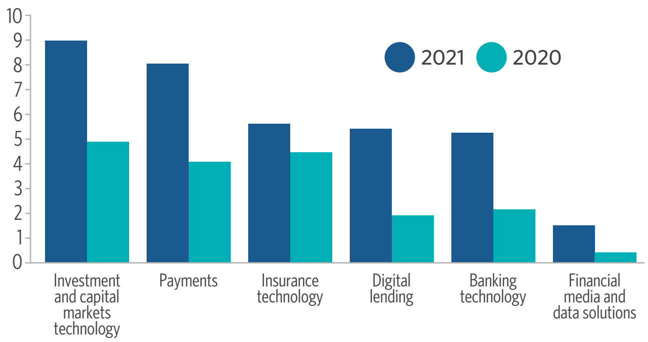
Australia's Prudential Regulation Authority (APRA) has indicated that it is working closely with other financial regulators, at home and abroad, "to understand and assess industry trends and emerging risks and the regulatory implications of new forms of finance."[164] The Reserve Bank of Australia and the Australian Securities & Investments Commission are seeking new regulatory powers to address these market changes.[165]

Some see these changes as presenting opportunity more so than risk. Among them, Australian Senator **Andrew Bragg** chairs a Senate Select Committee on Australia as a Technology and Financial Centre (known earlier as the Select Committee on Financial Technology and Regulatory Technology). Under his leadership, in October last year, the Select Committee issued a report addressing the risks and opportunities posed by blockchain technology, digital assets and cryptocurrencies, proposing a series of regulatory reform initiatives.[166] "The potential economic opportunities are enormous if Australia is able to create a forward-leaning environment for new and emerging digital asset products," the report concludes. Australian regulators have called for swift adoption of the Bragg committee's recommendations.[167]

As he began his own inquiry into the space, Senator Bragg writes in an **In Focus** insert here, "It was clear that Blockchain-based finance would be a significant opportunity for financial markets." ▸PAGE 291 Just as clear, however, were the significant challenges this would pose for financial regulators. "Consequently, a clear, certain, and comprehensive regulatory framework was urgently needed." Arguing that these new technologies represented an "existential challenge to the structure of financial regulation in Australia," Bragg called for a "root-and-branch reexamination" of the country's regulatory architecture.

With an estimated AUS $68.4 billion in added GDP expected to flow from this new financial space, a failure to capture such opportunity represents significant potential harm. "Australia would lose control of digital assets, with markets and custody occurring in offshore jurisdictions," Bragg warns. "We would see investment and talent continue to leak offshore," he adds. "Consumers would be left vulnerable to mass loss events." His Select Committee is thus focused on achieving certainty for the sector, and appropriate consumer protections, without imperiling technology developments. "In exploring answers to these questions, it will of course be necessary to attend to evolving company culture norms and the expected conduct of these new market participants," Bragg writes. "The same interests which are protected by existing financial regulations should be applied to the digital asset ecosystem," he concludes.

All categories of private US fintechs raised more venture capital in 2021 than in 2020 ($B)



Source: S&P Global Market Intelligence

To Wells Fargo star analyst Jeff Cantwell, the digital revolution in the financial sector represents a "$1.5 trillion annual revenue opportunity for Fintech companies globally." Cantwell expects to see 6% annual growth over the ensuing decade.[168] Earlier this year, JP Morgan signaled readiness to invest some $12 billion to compete effectively with the fintech players who have plowed into this space, backed by significant — even 'frothy' — investor backing. Venture capital funding of fintech doubled in 2021, to some $40 billion, S&P reports, with $9 billion going just to investments and capital markets technology plays.[169]

In a December 2021 article,[170] consultancy BCG extolled the virtue of Digital Trust Networks. "By understanding how technology will change the mechanisms, scale, and scope of trust," BCG enthused, "leaders can begin to redesign their organizations, systems, and ecosystems." This tone of optimism is heard in another **Good Counsel** contribution to this report, coming from **Linda Jeng**, a Visiting Scholar on Financial Technology and Adjunct Professor of Law at Georgetown University Law Center's Institute for International Economic Law, who has served as Chief of Staff for Risk, Data and Surveillance at the Federal Reserve Board of Governors and chaired the Working Group on Open Banking hosted by the Basel Committee on Banking Supervision. She writes with colleague **Ari Redbord**, a past Senior Advisor to the Undersecretary for Terrorism and Financial Intelligence at the US Department of the Treasury, and former Assistant United States Attorney for the District of Columbia.[171] ▶ **PAGE 187**

Jeng and Redbord open their piece citing Acting Director of FinCEN, Him Das, who echoes Senator Bragg in asking: "How do we build a regulatory framework that creates the room to foster what's positive about innovation while at the same time ensuring that bad actors can't take advantage of innovations more effectively than the good guys?" As we go to print, the US Securities and Exchange Commission has announced intent to expand an enforcement unit dedicated to crypto and cyber concerns.[172] Anticipating increased scrutiny, it was reported late last year, crypto firms have stepped up their hiring of compliance staff, now competing with traditional financial institutions for such specialized talent.[173]

Yet, despite the common misperception that the crypto sector is rife with criminal activity, Jeng and Redbord argue, "the risk controls inherent in blockchain technology make it far less likely for firms to engage in misconduct without being identified and traced." Just as criminals will use any form of value to launder money, so also can they use crypto. "However, the extreme transparency feature of blockchain makes detection of illicit activities easier since there is a shared, immediate, and immutable record of all transactions," Jeng and Redbord

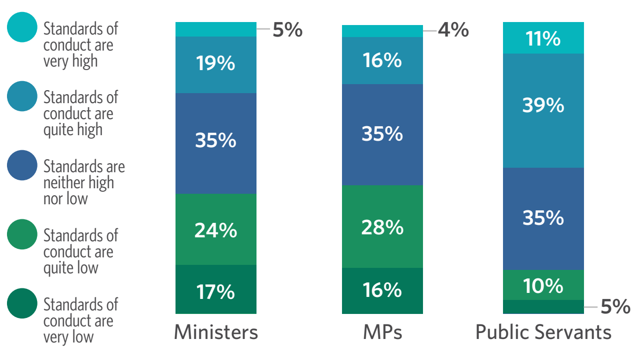
> The risk controls inherent in blockchain technology make it far less likely for firms to engage in misconduct without being identified and traced.

contend. In fact, blockchain analytics afford those in law enforcement, regulation, and compliance far more visibility into real-time financial flows then they have ever before enjoyed — something noted by the Financial Action Task Force (FATF), Jeng and Redbord point out. "Blockchain intelligence can help deter and identify illicit activities, and ultimately enhance the risk and conduct culture of many participants in the financial system," they conclude.

Fit for Purpose?

In November last year, the UK Parliament's Committee on Standards in Public Life issued a report on "Upholding Standards in Public Life," prepared by the former Director-General of MI5.[174] The Committee grew concerned when the UK's credit rating was downgraded by Moody's, in October 2020, which had cited a "weakening in the UK's institutions and governance."

Public views of the standards of ministers, MPs and public servants



Deltapoll survey of 1590 GB adults, 23-26 July 2021

Surveying public perceptions, the report found that the British public rated Members of Parliament and government Ministers most negatively on perceptions of integrity, honesty, selflessness, and openness. Some 66% of those surveyed reported believing that these public servants were "too easily influenced by the rich and powerful." Nearly half questioned whether these government officials sought to act in the public interest at all. "Such figures are perhaps to be expected," the report reads, "in the immediate aftermath of the Greensill Capital lobbying scandal."[175]

Prime Minister David Cameron had hired founder Lex Greensill as an advisor during his time at No. 10 Downing Street. Out of office in 2018, Cameron was hired by Greensill Capital and paid $1 million to act as a lobbyist for the firm and serve as part-time advisor to its board. This placed Cameron near the top of Greensill's payroll. Initially operating as a supply chain financier, the firm grew spectacularly after its founding in 2011, and diversified into financial services more broadly. Valued at $3.5 billion in 2018, the firm collapsed in March 2021, filing for bankruptcy in London.[176] The firm's collapse led to numerous and ongoing investigations and multiple legal actions, with claims and counter-claims filed in several global markets.[177]

And it raised lingering questions about how so large an accounting scandal could possibly have been missed, casting doubt on the reliability of the UK's audit profession and the integrity of its public officials.[178] (Audited by a relatively obscure accountancy firm, Greensill had sought unsuccessfully to retain one of the Big Four or other top-tier auditing firms, as it prepared for an intended public listing.)[179] Cameron was reportedly paid some $10 million in total prior the Greensill's collapse,[180] leaving many with the view that links between Westminster and the City of London are overly cozy.[181] Ensnared in the fallout was Credit Suisse, with an exposure over $2 billion,[182] adding to the firm's ongoing legal woes.[183] At the firm's Annual General Meeting last month, shareholders rejected the company's proposal to discharge legal liabilities for directors and executives who presided over its losses tied to both Archegos and Greensill.[184]

It is neither our purpose nor our place to comment on the merit of the claims and criticisms lodged amidst Greensill's collapse and the subsequent fallout. Our intent here is, however, to highlight how such circumstances contribute to an erosion of trust in the financial sector, and to argue that this is inextricably linked to a commensurate loss of faith in government. Lord Mervyn Davies, a former UK trade minister and regular in UK boardrooms, predicted that "anger and resentment will grow in society if you see leaders adopting a different moral and ethical code to normal life." Former Prime Minister Sir John Major warned that, "no government can function properly if its every word is treated with suspicion." Sir Douglas Flint, chair of Abrdn, reminds that democracy requires trust in leaders. "Once that trust is broken and observance of restrictions/rules is seen as a personal choice," he said, "a rules-based system cannot function."[185]

> Audit firms need the right culture to drive the right behaviours which, in turn, are necessary for high-quality audits.

As we noted last year, governments, the public, and employees are increasingly holding regulatory agencies to the same culture and conduct related standards that those bodies seek to assure among the firms they oversee. They are looked to as part of the frontline in defense of democracy, as the tech industry is fast discovering.[186] They are counted upon to protect market integrity and fairness.[187] And they are expected to assure the integrity and reliability of financial disclosures. If their own cultures condone misconduct, the public is left carrying the cost of the consequent 'negative externalities.'

As we will discuss in greater depth in a **Deeper Dive** supplement to our *Compendium*, to be released later in the year, this has brought heightened attention to the reliability of auditors and the audit profession, which is counted on to provide a "fourth line of defense" in preserving investor and public interests.[188]

Sarah Rapson is Executive Director for Supervision at the UK's audit industry regulator, the Financial Reporting Council (FRC). In an **In Focus** essay here, she describes ongoing reforms in the audit industry, prompted in significant part by perceived cultural lapses. ▶PAGE 231 Following large corporate failures in recent years, reviews of the FRC and the UK audit market were conducted in 2018 ('the Kingman Review'[189]) and further studied in 2019 ('the Brydon Review'[190]). Both reviews triggered reform initiatives aimed at improving the quality and effectiveness of audits, to help prevent corporate failures and to restore trust in the UK's audit profession, Rapson explains. As we go to print, the UK government faces pressure from the business community and others to implement the proposed reforms.[191]

The Kingman Review was catalyst for the evolution of the FRC itself, which is now set to be reconstituted as the Audit, Reporting and Governance Authority (ARGA).[192] The new entity will have "specific aim to operate as an 'Improvement Regulator', providing increased confidence in the UK market," Rapson explains. The Brydon Review had focused more closely on the role, scope and quality of audit work in the UK market. It offered a redefinition of audit and its purpose, emphasized the need for improved audit techniques — to include fraud detection and prevention — and suggested that audit might extend usefully beyond examining financial statements to embrace other information relevant to users of an audit, such as operational resilience and cultural considerations. The Brydon Review also highlighted the importance of culture and "mindset" in shaping audit standards and work quality, Rapson adds.

"Increased standards, training and processes alone will not improve audit quality," Rapson writes. "An auditor's mindset is as much a matter of behaviour and psychology as it is of knowledge and expertise," she adds. "Audit firms need the right culture to drive the right behaviours which, in turn, are necessary for high-quality audits." A purpose-led culture is thus viewed as key to aligning strategic objectives with performance outcomes, Rapson argues. "An audit firm with a culture focused on the public interest role of audit and that promotes behaviours correlating to high quality audit," she writes, will, "help to restore deserved trust in the audit opinion." In this direction, the FRC sees its own role as that of system partner and facilitator to the profession, in addition to the more traditional notions of the regulator as supervisor and enforcer. "We expect audit firms to understand the importance of culture," Rapson advises, warning that, "where a firm does not have an adequate culture programme in place, it should expect increased FRC supervisory scrutiny.

After the global financial crisis, bank regulators around the world dedicated their best efforts to institutional resiliency and systemic stability. However, former Federal Reserve Bank of New York (FRBNY) President Bill Dudley argued in 2013, that post-crisis regulatory enhancements were unlikely address an apparent lack of respect for law, regulation and the public trust that was in evidence at some firms. The problem, the NY Fed came to believe, stemmed from industry behavioral norms. Dudley and his team set out to investigate how normative change could be achieved, to practical effect.

What happens when one group's expectations conflict with those of another group? How do we decide which in-group status to maintain?

Jim Hennessy is a Senior Vice President in the Supervision Group at the NY Fed and has led its Governance and Culture Reform Initiative since 2014. Assistant Vice President and Counsel **Tom Noone**, with the Legal Group in the Bank Supervision and Markets division, chairs FRBNY's Education and Industry Forum (EIF) on Financial Services Culture. In an **In Focus** essay here, they emphasize the practical lessons available to regulators that are to be found in academia. ▸PAGE 199 Launched in 2019, the EIF brings together legal scholars and senior bankers, to produce 'case studies' that can support the training of those in the industry, and those who aspire to join it following their academic studies.

"I tried being more ethical. That's when people stopped trusting me."
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"Each of us belongs to multiple, overlapping groups," Hennessy and Noone write. This prompts important questions: "What happens when one group's expectations conflict with those of another group? How do we decide which in-group status to maintain?"

Many academics have wrestled with such questions, to include many who emphasize the behavioral "contagion" dynamics discussed by Damon Centola and Betsy Paluck, referenced above, and Robin Dunbar's observation that humans tend to 'cluster' into small groups bound by ties of trust and normative compliance.[193] "Ethics (or the lack of it) comes from the inside," Hennessy and Noone contend, with reference to the relevant research. "Inside the individual and inside the group."

It is a responsibility of regulators and business leaders to cultivate an industry profession that espouses and promotes good ethical and behavioral norms. "Collaboration, education and internationalisation are the watchwords" of the FICC Markets Standards Board (FMSB), write **Ted MacDonald**, a member of the FMSB Secretariat, and **Christopher Rich**, its General Counsel, in another of our **In Focus** essays. ▸PAGE 329 They describe the FMSB as a "unique body that looks not only at misconduct but the behaviours that drive it — and ways to interrupt history repeating itself."

The UK's 2015 Fair and Effective Markets Review found a 'regulatory void' between high-level principles and granular operational rules at work in the Fixed Income, Currencies and Commodities (FICC) markets. It also noted opportunity to address conduct risks arising in unregulated markets. The FMSB was created to help close the gap between industry principles and practices, and to raise conduct standards. A broad cross-section of global and domestic firms participate in FMSB initiatives, engaging in a regular dialogue with regulators and other key stakeholders in the course of developing standards and Statements of Good Practice.

The FMSB, MacDonald and Rich assert, "has demonstrated an ability to channel the power of industry-led solutions in collaboration with regulators and international standard setters to support the development of fair and effective markets without a constant need for more restrictive regulation." In an illustration of the practices Hennessy and Noone encourage, the FMSB is neither a regulator nor an industry lobby group. It enjoys no enforcement powers, but members formally agree to be bound by the standards that they help to establish. The group has in its sights future work to focus on topics discussed by others throughout this report: ESG, operational resilience, and digitalization of financial markets.

A healthy risk management culture will welcome unexpected good news on profits, business growth, and the like — but will carefully test this good news for unusual risks.

"It is obvious why the public sector cares about financial crime," writes **Charles Littrell**, until recently Inspector of Banks and Trusts at the Central Bank of the Bahamas, in another of our **In Focus** essays. "But why should the average bank or other firm care about reducing financial crime?" he asks rhetorically. ▶PAGE 207 In answer, Littrell argues firstly that firms failing to observe relevant legislative and regulatory requirements will face ruinous penalties and may lose their licenses to operate. Secondly, he continues, while dealing with financial criminals may be profitable in the short-term, it is highly destructive in the long-term. As such, "Financial crime risk is one among many risks that firms with healthy cultures will manage proactively," Littrell notes.

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The global AML regime raises operational costs for firms, constrains their ability to take on certain clients, and adds considerable risk of fines and reputational damage. Yet relevant law and regulation "is signally failing to reduce crime associated with money laundering noticeably," Littrell contends. Such outcomes lead to cynicism. "Over-compliance in this space will pointlessly reduce returns to capital, without much likelihood of reducing aggregate financial crime," he continues. For AML purposes, a healthy risk management culture will make life harder on risky clients while making it easier on low risk clients. "This trade-off is largely missing from AML compliance," Littrell observes, "but hopefully features in AML risk management." The distinction is not sematic.

"Healthy AML cultures focus upon risk management rather than compliance," Littrell concludes. Compliance is about comporting with 'black-letter'

Risk Behaviours

Leadership
Leaders at every level deliberately and consistently champion risk management, setting a clear tone and role-modelling appropriate risk behaviours to instil the desired risk culture throughout the entity

Decision-Making and Challenge
There is a demonstrated willingness to proactively consider diverse viewpoints and to give and receive constructive challenge across the entity

Communication and Escalation
Risk issues are openly communicated across the entity, supported by an environment where people feel safe to speak up without fear of retribution

Risk Capabilities
The level of skills and learning, well-being, processes, systems and data across the three lines of defence supports effective risk management practices and behaviours

Alignment with Purpose and Values
The entity's espoused Purpose and Values promote and support good risk management behaviours

Risk Architecture

Risk Culture Assessment and Board Oversight
The Board has a robust approach to overseeing the assessment of risk culture in order to form a view, identify desirable changes and ensure steps are being taken to address these changes

Risk Appetite and Strategy
Business and strategic decisions align with the Risk Appetite Statement

Risk Governance and Controls
Across the entity there is effective oversight of risk, and risk management is supported by appropriate risk frameworks, policies, controls and reporting

Responsibility and Accountability
Responsibility and accountabilities for risk are clearly understood, embraced and discharged across the three lines of defence

Performance Management and Incentives
Good risk management behaviour is rewarded and poor risk behaviour has proportionate consequences

Source: APRA

law. "A healthy risk management culture," by contrast, "will welcome unexpected good news on profits, business growth, and the like — but will carefully test this good news for unusual risks."

Chair of the Australian Prudential Regulation Authority (APRA) since 2014, and past-Secretary General of the Basel Committee on Banking Supervision, **Wayne Byres** joins our **In Focus** contributors with a discussion of how APRA is bringing a "risk culture" lens to bank supervision. ▸PAGE 297 Prior to the financial crisis, a focus on short-term financial success eclipsed regard for the way in which those results were generated, allowing for excessive risk-taking, "with significant costs ultimately borne by shareholders, employees, creditors and taxpayers," Byres opens his essay. This led to a focus on risk and culture among bank regulators and supervisors worldwide.

For prudential regulators most particularly, this posed a challenge: while frameworks and metrics for financial risks such as capital and liquidity are well-established, Byres explains, "assessing the behaviours, mindsets and motivations of people — both individually and collectively — is much more difficult." Following APRA's 2018 Prudential Inquiry into the Commonwealth Bank of Australia,[194] and criticism directed at APRA itself in the course of the Hayne Commission (2017-2019),[195] it was clear that incremental change would not suffice: APRA would need to help drive a transformation in risk culture across the Australian financial sector.

APRA has sought to pursue this through: increasing the prominence of governance, risk culture, remuneration and accountability questions in its supervisory assessment model;[196] developing a structured framework — the Risk Culture 10 Dimensions — for assessing risk culture;[197] and bringing more robust data-driven insights to its supervisory opinions.

A risk culture survey has been central to the latter effort, "designed to provide insights from employees within financial institutions on perceived risk behaviours and the effectiveness of the risk management architecture they work within." Initial findings reveal opportunities for improvement in firms' risk governance and controls, decision-making and challenge, and responsibility and accountability. Over time, APRA expects that the survey data collected will provide it with an ability to conduct a horizontal peer review, benchmarking results across several of the institutions it oversees.

"Risk cultures do not just vary between organisations," Byres observes, "they also vary within them." APRA therefore sought to study difference in performance across business units and corporate functions within each institution it surveyed. Perhaps unsurprisingly, strongest results were found among those in Financial Control, Legal, Compliance and Risk. Worryingly, however, poorest results were found among employees working in first line and customer-facing roles. "There can be direct risks to financial soundness and the community's trust and confidence in an institution from poor customer outcomes," Byres warns, "as well as indirect impacts from the root causes of those outcomes, e.g. systemic deficiencies in governance, risk management or risk culture."

There can be direct risks to financial soundness and the community's trust and confidence in an institution from poor customer outcomes.

While its survey provides valuable insights into such risks, APRA is also exploring the development of reliable non-financial risk metrics through machine learning tools such as Natural Language Processing and Sentiment Analysis, and is trialing a number of data visualization techniques to help convey key information. "We not only aim to produce better supervisory assessments," Byres concludes, "but also to provide financial institutions themselves with better feedback, including valuable peer comparisons, that can help boards and senior executives better manage their own businesses."

We are delighted that Canada's Office of the Superintendent of Financial Institutions (OSFI) was able to join our **In Focus** series this year. Superintendent **Peter Routledge**, who took the helm at OSFI in June last year, joins us for an interview in which he discusses the regulator's shifting priorities around culture and conduct risk governance. ▶PAGE 221

With the onset of the covid pandemic, financial regulators and governments took extraordinary measures to lessen the consequent financial risks faced by financial institutions. Though generally effective, Routledge contends, these were not comprehensive in addressing emerging concerns, such as increased operational risks and broader societal shifts. "By that, I mean an increase in the public consciousness of Environment, Social, and Governance (ESG) issues and risks," he clarifies. OSFI will publish related culture guidance by the end of the year, Routledge advises, which will contemplate related disclosures to support prudential outcomes. "Disclosures support accountability for actions, decisions and norms that should reflect organizational purpose and values," he observes. "Shareholders, consumers and employees want to support organizations whose values resemble their own."

Shareholders, consumers and employees want to support organizations whose values resemble their own.

"Diversity is a strategic imperative in building a more resilient organization, navigating change, and arriving at better decisions," Routledge argues. This applies equally to regulatory bodies, as well as the firms they oversee, and OSFI's December 2021 "Blueprint" reflects this.[198] "We, as a Canadian federal financial regulator, must hold ourselves accountable to higher standards for diversity," Routledge asserts. A culture of equality and inclusion is essential in this context. "This can be easy to say and sometimes hard to practice," he allows, "which is why our approach recognizes the need for psychological safety for employees where it is safe-to-fail and safe-to-be different."

A Culture & Compliance Risk Division has led development of OSFI's approach to culture supervision, with a focus on achieving better understandings as to how institutions assess and manage their behavioural risks and assure effective promotion of desired culture. Prudential regulation often takes shape outside the glare of public scrutiny, Routledge notes. Shifting priorities has changed that. "The greatest risk for a regulator in fulfilling their mandate is to not act, or to act too slowly," he says. "The costs and consequences of not acting can erode our credibility, public confidence, as well as the financial stability we seek to achieve."

Also relatively new in post is **Chris Calabia**, Chief Executive of the Dubai Financial Services Authority (DFSA), who took up the role in October last year. In another of our **In Focus** interviews, Calabia discusses how learnings he achieved earlier in his career, with the New York Fed and the Bill and Melinda Gates Foundation, suggest promising directions for him in Dubai. ▸PAGE 281

"When you speak with a DFSA regulator," Calabia points out, "in many cases you're talking with someone who has worked for years on regulatory issues in other major jurisdictions." This cosmopolitanism serves a market like Dubai well, providing a beneficial diversity of regulatory experience. "Firms that conduct business in London, Sydney, Singapore, New York, or similar hubs feel comfortable with our approach to regulation and adapt quickly," he claims.

When he started his career in bank regulation, Calabia confides, he'd expected it to be fairly dry work. He was surprised to discover, however, just how much creative broad-mindedness was called for. "Given how dynamic and fast-paced the economy can be, I saw that being a regulator requires humility and a real love of learning to keep pace with, and even anticipate, risks and opportunities on the horizon," Calabia writes. This time in his career exposed Calabia to crises such as the September 11 attacks and the 2008 global financial crisis. Courage and imagination were needed to help shape desired outcomes amidst such difficult circumstances, he recalls. This equipped Calabia with a perspective highly relevant to the work of the Bill and Melinda Gates Foundation, where he spent four years prior to joining the DFSA.

"Studying emerging markets and the needs of society's most vulnerable required me to examine some of my long-held beliefs about who should provide financial services and how," Calabia writes. His work at the Foundation involved sponsoring research and dialogue to explore how innovative offerings might help to facilitate greater financial inclusion. "Many of these innovations could bring in new kinds of providers and a wider range of customers than the financial sector had served before," Calabia explains. Experience such as this has left him eager to emphasize innovation at the DFSA, which has launched a number of initiatives and has developed and deployed some 'SupTech' tools in house.

"I'd like to share our lessons and hopefully our technology with other regulators, too," Calabia says. "Since financial services are global, it's in everyone's interest for regulators collaborate and cooperate to ensure that the global financial system is resilient, sustainable, and inclusive." In that direction, "dialogue across providers, innovators, technology providers, customers and regulators is key to building the future of finance and regulation," Calabia concludes.

Better together

Contributing from **The Academy**, Management Practice Professor of Finance at Cambridge Judge Business School, and Director and Co-founder of the Cambridge Centre for Alternative Finance, **Bob Wardrop**, emphasizes the importance of what he calls "consensus structures." ▸PAGE 375 Adding to the disruptions endured throughout the covid pandemic, technology change, geopolitical tensions, and sustainability challenges are adding to the complexity of financial sector regulation. "A growing number of organisations have concluded that there are diminishing returns from throwing more human resources at this complexity and are migrating to more machine-based compliance processes," Wardrop writes.

> Dialogue across providers, innovators, technology providers, customers and regulators is key to building the future of finance and regulation.

Applications running on machines cannot 'read' regulatory content produced for human consumption, of course. This information must be rendered 'machine readable' and, in the course of such 'translation' work, structure is imposed on data — an organizing framework that makes content meaningful for the purposes of an application and its end users. The work involved is complex, and all the more challenging where regulation is aimed at addressing qualitative challenges, such as those posed by environmental, societal, and governance (ESG) risk reporting. Such traditionally non-quantifiable metrics must be fitted to both the regulator's rulebook and the industry's go-to tools, Wardrop explains. "For example, including culture and conduct metrics in traditional financial sector assessments and finding a place for them in the Governance, Risk and Compliance (GRC) systems used by firms," he offers by way of illustration.

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"If we want to succeed as a team, we need to put aside our own selfish, individual interests and start doing things my way."

"A consensus structure," Wardrop continues, "is one that preserves meaning across organisations and functions." This is essential to avoiding duplication of effort, organizational silos, interoperability challenges, and vendor lock-in. Reaching consensus will necessarily involve regulators, supervised entities, and technology innovators. "Regulated firms crave certainty and safety in numbers," Wardrop writes, "and they are never keen to converge on standards without a good sense of the regulator's approval." At the same time, "regulators have been reluctant to influence or own industry standards at this operational level." In the RegTech era, Wardrop advises, this must change.

> Regulated firms crave certainty and safety in numbers and they are never keen to converge on standards without a good sense of the regulator's approval.

Such technologies can help to augment human judgment but, “without a consensus structure to guide both data collection and business practice,” he warns, “the opportunity for duplication, and for inconsistent aims and measurements between firms, is enormous.” What should a risk-based, consensus structure for ESG look like, Wardrop asks. “Regulators, firms and technologists will need to work together in coming years to answer this question comprehensively, practically, and at scale,” he concludes.

We recognise the key role that culture plays in ensuring a strong control environment from a risk-taking perspective. The challenge is being able to assess culture in objective terms and to be able to identify problems early on.

Marcus Lim is Assistant Managing Director of the Banking and Insurance Group at the Monetary Authority of Singapore (MAS), where he oversees the licensing and supervision of all banks, insurers and finance companies. In another **In Focus** essay, Lim provides an illustration of the collaboration between regulator, firms, and technologists that Wardrop urges. ▸PAGE 263 “While artificial intelligence has become more embedded in our daily life,” Lim writes, “its increasing adoption has added impetus for us to explicitly codify what is acceptable behaviour so that we do not end up with unintended outcomes.” To facilitate responsible adoption of artificial intelligence and data analytics tools, in 2018, MAS promulgated a set of ‘FEAT Principles’ that work to promote Fairness, Ethics, Accountability and Transparency.

To translate the FEAT Principles into tangible measures, in 2020 MAS established the Veritas consortium, convening financial institution executives, top AI firms, industry associations, and consulting firms to develop an assessment methodology and open-source evaluative software toolkit. The toolkit enables automation of the “fairness” metrics assessment, provides a visualization interface, and offers plug-ins that integrate with IT systems in use among financial institutions. In its next phase of work, the consortium will develop additional use cases and run pilots with selected firms aimed at integrating the methodologies it is developing with consortium members’ existing governance frameworks. MAS is also working to enhance its ability to supervise the use of artificial intelligence and data analytics tools by piloting the use of Veritas in its inspections of financial institutions.

Culture can be observed, Lim writes. It can be felt. “Yet giving it a score and benchmarking one firm against another has proven to be practically difficult,” he allows. However, the success of the Veritas consortium demonstrates that it is possible to put quantitative metrics to qualitative notions such as fairness. This suggests that culture could be similarly defined and measured, Lim concludes. MAS has been working on a Culture Assessment Framework leveraging behavioural science and organizational psychology. “As a financial supervisor, we recognise the key role that culture plays in ensuring a strong control environment from a risk-taking perspective,” Lim writes. “The challenge is being able to assess culture in objective terms and to be able to identify problems early on.” The experience of MAS and the Veritas consortium suggests that artificial intelligence and data analytics tools may be advancing such capabilities.

A key trend during the covid pandemic, data provider Refinitive details in its 2021 *Global Risk and Compliance Report*, has been greater collaboration between businesses, people, and institutions, towards advancing the common good.[199]

Singapore has begun working more closely with Chinese regulators to boost supervisory cooperation.[200] In February this year, it announced that it would advance cooperation with the China Securities Regulatory Commission.[201] Singapore has also announced expanded cooperation with the

Bank of Indonesia across central banking, regulation and innovation.[202] In March this year, it announced it would work with the Central Bank of Cambodia to develop Central Bank Digital Currencies.[203] Last summer, Singapore and the UK announced intent to deepen their own regulatory collaboration.[204]

The pace of change in technology is remarkable and accelerating.

In a first of a kind effort, last December, the Monetary Authority of Singapore and Hong Kong's Securities & Futures Commission jointly broke up an international criminal syndicate running 'pump & dump' scams involving stocks traded on the Hong Kong Exchange.[205] Banks in Singapore are increasing collaboration aimed at thwarting financial crime.[206] And global financial institutions are increasingly sharing data on non-financial risk exposures.[207]

The Hong Kong Monetary Authority and People's Bank of China are working to establish a one-stop 'sandbox' through which to promote greater fintech innovation.[208] The Hong Kong Insurance Authority is exploring the development of an Open API Framework to facilitate collaboration between insurers, regulators, and third-party service providers.[209]

Similarly, the Dubai Financial Services Authority aims at greater international cooperation.[210] In April, it signed an MoU with the Central Bank of Mauritius, aimed at mutual assistance in their respective regulatory functions and greater knowledge exchange on technologically enabled financial innovation.[211]

Created in 2019, the Bank for International Settlements (BIS) 'Innovation Hub' was established to identify critical trends in technology affecting central banking, to develop public goods in the technology space geared towards improving the functioning of the global financial system, and to serve as the focal point for a network of central bank experts on innovation.[212] Last summer, it announced a partnership with the Bank of England to create a London innovation center.[213] After a busy start among the first three Innovation Hub Centers, in Switzerland, Hong Kong and Singapore, the BIS announced a still more extensive work program for 2022.[214] In March this year, its Singapore center announced the joint development of a supervisory analytics platform with MAS.[215] And its London center outlined its initial projects.[216]

"The pace of change in technology is remarkable and accelerating," BIS London center head **Francesca Hopwood Road** writes in an **In Focus** essay. ▸PAGE 317 "The thrust of these Centres has been to drive cooperation and collaboration with their host central banks and with partners in the public and private sectors and academia so as to deliver valuable contributions that enhance understanding and capability of new technologies," she explains. In this direction, the center is pursuing six workstreams: central bank digital currencies, next generation financial market infrastructures, technology applications for regulation and supervision, open finance, green finance, and cyber security.

"From my previous vantage point, as head of RegTech & Advanced Analytics (SupTech) at the UK's Financial Conduct Authority," Hopwood Road adds, "I saw the transformational impact that technology was having in the markets we regulated and the response it required." She writes of SupTech tools she had seen to help regulators increase efficiency by automating manual processes, and by deriving critical insights from data that enabled a better understanding of emerging risks. "So, I am an advocate — albeit a clear-eyed one — for the role SupTech can play," she writes.

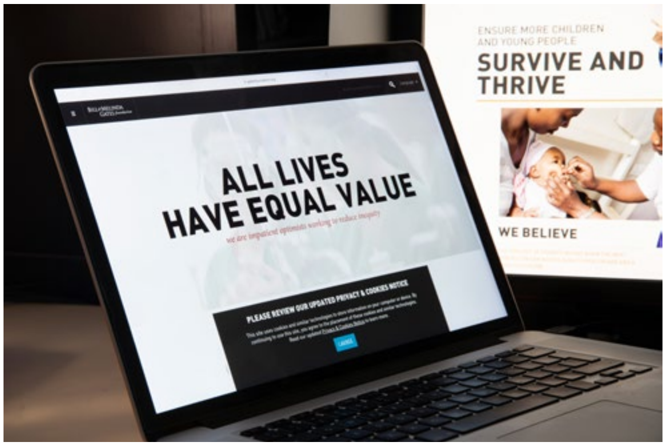
Hopwood Road is joined in this essay by **Joy Wann**, an advisor to the BIS Innovation Hub Centre in Singapore, where she is lead for projects on regulatory data analytics and climate-related financial risks. "A core principle for effective banking supervision is the development of forward-looking assessments of banks' risk profiles," Wann writes, "to identify and assess early on issues that may arise in the future and to be able to intervene if needed." In order to meet this objective, supervisors need access to current, timely, and relevant data. What they get, however, is regulatory reporting burdened by fixed templates, infrequent collection, and data muddled by aggregation. "This does not support new tools or applications that could enable real-time or early warning analytics," Wann complains.

'Project Ellipse' was launched by MAS and the BIS Singapore Center to explore solutions that could address these issues. With the goal of creating a single regulatory data and analytics platform that would combine structured regulatory data with unstructured sources of real-time data, Project Ellipse is intended to then allow advanced analytics that yield early warning indicators and prudential metrics for supervisors. "Cooperation with multiple stakeholders was crucial for moving this project from a proof-of-concept to a working prototype," Wann emphasizes.

> There is now widespread recognition of the potentially significant benefits and opportunities regtech and suptech offer regulated entities and supervisory authorities alike.

The Ellipse platform will be shared with authorities globally, and Project Ellipse will be the first BIS Innovation Hub pilot to launch a collaborative community, through the BIS Open Tech initiative for sharing statistical and financial software as public goods. "There is now widespread recognition of the potentially significant benefits and opportunities regtech and suptech offer regulated entities and supervisory authorities alike," Wann concludes. "By joining forces through a collaborative community, central banks and regulatory authorities can work together to create new applications that serve common use cases and priorities."

As part of our **Ground Breakers** series, we interview **Kanwaljit Singh**, Senior Program Officer at the Bill & Melinda Gates Foundation (BMGF), where he leads the emerging technologies portfolio of the 'Financial Services for the Poor' team. ▶PAGE 121 Singh joined the BMGF from Intel, where he was pursuing cutting-edge research into quantum computing. "I loved the work I was doing at Intel — I would never have quit," he says. But during a chance visit to Seattle, Singh visited the Foundation's Discovery Center and reports being struck, viscerally, by an exhibit which confronted visitors with the struggle countless children in the developing world face daily just to obtain water. "I felt that I needed to do more," he says.



A sign in the Discovery Center lobby carried the tagline: arrive curious, leave inspired. "And that's exactly what happened for me," Singh recounts. Describing the "Financial Services for the Poor" initiative, Singh begins with a statistic: 1.7 billion people in the world do not have any sort of a financial account. "Where do you borrow money when you're hungry? Where do you borrow money in an emergency, or when somebody's sick?" With well-developed technology skills, Singh felt positioned to make a difference. In a portfolio of technology investments he manages, Singh aspires to bring financial services to these populations, "to give them a chance at leading a more prosperous life."

We can't expect regulators to become technologists," Singh argues. "Nor can we expect the technologists to become regulators. We need to work together.

Because an account cannot be opened without a customer first having an ability to verify his or her identity, the BMGF funds an open-source identity platform. "Identity is one of those core enablers," Singh explains. The administrative burden typical of traditional financial institutions represents a cost for firms that is passed along to customers — a cost that poor customers cannot afford to absorb. Digital technologies, however, allow for mobile money products that can serve the poor profitably. But reliance upon these technologies comes with its own attendant risks. "On one hand, I try to make investments that break barriers to allow populations to become more financially resilient," Singh explains. "But then I also have investments in risk mitigation like cyber-security, data privacy."

A third part of his portfolio aims at making technology more accessible. "I can speak to an Alexa device, or any of the many other voice-based digital assistants, and I can speak in English and many other mainstream languages," Singh observes. "But these digital devices don't speak the languages of the poor. What about Kiswahili? How many people speak Kiswahili? What about Bhojpuri? How many people speak that?" Making sure that such technologies cater to the realities of the poor and excluded is catalytic of prosperity. "All lives have equal value," Singh asserts, summing up the ethic that motivates his work with the Foundation.

"Fin wants to become Tech and Tech wants to become Fin," Singh notes, "So, we see the finance companies buying the tech companies, or the tech companies buying the finance companies." Instead, he calls for more system-level thinking. Technologists are good at thinking in terms of platforms with extendibility well beyond their initial intended functions, Singh says. "Who do regulators trust?" he asks. "They trust other regulators." So, there is need for innovation that brings technologists together with regulators to work jointly towards solutions that provide for greater financial inclusion. "We can't expect regulators to become technologists," Singh argues. "Nor can we expect the technologists to become regulators. We need to work together," he concludes.

Cognitive prosthetics

Deputy Secretary-General of the Organisation for Economic Co-operation and Development (OECD) **Yoshiki Takeuchi** represents the OECD on the Financial Stability Board. Here, he offers an **In Focus** discussion of the OECD's recent work on assuring 'trustworthy AI' applications in business and finance. ▸PAGE 337 "AI-powered applications are now a familiar feature of the fast evolving landscape of technological innovations in financial services and regulation (FinTech and RegTech)," Takeuchi writes. Acknowledging the opportunities these technologies offer to increase efficiencies and even reinforce financial stability, he cautions that the broad and expanding use of AI applications also poses real risks. "Policy makers and market participants must redouble their engagement on the rules needed to ensure trustworthy AI for trustworthy financial markets," Takeuchi urges. "It is up to us — governments, business, and the international community — to strike this balance, together."

We need the strength that comes from multilateralism.

The OECD's 2021 Business and Finance Outlook examines the growing importance of AI applications in key policy areas of finance, to include responsible business conduct.[217] A key risk, outlined in the report, stems from the challenges of making AI algorithms 'explainable,' potentially leading to an amplification of risks that beset the financial industry. This represents still another expansion of the regulatory perimeter. "There is growing awareness that existing financial regulations may fall short of addressing systemic risks presented by wide-scale adoption of AI by financial firms," Takeuchi observes. Common approaches between countries are necessary to avoid fragmentation and assure a level playing field. "We need the strength that comes from multilateralism," he emphasizes. "As AI applications become more closely stitched into the fabric of how we do business and finance today, the use of trustworthy AI becomes increasingly important for ensuring trustworthy businesses and financial markets," Takeuchi concludes.

In addition to questions about the explainability of AI *outputs*, thorny privacy rights concerns must be navigated in establishing socially acceptable data *inputs* into AI analytics engines. Beyond assuring that model methodology and assumptions are conceptually sound, fit for intended purpose, and have good predictive power, firms must establish a regular means of "vetting of data inputs to ensure accuracy, completeness and appropriateness," the BIS argued in an August 2021 paper entitled, "Humans keeping AI in check: emerging regulatory expectations in the financial sector."[218]

Conversely, in another essay from **The Academy** found here, Editorial Director of the *MIT Sloan Management Review* **David Kiron** suggests that AI may play an important role in keeping *humans* in check, after a fashion. ▸PAGE 365

In industry after industry, we see innovative analytics leading to innovative metrics.

Harvard Business School's Robert S. Kaplan was an originator of the 'KPI' — Key Performance Indicators — now a common set of metrics used in countless management practices. Here, Kiron recounts a discussion with Professor Kaplan about the growing use of machine learning to refine KPIs. "Our own research was finding that more companies were using KPI outcome data to train machine learning algorithms to evaluate strategic and operational assumptions," Kiron writes. But Kaplan was more interested in a higher-order topic: how AI and machine learning tools could help executives to define and communicate *new* KPIs, and to align organizational behaviors around these new metrics.

Companies' systems of strategic measurement are built to support leadership objectives. "But our research was identifying a new wrinkle," Kiron writes. "Executives were using artificial intelligence and machine learning to discover new ways to drive growth, identifying and enabling new metrics and new behaviors." This is not a subtle shift, he continues. "A new trend is emerging: how you measure can be just as important as what you measure." That is, new technologies are allowing for the discovery of new metrics, better suited to discerning drivers of desired performance and for the development of a richer set of KPIs. These more finely tuned measures lead to better alignment of behaviors with strategic objectives. "In industry after industry, we see innovative analytics leading to innovative metrics and new organizational behaviors that drive superior performance outcomes," Kiron writes.

How you measure can be just as important as what you measure.

Kiron sees an emerging hybrid leadership environment, informed by both human judgement and hitherto unavailable management guidance achieved through AI, to foster "predictive alignment" of strategy and operations. This has several key implications: (1) using AI to source new indicators of success will blur the line between strategy development and execution — "AI can help redefine, not just improve, performance"; (2) leaders will be held accountable not only for how they perform on standard business metrics, but for how well they are able to cultivate and apply new, superior metrics that help to test assumptions and to formulate new strategic hypotheses; and (3) leaders will need to use AI to align organizational behaviors with new KPIs, and to spot new relationships among those KPIs — "That is, instead of merely maximizing performance on individual KPIs, AI can be used to optimize performance across KPIs," Kiron writes.

Central to the themes of this report, Kiron shares recent research from MIT and consultancy BCG which finds that, "AI solutions that improve decision quality and efficiency also improve several aspects of team culture, including morale, collaboration and learning."[219] Effective use of AI helps to improve culture and performance, Kiron concludes, to the benefit of shareholders and other stakeholders. As we debate the ethics attached to the use of AI in finance, and in the workplace more generally, so must we consider the ethical implications that attach to decisions *not to use AI* where such performance improvements are put within reach.

AI solutions that improve decision quality and efficiency also improve several aspects of team culture, including morale, collaboration and learning.

In an **Our View** essay here, Stanford sociologist **Karen Cook**, Director of MIT's Center for Collective Intelligence **Tom Malone**, and Harvard Business School professor of leadership **Amy Edmondson**, suggest that we reframe the debate about AI use, to avoid what often sounds like a shouting match between techno-utopians and Luddites. ▸PAGE 457 Rather than replacing human judgement, they argue, AI provides "Augmented Intelligence" capabilities — serving as a form of cognitive prosthetics for human decision-makers.

In this context, the debate about 'trustworthy AI' turns on a discussion of how we trust at all. "By evolutionary design, we are inclined to trust others whom we believe to be like ourselves," they write. Assuming people like us to work from the same background knowledge, beliefs and values as we do, we feel that we can accurately infer what someone else is thinking. This is referred to as Theory of Mind: 'I think that you think that I think…' and so on.[220] But we have no such theory of mind when it comes to AI. "We don't know what the algorithms are 'thinking,' and we have no basis for

inferring that machine intelligence systems ‘think’ as we do at all,” the authors observe. “Indeed, we know that they do not.” So how are we to trust AI?

The decision to trust has cognitive and affective components. Before trusting in someone, we want to know that they are competent and reliable. These cognitive elements are insufficient, however. We also want to know that they are honest and benevolent towards us in orientation. We trust, that is, from both the head and the heart.

And this is the trouble with AI used in workplace surveillance, for instance. Risk and compliance officers, as well as bank examiners and supervisors, are sufficiently experienced with such technologies that they can judge well the competence and reliability of surveillance tools. However, those subject to that surveillance — employees — are not equally well positioned. And while bank managers and supervisors may believe themselves to act with honesty and benevolence, employees are understandably more circumspect. “Trustworthy AI is a community-endeavor,” Cook, Malone, and Edmondson conclude. If we are to see AI welcomed more gladly in the workplace, then employees, managers, regulators, and AI vendors must satisfy the four key tests of trust:

Trustworthy AI is a community-endeavor

- Is it competent — does this tool work properly in this context?
- Is it reliable — can we count on this tool to work when we need it to?
- Is it honest — is the functioning and the intent of tool transparent?
- Is it benevolent — is it designed and deployed to serve my best interests?

AI offers new means of connecting the dots between current circumstances and future outcomes in ways that may be non-obvious, and even counterintuitive, as David Kiron argues. In the context of culture and conduct risk management, where AI tools pass the four key tests of trust, their adoption may permit us to predict and prevent adverse outcomes, rather than merely detecting and correcting for them. **Tom Reader**, a professor of organizational psychology at the London School of Economics & Political Science, addresses this in a final **Our View** essay here. ▶PAGE 441

“Behavioral risk management in banking is most typically an exercise in applied hindsight,” he writes, “we investigate misconduct only after it is discovered to have taken place.” This is unacceptable as a standard of care in other industries: nuclear power, aviation, and healthcare, for instance. In such industries, when risk and safety measures fail, lives are lost. After suffering through past disasters, government and industry leaders in these sectors came together to establish a better standard of care; one that emphasized forecasting and averting such operational failures. Crucial to the success of these efforts were: successfully creating ‘speak-up’ cultures; working through public-private partnerships to establish new risk and safety protocols and practices; cooperating with competitors to share evolving best practices; and transitioning from reactive to proactive methods of managing and controlling for hazard — a forward defense.

"If we are to manage from a proactive posture," Readers concludes, "we need to take a dynamic view of risk and to recognize that risk unfolds into accident within an evolving social context." In many instances, unrecognized cultural norms drive poor behavior, through a 'normalization of deviance'[221] that leads to eventual catastrophic failure. As such, Reader warns, "Risk management systems that fail to take culture as a starting point are compromised at the outset."

Risk management systems that fail to take culture as a starting point are compromised at the outset.

Welcome to the revolution

"Lessons in life will be repeated until they are learned," **Klaas Knot** writes in **Closing Comments** to our report. ▸PAGE 479 "In recent years," Knot observes, "there has been increasing recognition that governance and culture relating to financial risks cannot be separated from governance and culture of firms' activities considered more broadly."

Serving as President of *De Nederlandsche Bank* since 2011, in December last year, Knot took up chairmanship of the Financial Stability Board — created in the wake of the financial crisis to provide a forum where national financial authorities and international standard-setting bodies could collaborate and coordinate in the promulgation of effective regulatory, supervisory, and other financial sector policies.

Governance and culture relating to financial risks cannot be separated from governance and culture of firms' activities considered more broadly.

"Strong governance frameworks provide crucial safeguards, enabling institutions to be adequately prepared for unexpected developments and structural changes in the financial system," Knot maintains, pointing to the manifold challenges posed by Russia's invasion of Ukraine, the pandemic, digital innovation, cyber threats, decentralized finance, and a transition towards a green economy. Against the backdrop of these and other challenges receiving heightened public attention today, "the business model of a financial institution is only sustainable if it is based on providing services to society with long-term added value," Knot cautions.

With the majority of contributors to our report, Knot argues that the governance and culture of firms are crucial to their ability to manage operational risks. Culture and conduct risk governance capabilities are fundamental to the integrity of the financial system, Knot suggests, and must be regarded as such. Therefore, "international coordination among supervisors and regulators to keep their frameworks relevant for today's challenges is crucial," Knot concludes.

"History shows that when a revolution takes place, it tends to succeed *not* when a tiny majority of committed activists embrace the cause," writes Gillian Tett in *Anthro-vision*, but when enough among us decide, "it is too dangerous or pointless to resist change." In culture and conduct risk governance reform, we may have crossed that threshold.

GROUND BREAKERS

"The market is not just companies, corporations, buying and selling, profits and losses. It is also a mindset, a mentality, a way of looking at things."

RABBI LORD JONATHAN SACKS

MORALITY: RESTORING THE COMMON GOOD IN DIVIDED TIMES [2020]

Ground Breakers

An Interview with Kathleen Taylor

Kathleen Taylor

Q: A key theme in our report this year is that a firm's culture, and the conduct it promotes, should be viewed as critical governance concerns — the G in ESG. You've said that well governed companies have long adhered to the principles we now think of 'ESG.' Can you say a bit more in that regard?

A: It's been a longstanding belief of mine that there's an inextricable link between a company's purpose, its strategy and its plans for how it's going to execute on that strategy. And one of things that fuels all of that, of course, is its culture. All of these elements have to be connected in a way that allows the organization to figure out what value it wants to add to the world, how it wants to do that with individual customers, clients and business partners, how it's going to do that in a responsible way, and how it's going to create a culture that encourages employees and others to want to align themselves with the values and goals of the organization.

Again, this implies an inextricable link between strategic direction, risk appetite, purpose and culture. All of that has to come together as different building blocks that go into making a successful business. So, from a governance perspective, it's no surprise that relevant oversight and stewardship of culture should be seen as a core responsibility of the board of directors. We have to understand what the organization thinks its purpose is, its destination is, its mission is, and how it's going to serve its clients and its customers, whether those be individual consumers or business partners. And then doing that in a way that creates a sustainable proposition for long term success. All of that has to be taken into account.

Q: Under your leadership, the Four Seasons hotel chain — renowned worldwide for its excellence in service — viewed itself as operating within what you've called an "ecosystem." This implied that choices the company made might lead to unexpected results well into the future. How did this reality shape Four Season's strategy and outcomes?

A: As I just noted, building a culture that supports both community engagement, client engagement, and employee engagement is incredibly important to the successful execution of any strategy. It's important to know 'what' you want to do in business, but it is also very important to know 'how' you want to do it.

When I was at Four Seasons we spoke of culture as fundamental to the product we were bringing to market. The culture there, simply stated, was to treat others the way you would want to be treated if you were them. A 'Golden Rule' culture. And at the end of the day, that informed how we hired, managed and inspired our people, all in furtherance of a clear business purpose — which was to provide our guests with extraordinary, bespoke experiences, whether they visited us for business or for pleasure.

We worked hard to make sure we had an empowered workforce, one that was prepared to step up — in those "moments of truth" — to make sure that we were delivering on our brand promise to our customers. This was incredibly important to the fulfillment of our business strategy because, in the hospitality industry, the product is delivered the moment a guest comes into contact with an employee. It could be eye contact, it could be verbal contact, it could be visual contact. That's when the service begins and the customer experience starts. There's no room for after production quality control. It's just right out there in the moment.

When I retired, we were operating in 90 locations in 36 countries. So making sure employees — in vastly different cultures, different locations, different kinds of buildings — all got up every morning with the idea that our culture — and the foundation of our competitive advantage — was to treat our guests the way we would want to be treated if we were them. And that spilled over to treating each other the same way. Our Golden Rule culture was integral to our business purpose, our strategy and our brand promise, and so delivering on that for one another as well as for our guests was essential to ensuring that they came back again and again.

Every business has its own needs in this regard. It doesn't matter whether you are a one store retail outlet, a large universal bank, or a global airline. At some point in your journey, you have to figure out not only what you want to do, but how you want to do it. If we think about the purpose of the Royal Bank of Canada — 'Helping clients thrive and communities prosper' — the culture and behaviours are directly attached to making sure that we are doing the right thing for our clients and our communities.

That is a guiding North-Star for our employees: to ask, "all right, does this fit within the cultural frame of reference of what it is we're trying to do here?" And if you can have some common language around your values and the way that you want your business to be perceived by your various stakeholders, and you continue to speak to those aspirations over and over again, it forms an important grounding and a base for employees to do their best work in the best way they know how.

Q: It's interesting how you've linked strategy and culture to alignment and sustainability. Today, various stakeholders — including investors — expect public companies to be a catalyst for positive change. You have stressed that "substance over form" is essential here. Would you say more?

A: First off, I think it is incredibly important to recognize that organizations of all shapes and sizes participating in the economy are, by definition, also participating in society. And so, ultimately, it's critical for each and every one of them to have an understanding of where they fit in, what business it is they're trying to do, what purpose it is they're trying to serve, what destination they're trying to achieve with their overall strategy. Embedded in all of those conversations is the question, what are we going to take from the resources on offer to us in order to help us run our business, and what are we going to give back in the way we think about that? So, it's implicit in my way of thinking about business that the E, the S and the G are front and center.

People need to think about this in the scheme of the businesses they're building. Companies have to view themselves as participants in this social journey that we're all on. Because all dots are connected: as we're learning in the world of the pandemic; as we're learning in a world suddenly confronted by war in Europe. All these dots are connected, and there's no real way to say, "okay, my company has nothing to do with all that." If you're participating in the economy, if you're participating in a community that hosts your business, if you're hiring people, if you're producing goods, if you're emitting carbon, then you're simply connected to so many other things. Recognizing business as a participant in all of this is important.

> There's no room for after production quality control.

And we can't think of ourselves as passive participants. Business has to be an active participant in the sense that we take responsibility for the things a company stands for, the things it wants to see accomplished, the things it wants to champion. All of that comes back to your question of how businesses can be catalyst for the important change that needs to happen in the world. If solving climate change had been easy, it would've been done by now. If solving social injustice was easy, it would've been done by now. These are complex interconnected problems that require a vast and coordinated effort to get to the right answers. Everybody has to be prepared to do their part. And to do so in a way that isn't just about aggrandizing their public profile.

Q: In this regard, perhaps we can drill down to explore the approach to ESG that characterizes the board of RBC. Would you describe the board's role in ESG risk oversight? What does this mean for board structure and the necessary board expertise?

A: We can say a lot about how the world ought to be. But taking action, doing things that usher in some of this important change, that's where the hard work is. Signing up for all of these things is very important, but actually following through with action plans and measurement metrics to see whether we're achieving these important goals is important work for all businesses.

We have to view the E and the S and the G as fundamental to any successful strategy. And it doesn't matter much which industry you're in or where you sit within a given industry. Your approach to environmental issues, your approach to social and human capital issues, and your approach to good governance, all of these three areas are going to have significant impact on getting your strategy and your business execution right over the medium and long term.

So with all that said, the board's role in a company's ESG journey is central. We've been talking about governance for a long, long time inside boardrooms. Good corporate governance now involves assessing boards with a view to their adherence to good governance, their structures for good governance, their processes for good governance. But governance goes beyond the board too. And part of the board's job is not only to ensure that they have great governance, but also that the management teams that they're helping to oversee are adhering to good governance across the organization.

We have to view the E and the S and the G as fundamental to any successful strategy.

That includes governance around risk management, talent retention and development and succession planning. It includes governance around your approach to climate and your specific climate targets and climate journey. Board and management governance underpins all of that, and so an important part of the work that all boards do.

Q: You've said that "competence, curiosity and courage" are key characteristics of good corporate directors. What led you to this view? Can you offer some detail as to what each of these characteristics means to you in terms of a high performing board?

A: The three Cs, as I like to call them — competency, curiosity and courage — are plagiarized from a dear friend, Stephen Jarislowsky, who is one of Canada's most illustrious institutional investors and the co-founder of the Canadian Coalition for Good Governance. He spoke to me early on in my board journey about his views on what made a good corporate director. And those were his three Cs. I started thinking about them over and over and over again, not only as I observed my own behavior and learning in the boardroom, but also as they applied to those around me.

Competence means that a director has to have the relevant ability and skills to serve as a steward of the business that he or she has been asked to oversee. Sometimes that will mean possessing a deep knowledge of the vertical that you're in. So, it wouldn't be surprising to anyone to see that we have financial services experts serving on the board at RBC. But it goes beyond that. It's about all the elements of the business. And, so, we need people who understand technology deeply, human capital deeply, client and customer services deeply, etc. Competence is essentially a gating issue: does the person have the experience, the background and the knowledge that will make them an effective and contributing director?

The second 'C' — Curiosity — is just as important. Where Competence is table-stakes, Curiosity is all about the need for continuous learning. The organizations that we are directors of — whether a large universal bank, an airline, and investment fund, or talent staffing business, just to name four that I'm involved in — are all constantly evolving, the markets they serve and the products they offer are constantly changing. Think about the last two years dealing with the previously unthinkable challenges posed by the pandemic, and now the war in Ukraine. There's no touchstone for that in business, no handbook, no way of saying, "okay, here's what we did the last time..." So, this experience of the past couple of years serves as a great reminder of the need to be constantly learning, constantly curious, asking questions that might not seem that obvious, probing areas that are either emerging or opaque that need further dialogue and discussion to make sure that everything important is getting surfaced. That constant learning, that constant curiosity, that constant desire to be in a dynamic and ever-changing environment is an important characteristic of a strong director.

It's always difficult in a collective body to ensure that people have the freedom to speak up.

And then Courage, the last C, speaks for itself. It's always difficult in a collective body to ensure that people have the freedom to speak up, the freedom to ask the difficult questions, the freedom to say a difficult or different thing. It doesn't mean they have to say it in a difficult way or in a way that is hurtful or insulting to others, but people need to get to the heart of difficult issues and be prepared to say "I don't understand this," or "I don't agree with this," or "we need to take this offline, we need to hear more about this, I need to see more before I can be in support of this decision." That courage in the collective is very, very instrumental.

Sometimes this is seen almost inadvertently, where people say, "well, I'm just really not getting this." And you start to dig down and dig down and you can see that, well, maybe there is more work to do. Sometimes it has to be a little bit more forceful than that. As a director, there might come a day when you're going to have to be ready to stand up and say, "I don't agree or I don't understand or I need more information in order to decide and act effectively."

And to bring all those Cs into perspective, there's probably a whole bunch of other things that are required. The culture in the boardroom, for instance. The collegiality. When we use the word collegiality it sometimes maybe sounds a little too much like being nice or group think. I don't mean it that way. I mean it in a way where directors are very respectful of one another's points of view, their continued learning journey, their diverse backgrounds and experiences. But effective directors have to able to bring all of that together so that their collective competence, curiosity and courage adds real strategic value to the company.

Q: So, we've now got five Cs, if you add in culture and collegiality! I'm curious: of those first three qualities — competence, curiosity, and courage — which is the toughest to hire for?

A: I would say competence is the easiest, relatively speaking, because what you're looking at there is the person's list of executive accomplishments, boardroom work if they've done that, involvement in the community if they've done that, and you have an ability to reference all of that. You can check to make sure that those degrees were had, those executive successes were as described, etc.

Curiosity is one too that you can delve into and make sure that the person is of that mindset. You can see that through the choices they've made in the things that they're interested in doing. If they keep doing one thing and it's inside a comfort zone, chances are that they haven't been on as steep a learning curve as someone who maybe has decided to branch out and learn about a lot of different things. You can see it in the way they approached their education, and their continuing education, whether that be in governance or in the industrial vertical that your organization is involved in, etc.

And you can see the way different people deal with uncertainty. People say there's a lot of uncertainty in business today but, in my experience, there's been always a lot of uncertainty in business. And when you think about the various factors that go into making great decisions, and being comfortable with them, you always need to confront a certain amount of uncertainty. Therefore, you'll want to pursue a lot of continuous learning to best deal with that.

Courage is maybe is the most difficult to solve for, because you usually only get to see it in a moment of difficulty. That's when someone has to step forward. In a director you may hear them say "we're not doing enough on this," or "we need to be doing more on this." And then probing the management team on what else can be done. Along with that comes an ability to achieve influence. That is a hugely important characteristic of an effective manager or effective director. I think I would even say an effective human.

Experience builds character. We're all a function of our own experiences. And that's where this diversity of thought, diversity of mindset, diversity of backgrounds is very valuable. And while I think adversity can build resilience, it's also true that one's character shows itself amidst adversity. And a compelling character is in many ways the key to being able to influence others — to get them to appreciate your way of thinking, or at least to get them to engage open-mindedly in a conversation about something.

That's really important and it takes courage and character. That capability set is harder to see, at first glance. But you want someone who, when they see something, they want to say something, and they're good at creating an environment in which speaking up honestly is both welcome and encouraged and received in the right way and then meaningfully worked on. That's an important part of fostering courage in your fellow directors as well.

Q: Let me follow up on that with another "C" — culture. The term is often viewed as being an intangible. What is your experience in efforts to produce a culture that engages employees, aligns values with conduct, and drives superior shareholder returns?

A: Let me come back to culture at Four Seasons. I think they still do this in the hotels every morning. They get the staff together and talk about everything that went wrong the day before. Not so they can blame somebody for dropping something on somebody's jacket or being late with a delivery or wake up call, but so the team has a chance to 'recover'. This philosophy around service recovery was born in a day and age when we didn't have cell phones and we didn't have easy access to personal communication tools. And back then the average length of a stay in a city hotel was about day and a half. So if something went wrong and we didn't get to you before you left, the chances of us effectively 'recovering' was close to zero — AND you might not ever come back.

And so this unbelievable urgency developed around, "oh shoot, something went wrong, we have to fix it now!" And the only things that get talked about in the morning meetings are the things that didn't get fixed, because Four Seasons employees are highly empowered to fix things on the go. But if it's a big thing, then senior management takes it offline and then tries to get at it right away. But again, it's just part of how that culture gets built. All of these little processes were designed to support the culture of making sure the client got what they needed when they needed it, so to speak.

Q: DE&I is an area where corporations are under greater scrutiny, with stakeholders expecting firms to act as agents of positive change. Many investors have started voting against board and committee nominations at companies that haven't embraced diversity. Has this served as a "wake up call" for corporations? Talk to us about the journey your board is on in this regard. Any insights you can share with us on progress? Can you provide us with insights on how DE&I can lead to good outcomes?

It's important to create diversity for good business reasons, as well as good social reasons.

A: I would say diversity, equity and inclusion is an area of great focus for all enterprises. To me, it's important to create diversity for good business reasons, as well as good social reasons. It's not enough that we have numbers of diverse people. It's also important that we figure out how to make our cultures and our business places and workplaces inclusive. So we're really focused on the fact of diversity in some statistical sense, but we're also working to assure that the desired impact and the action and the value associated with diversity is there.

Ultimately, that means moving even beyond diversity, inclusion and equity to consider belonging. People need to feel that they can bring their whole self to work, their authentic self, and believe that the organization feels it is going to be made better and stronger by the fact that they are there. It's established science that diversity of thought creates better outcomes. Diverse groups are more innovative. They don't get caught out by groupthink. They're more likely to create environments where people bring the differing points of view that help to create better products, better outcomes, and potentially to avoid pitfalls.

I think for humans to do their best work — whether they're board members or management members or members of a diverse team — they have to know that they are cared for, that they're in a safe place, that minor mistakes are not going to be a big issue that derails them. We want people to really feel like they can bring their whole self to the job, their creativity, their innovation, their new ideas. We all have dreams as individuals, but in order for us to be able to share those with others, we want to know that the environment is one that's going to be supportive of different ways of thinking.

Q: You've said that "psychological safety needs numbers." I wonder if you could say a little bit about that in the context of your own career?

A: Yes, psychological safety sometimes requires numbers. There's a long-held theory that one woman on a board may make some difference, but in order to get to critical mass and real diverse thinking, you need to get to three. Now, three out of 30 is maybe not sufficient. But three out of a regular-sized board was felt to be fine. And then we've gotten to 30% targets, and then 40%, and now some aspirations around 50%.

My own journey has been a very interesting one. I started in the workforce shortly before my 30th birthday. I'd been a perennial student and grad student before that. Suffice it to say I had many roles where there were no female role models. My career at Four Seasons was characterized by me being in roles that were typically held by men, and being in business meetings where I was often the only woman.

And even when I began my journey in board governance, I would say that virtually every opportunity that came my way was probably because I was a woman. It was important for the boards to start to diversify their talent and their thought processes — and having a global executive career didn't hurt either! I saw that as presenting me with a great opportunity, not only to become the first woman to do some things, but to ensure that I was never the last. I tried to make sure that, if I was the first woman, then there was another woman there before long. And then the two of us got together and said, "okay, let's keep going and so we sought out other capable women to join us in that effort.

We still have a lot of work to do on the gender file, for sure. But we have a need to also catch up on non-gender diversity issues. Whether that's people of color, or people from our indigenous communities, or people from our immigrant populations, or those in our circles who are disabled, whatever it may be. Many groups remain underrepresented, not only in boardrooms, but also in the talent pipelines.

Sometimes there's a feeling that things will just change over time. But this kind of change takes a lot of work, a lot of determination. And from my own vantage point, I think that work requires planning, like anything else in business. We make long range plans if we're launching a new product or investing in a new vertical. The same has to be true of our talent management. We have to be making long range plans to invest in a wide spectrum of human capital to make sure that as these folks come up through the development ranks and learn one job and move on to the next that we're continuing to build that diversity of voice, that diversity of experience, that diversity of outlook across the management ranks. That's critical if we are going to be successful in the highly complex and rapidly changing environment we all live in.

Q: On matters related to diversity and inclusion, you have argued that "symmetry between management and the Board is paramount, as it helps create a holistic approach to advance the bank's goals." Can you elaborate on this point?

A: Well, I think with DE&I, it's really important for boards and management teams to establish a coordinated and collective approach. Sometimes a management team will be pushing its board for a greater level of diversity, and sometimes a board will be pushing a management team for greater levels of diversity. But that needs to be in furtherance of a coordinated approach, so that there's no daylight between the strategic aspirations of the board relative to the strategic aspirations of the organization and the senior management team.

When that's done well, I think ultimately there can be a great amount of success. Employees look up at the board of directors and they see who is stewarding the organization. And if they don't see a reflection of the community that the organization serves, then they probably wonder what the heck's going on. Similarly, if the board is highly diverse, but they look around their workplace and see that the company hasn't moved at the same speed, then again we're left wondering about that disconnect.

Employees look up at the board of directors and they see who is stewarding the organization.

We need to make sure that the board and the organization are moving along a continuum to advance diversity, equity, and inclusion at all levels, in a way that it is both actionable and sustainable. It's not enough — back to form over substance — to say we're going to be advocates for this. The proof is in the doing. And, so, we need to make sure that the right aspirational targets are being set, the right measurements are being bought to bear, to ensure that progress in the DE&I agenda is working the way it was expected to. Or, if it's not, then we need to ensure that the right adjustments are being made so outcomes improve over time. Having a really open, transparent and coordinated approach to this between the board and the senior management team is critical.

Q: Not surprisingly, an important area of focus for the RBC board relates to the bank's approach to its climate action plan. Your 2021 letter to shareholders spoke to the importance of "aligning the Net-Zero ambitions of the bank with the needs of society…" Why is this important? What is the end goal?

A: The devastating effects of climate change are rapidly becoming increasingly more evident in Canada and around the world. Extreme weather upends lives, destroys property, and places countless species at risk. It is also threatening to widen inequality, as our most economically and socially disadvantaged citizens are vulnerable to severe heat and cold. A root problem to all of this, of course, is greenhouse gas emissions caused by human activity.

Left unchecked, climate change will make it more difficult for people to thrive and for communities to prosper. That would have a huge impact on society and on RBC, because we operate in an ecosystem of stakeholders where our success very much depends on theirs.

And so, not surprisingly, the bank's end goal is simple: to accelerate the transition to a net-zero world. That's how RBC will help ensure that our society, our communities and our clients are on a more sustainable and, in turn, more prosperous path to a low carbon world. The good news is RBC is equipped and empowered to help build a cleaner economy, and in turn, a healthier planet and we have a number of pillars to support our climate strategy.

First, is moving our own operations to 100% renewable energy sources and minimizing the bank's reliance on carbon offsets in the next couple of years.

Second, we will help our clients make their own transitions to net-zero, supporting them with financing and know-how as they work to build their own transition strategies. This includes our commitment to deploy $500 billion in sustainable finance by 2025, an increase from our previous commitment of $100 billion, which was achieved in 2020.

Third, RBC is also holding itself accountable by setting interim financed emission reduction targets aligned with our clients' plans, and is committed to provide public updates on our progress. In fact, we anticipate disclosing interim financed emission reduction targets for clients in our oil and gas, power and utilities, and automotive and transportation portfolios in 2022.

And fourth RBC will continue to advance climate solutions more broadly through our work with government, regulators, bank peers and other stakeholders. The bank regularly publishes research that advances important public policy conversations, and last year it joined the Net-Zero Banking Alliance to accelerate and support a just and orderly climate transition, making sure we don't leave people, communities and economies behind.

The Board is actively engaged with management on the direction of RBC's climate strategy so that the risks and opportunities are reviewed and understood. We also make sure the interests of the Bank's stakeholders, including shareholders, are fully considered.

The transition to net zero will be a multi-decade undertaking and is a complex and dynamic journey representing one of the greatest opportunities for RBC today. As such, it is important to ensure it is given the time and attention required at various committees and at the full board, helping us keep pace with rapidly evolving scenarios and expectations and ensuring that RBC continues to benefit from industry-leading best practices.

Q: Let me ask you to look ahead: when we're writing next year's report, what do you expect to be at the fore in terms of trends and debates regarding the themes we cover in the *Compendium*?

A: The themes of the future will probably not be too different than what we are seeing this year. This is largely because there's so much unfinished work. Whether it's our approach to the environment and how business and policy makers are going to have to work together to get us to the right place for the planet; whether it's issues around human capital like labor shortages, DE&I, social justice, and the economic impacts of all of that; these monumental issues are going to remain front and center.

And obviously the current geopolitical backdrop cannot be ignored. It's been heartening to see both the governmental and non-governmental response to the events in Ukraine, where in some cases private companies have taken actions that go well beyond government sanctions. I don't know if it's the first time we've ever seen that, but it is a time when we see people saying, "I'm going to do this because I think it is right, even though it wasn't asked of me."

And then overlaying or underpinning all of this is the power of the social network. Not in the Facebook sense, but the social network that is humanity and what that means for businesses, for governments, for democracy. It's a fascinating time.

But at the heart of it all, I think, is going to remain the questions around how we as business leaders can help to make the world a better place for people from all walks of life to work in, live in and thrive in. A lot issues stem from socioeconomic divides, racial inequities, geographic and territorial inequities. All of these themes are going to continue to influence the world of business in ways that most of us probably wouldn't even have thought possible ten years ago.

Q: Allow me one last question, please. The contributors to this report enjoy positions of prestige and privilege that most will never know. What's that been like for you? What leaves you feeling proud?

A: Well, I think the answer to this question brings us back to the topic of purpose and its importance in business and in our daily lives. The thing I am proudest of in my career, for sure, is my family. There's no question that the career I had over decades in the travel and hospitality industry was very, very taxing from a time at home perspective. I'm proud that my husband and I managed to figure out how achieve some level of work / life integration. I never call it balance — there was no natural balance — but, instead, there was a way of integrating my work and my life that allowed our family and our children to thrive.

In terms of the privileged part, you're right. There's no question that I've had a fantastically fun and interesting global career that has allowed me to meet and work with people across different cultures and geographies all around the world. Unending joy comes from that. But the most important part of any career that affords you these sorts of opportunities is to ensure that you find a way to give back. Mentoring and working in philanthropy has been a gift to me, and one that fulfills me greatly. My work in children's health, or on women's diversity issues and the advancement of women in the economy, and the work I do around education and advising universities on strategy and programming and the future of education, all of this is incredibly fulfilling and very, very interesting.

I'm a classic Myers Briggs capital "E" extrovert. I derive my energy from working with and experiencing the world with and through others. Throughout my career — and this remains true as I've been working during my 'portfolio-life' — my greatest inspiration and happiness has always derived from working with people; with my board colleagues, as a member of the special teams and organizations through which I'm doing philanthropic work or youth mentoring. I mentor dozens of young men and women, helping them to navigate the ins and outs of the complicated career trajectories upon which many of them have embarked. They're often making choices they've never had to make before, being early in a career, and this is often around new opportunities and new ideas that they're trying to wrap their minds around.

And as I look back over my career — in every interaction, every business deal, every crisis or difficult situation — I'm also happy to have found a way to work with other people very collaboratively. I was taught early in my career, as a negotiator with Four Seasons, to take home only what was needed from a deal or from the moment. To make sure that the person on the other side of the table felt like we were partners in a long term-business relationship. That was a foundational element of how we did business and made sure the Four Seasons brand, and the company, flourished. It was important that other people got what they needed from our mutual engagement, to the extent that it didn't directly conflict with what we needed, and that we all felt better off as a result of the work we chose to do together.

Every time you engage with a customer, employee, partner, or investor, your brand is either burnished or tarnished.

Again, every time you engage with a customer, employee, partner, or investor, your brand is either burnished or tarnished. People always used to say to me, "Oh, well, that's such an easy thing for you to say, coming from Four Seasons, because of the business you're in." And my response would always be, "Yeah, but this doesn't just apply to Four Seasons." Sure, McDonald's is not Four Seasons. But when you step through the doors, you still expect the fries to be those extraordinarily great, perfectly salty, hot and crispy McDonald's fries. When you have that experience, the brand is burnished. And when the fries are cold or soggy, that's an unhappy moment that leaves the brand tarnished. There is no in-between. And I think that's true of every business. There's a way to do things that is difficult but leaves those involved feeling better.

We must strive to create that little extra bit of happiness or contentment or satisfaction or comfort or trust. Whether an internal or external engagement — client-facing or employee-facing or business partner-facing or other — we always operated in a way that aimed to make our company better, and to help ensure that this was true for others, too. I would say that a generosity of spirit infused the nature of the work we did. I mean, it was grounded in hospitality, right? And the essence of hospitality is to make the lives of others better. For that to be a lived-out business philosophy was quite important to us and very important to me. Whether reaching back or reaching forward, it's been important to me that others were lifted-up by the work I got to do, and made better able to enjoy the same or even better opportunities than those that I got to enjoy. This is simply part of what leaders should do at different points in their careers: we have a responsibility to give back.

Kathleen Taylor *is the chair of the board of the Royal Bank of Canada (RBC), and the first woman to chair the board of a major Canadian bank.*

Ground Breakers

An Interview with Axel Weber

Axel Weber

Q: We've come through challenging few years. The covid pandemic has ushered in changed work patterns, and revealed or highlighted the importance of company culture. What has your own experience been in this regard?

A: As regards changed work patterns, you're right. A mix of working from home and from the office has become the norm for many. Surveys indicate very strong support, even today, for continued flexibility in that regard — which we support as a firm. We found that roughly 75% of our employees could be eligible to work in a hybrid setup. This hybrid model makes us a lot more attractive for employees and allows us to draw from a wider applicant pool. The hybrid set up will also help to foster better work-life balance. Early career talent probably finds the hybrid work model a more attractive way of working. And that's also true for working parents, or job returners coming back after a parental break.

This has focused attention to the technology necessary to support hybrid working, and sparked a lot of innovative thinking. It has front-loaded and accelerated technology transformation at many banks, e.g., by moving some applications to the cloud.

In the past, clients met us in the offices. But now we are in their living room, digitally. For example, we can share portfolio and scenario analyses with a client on an iPad. That's a whole different way of delivering services. The technology part of client service is more advanced now, allowing us to respond better and faster to client needs.

During covid, we wanted our employees to know that we were listening to them and developing solutions for them tailored to their specific situations. Regular surveys helped us to get important employee feedback around remote work issues, stress, communication challenges and other matters that they have struggled with during this period.

We also have bespoke e-learning programs, physical and mental health programs, and we've offered our staff opportunities to engage in volunteering programs. All of this was the result of employees having asked for such programs.

I'm very happy with the sensitivity we showed during the covid period. It wasn't just "go and work from home." In fact, we said, "We are here for you, we're close to you, we hear what you're saying, we will try and help you with the problems that come from working from home." I felt that it was quite a unique experience for the bank.

When it comes to corporate culture, there is a debate around the impact of covid-related dislocations. New joiners that couldn't join us physically, but who joined us virtually in this period, have had much less of an experience regarding what our corporate culture is, what it stands for. This has strengthened our appreciation for the need to maintain a very high corporate culture standard.

Q: You led UBS through its own corporate culture journey, in the wake of the Financial Crisis. As you step away from your role as Chairman, I wonder if you'd care to offer a 'look-back' on key lessons learned. What related counsel would you offer the next generation of leadership of the firm? And the generation that follows thereafter, and so on…?

A: You might be aware of the three keys in our logo. We also have a three keys program — three pillars — in connection with our culture, principles and the behaviors that follow from that. We've had that program over the entire 10 years during which I've been Chair. That has helped us when we onboard people, allowing us to give them a clear set of expectations.

We promote this through many locally driven culture-building initiatives and schemes like our group franchise award, where people are recognized and rewarded for promoting cross-divisional collaboration and innovation. This is important for a bank like UBS with different business divisions. We try to maintain a single client-facing front end, and then collaborate between divisions to support that.

Long-term thinking is very much embedded into the Swiss culture. The challenge is to scale culture across a global franchise. Having clear principles about how we want to operate has really helped in that regard.

During my 10-year journey at UBS, I have tried to push the idea that being a sustainable firm — which has become an in-thing — really requires thinking and acting with long-term interests in mind and with the right culture. I'm a former regulator and central banker, and focus on the medium to long term has been important in that job. Bringing long-term orientation to a private bank has really been a game changer over these years.

Culture and conduct reform, in my view, is an ongoing process. It won't go away. I remember discussing this with Bill Dudley at the New York Fed many years ago. I was the only market participant in that discussion, as I recall, sitting between the General Counsel of the Fed, law enforcement, the CIA and others. All of them had to deal with conduct issues related to the Financial Crisis and its aftermath. We put so much effort into building a sustainability-oriented culture after the Financial Crisis because it is the only answer to ensuring the right conduct. And it was expected from the other side of the table — from the regulators.

But I also felt it was really in the self-interest of the bank to have a long-term orientation. We rebuilt our strategy in 2012. We focused on building capital as a strength, not as a regulatory requirement. Now, we have a 15% capital ratio, two percentage points above our guidance. While we look at capital buffers as a sign of strength and demonstration that the business generates significant amounts of capital, we also have

Our Pillars What we're built on.	Our Principles What we stand for.	Our Behaviors How we do it.
Capital strength A balance sheet for all seasons	**Client centricity** Clients are at the heart of everything we do	**Accountability with integrity** Take ownership
Simplification & efficiency Make it easy to do business	**Connectivity** Create success by connecting people, ideas and opportunities	**Collaboration** Work as one UBS
Risk management Anticipate and handle risks effectively	**Sustainable impact** Act today with tomorrow in mind	**Innovation** Improve every day

the shareholders' interests in mind and are currently returning the highest amounts in a decade to them through buy-backs and dividends.

And this is also important in connection with the G in ESG. ▸PAGE 427 Governance issues will become dominant for listed companies globally. They will be judged on the G part as much as they're judged on the E part and the S part. I'm convinced that we need a permanent culture change in banking, and across corporations more generally.

Culture and conduct reform, in my view, is an ongoing process. It won't go away.

The "purpose" discussion is very recent. We didn't call it purpose when we started looking at culture 10 years ago. We have recently come out with a purpose statement that enlivens the firm's principles, how we want to do business, why we are here. I think that being explicit in our purpose statement is an important part of our long-term success. It's not just the results we achieve that are important, but also how we achieve them. ▸PAGE 81 When you're a global wealth manager, your clients want to be able to put their trust in the company, and count on it having a long-term focus. When I first came to UBS, I asked clients how they would best describe what UBS means for them. The answer I heard from quite a lot of them and remember most was, "We've been with UBS for generations. My father, my grand–father started banking with this firm." And we look at our role as managing the wealth of generations, for generations to come.

I'm convinced that we need a permanent culture change in banking, and across corporations more generally.

Our clients are not just interested in financial results. They look at us as managing a family fortune with a view to longevity, and as preserving an endowment to future generations of the family. They look to us as a trusted advisor and the sort of counter-party who is not just interested in short-term profits, but who is watching out for the long-term sustainability of wealth previously generated.

That has made it much easier, in my view, to align long-term thinking with a long-term oriented culture, as a wealth manager. It is important that even the more shorter-term, market driven businesses, like the investment bank, adopted that long-term view to support the core of the UBS franchise.

Q: During your tenure as Chairman, UBS created a Corporate Culture and Responsibility Committee (CCRC). Can you say a bit about what led to that? What is the intended role of the CCRC? What substantive changes or improvements resulted from its work? And what institutional resistance may there have been in this regard?

A: The bank's Corporate Responsibility Committee was established already in 2001. After I took over as Chairman, we renamed it the Corporate Culture and Responsibility Committee, adding the term "Culture," and upgraded it to a top-level committee, chaired by myself. The committee is tasked with embedding the longest-term thinking possible into the bank's corporate structure. And this meant thinking a bit outside the box. Since 2013, we aligned the frequency of meetings with the frequency of our board meetings. It became an integral part of our board deliberations at every meeting, just like any other committee.

Through the whole discussion around climate, sustainable finance, long-term regulatory developments, etc. this committee became a thought leader on these issues. Programs around climate change or corporate culture were designed in the Corporate Culture and Responsibility Committee and then handed off to management who then were tasked with reporting on this to the Board at future meetings. That trickled down into the entire organization and became part of the day-to-day work, which helped us a lot when it came to sustainability and to environmental questions.

We're now the first Swiss bank that has come out with a "say on climate" vote, where our shareholders have a consultative vote, just like in our "say on pay."

The long-term orientation of our clients lends itself to being a leader in sustainability, because they also ask: "how do I pass this planet onto my children and grandchildren?" It doesn't help a lot if you know that you're financially secure but that the environment — in which future generations will live — is compromised. So, it was natural to tie our long-term orientation in investing and managing wealth to climate and sustainability.

Q: It is increasingly common to see firms marrying their remuneration programs with their risk controls. But are incentives all about money, or are there other incentives that are as (or more) important?

A: I do think it is very important to align pay programs with performance, but also with risk governance. At UBS we have a scorecard for our senior executives that we go through. We commit to several objectives and targets, which we disclose. And then we work towards meeting those objectives: financial achievements, return on capital, building our capital ratios, etc. But then, on top of that, there are other objectives, like being a role model in conducting business. As I described earlier, we look at the 'three keys' — our pillars, principles and behaviors. This is also very important in our assessment of performance. When we talk about these three keys in the scorecard, we basically say "good risk management is an important part of this." Another part is capital strength. We don't want our clients to worry about their money being safe with us because they read in the news that their bank has a too low capital ratio, or that it suffered some adverse financial developments.

I do think it is very important to align pay programs with performance, but also with risk governance.

Many organizations talk about client centricity, but we instead solicit direct feedback from our clients about how we are managing their money. For us, client centricity means a personalized engagement with the client, a connectivity that helps us to know what is on the client's mind. And our clients must know that their client advisor at UBS is also properly connected within the bank. We want our employees to interact with their peers and with their clients, as opposed to just managing a portfolio and pushing products. And we look for successful collaboration. We want the client to have a single contact point. The clients tell us what they want, and then we deliver, involving all relevant parties internally.

In the end, all this information becomes part of the compensation process. For us, our elaborate pay structure is based on our scorecards, performance reviews, 360-degree reviews, etc. It's not only about the financial results achieved, but equally about how they were achieved.

Q: You referenced Bill Dudley's early leadership on these issues at the NY Fed. In more recent years, thinking regarding firm culture has shifted away from a vague set of considerations relevant to those in HR — 'soft stuff' — to become more of a mainstream management priority that's seen as central to the bottom line — 'hard stuff'. What do you see happening here, and where are we headed?

A: I think that's right. Culture is not an issue for the HR department alone. I look at HR as also having an audit role — sort of postmortem. If things pop up in the HR department, that's because there is a lack of proper culture which has manifested itself in client complaints, regulatory complaints or legal cases.

What you need to be influencing is the way business is done in the front line. And you want close alignment of the client-facing roles with the risk controls at the second line of defense. But it's important that the first line take it upon themselves to make sure they're doing the right thing, rather than counting on other lines of defense. The firm cannot act as an audit-centric organization. There must be holistic alignment within the first line in how they do business, as well as checks and controls. And not because they fear being caught out by the compliance or risk teams, but because they are focused on the best interests of clients.

A lot of internal investigations take place because things go wrong. Often this leads to establishing a "culture of compliance," from the second and third lines rather than making sure that the first line adopts a culture that prioritizes the delivery of good quality outcomes for clients.

As a former regulator, I've regularly observed that one does not notice a good culture, per se. What you notice is a lack thereof at a firm. I think many firms that don't have a clear culture, around which they evolve their business, sooner or later find themselves facing problems. That lack of focus on desired culture means that such firms have a higher idiosyncratic risk of misbehavior, reflected in the attitude "it's allowed if it's not explicitly forbidden." Well, not everything that is not explicitly forbidden is allowed, and even more to the point, even what may be allowed is not always in the interest of clients.

I've regularly observed that one does not notice a good culture, per se. What you notice is a lack thereof at a firm.

When I joined UBS, it was seen as a former icon in Switzerland. It had somehow lost ground and it was having problems. Reinstalling this iconic character into the organization as the country's largest and most successful bank was very important. I think we're getting back there.

People told me they felt that "when somebody like you joins UBS at a point where the organization is in deep trouble, we take this as a signal that you have had the confidence that this can be put right." That's what we needed to instill in employees — that we're going to work hard to bring UBS back to where it needs to be.

For the people who became part of that journey, that sense of purpose was a much more important motivator than pay. Very often, as the Chair or the CEO, you get praised for these turnarounds. You may be a part of that, but a small part. A successful culture meant that the 71,000 people at UBS were fighting back, trying to make it to the top again.

Q: Today we want disclosures around a firm's environmental impact, and how it is acting to promote good social outcomes. The governance piece, you said earlier, is perhaps the most important piece. So, what sort of disclosure requirements do you think might be helpful, with regard to the purpose, culture and risk issues you've been addressing here?

A: I think that's a difficult question. When I talk to employees or our shareholders, the part they want to understand is, how do you measure success? You can do 360-degree reviews. You can get feedback and work to make sure people act on that feedback. But it becomes very hard to put that into disclosures.

For example, we had a loss related to Archegos in the last year. That impacted pay with downward discretion, because we did an accountability review. We looked at who was close to the problem and asked whether they had done their job the way they should have done. We found that the answer to that was, no, not perfectly. This was a major risk materializing, and it shouldn't have materialized.

I think it's important to take responsibility for things that aren't going well, not letting that become a problem for the shareholder. Taking responsibility is important as opposed to assigning responsibilities. Although this is something that took place in our best year in 15 years for UBS, this was still a downside. It shouldn't have happened.

And it's precisely here where I think shareholders want to see robust processes in an organization. They want to see people taking responsibility if things go wrong, not just taking credit for the things that work out alright. There is a famous proverb: success has many fathers; failure is an orphan. Failure should have as many fathers as success, because usually when things go wrong, they go wrong in multiple dimensions.

But I do think that the more transparency one provides in situations like this, the better. I talk to our top 100 investors twice a year. Given our successful financial performance, we could have glossed over our troubles in connection with Archegos, but that would've been exactly the wrong cultural message. The fact that we acknowledged the issue, apologized for it to shareholders publicly, and that we made everyone accountable and that our people accepted that accountability, in my view was the right way to handle things.

Q: Regulators are paying increased attention to the promise of supervisory and regulatory technologies ("SupTech" and "RegTech") that marry Big Data to AI, with some suggesting that these tools may help in managing and supervising culture and conduct risks. Yet, while there has been some early experimentation with these tools among firms, adoption rates remain relatively low. What do you see next for the SupTech and RegTech space?

A: I think they offer a lot if used in the right way. These technologies help standardize many manual work processes that would otherwise absorb a lot of the attention of people working in, say, the second or third line of defense. These technologies promise to free up time to focus on issues that require judgment. So, in that sense, I do welcome these technologies and we are using them intensively.

For instance, we have installed dozens and dozens of 'bots' in audit, to standardize data gathering exercises and move from spreadsheets into something that better supports our decision processes. Again, for me the major advantage is that we can make better decisions with better informed judgement. Sometimes these audit and compliance jobs can be repetitive, even tiring, and people may make mistakes. But machines are not bothered by repetition. They don't get tired. And they make far fewer mistakes in these automated processes.

Still, you need both: automatized systems and human judgment. The line manager of the future will have to be much more tech savvy to manage both people and machines.

Q: If we hope to see new tools brought to bear in connection with entrenched problems, it seems clear that this will require collaboration — among regulators, firms and technologists. What role do you see here for industry bodies like the Institute of International Finance (IIF), where you have been chairman for several years?

A: The IIF helped form what has ultimately become the Europol Financial Intelligence Public Private Partnership in 2017, an initiative which has grown into the first multilateral partnership on financial crime issues between regulators, law enforcement, financial intelligence units and the private sector across the EU, UK, US and Australia.

Let me give you one example. AML is usually about looking for a needle in a haystack. You look at a vast flow of data and you need to find the couple of data points that are outliers or appear problematic. That's where AI can play an important role. And that's true in a reverse exercise, where law enforcement or intelligence agencies tell you that they have a couple of suspicious cases and ask if you could screen your data to see if you have anything of relevance related to those people, those accounts, or those activities.

Most of RegTech tools are institution-specific. But I think, ultimately, we need to see collaboration through a private-public partnership where both sides know that the other side is contributing to achieve shared goals. For me, as someone who's been a regulator who then moved to a private bank — and this relates also to my IIF role — I have attempted since the Financial Crisis to show that there is a lot the private sector and the public sector can better achieve together. The supervisors and banks were too far apart because there wasn't a trusted relationship. I think that's where organizations like the IIF can play a key role, as a convenor and mediator. And I think the IIF has done that.

The line manager of the future will have to be much more tech savvy to manage both people and machines.

Whether it's been in connection with technology transformation, RegTech, FinTech, the digitalization of banking, or the latest initiatives on sustainability, the IIF has had programs for all these areas. Because it matters to the public at large, it matters to the regulators, it matters to the banks and their clients. But we need to bring both sides together to get good regulation.

What often creates problems are new regulations without even consulting the financial industry. Then that is put into a legal text, passed as a law, and then the industry is asked to do an impact assessment to see how things map out. That's usually not the best way to regulate.

Banks have to understand that they are part of society. And it comes with a responsibility that has to be met.

What is needed is working on regulatory initiatives together. One might find the proposed regulation triggers important unintended consequences. One can then work to eliminate those before going live with a regulation. Part of what I've really wanted to achieve was more mutual recognition of both sides — public and private — to develop a better appreciation for how either side is doing its best to achieve a common good.

Banks have to understand that they are part of society. They are in the middle of society and have a very important role in everybody's daily life because banks look after people's money, facilitate their transactions, and invest their savings. That societal role of banking is essential. And it comes with a responsibility that has to be met.

Q: Any other thoughts on these topics that you'd like to share, or that you think we should attend to more closely in future issues of this report?

A: The two major Swiss banks were founded to finance the construction of the Gotthard Tunnel and the Gotthard Railway, which is a major connection between Northern Europe and Italy. When the banks were founded, it was clear that they would serve the Swiss people. The banks collected capital from wealthy individuals and used it in public construction projects while paying attractive returns. The purpose of the banks was to generate returns for the country, for clients, and for shareholders.

This link between banking and society has never been as clear as it is today. With a war raging on European territory, it's clear that not being part of the current sanctions regime was not an option for banks. Not for UBS, not for Switzerland, not for anyone. Because this goes right to the heart of our current understanding of what humanity is about. Aggression and wars of this type are no longer compatible with the way humanity has progressed over the centuries. We therefore need to be part of a very clear response to stop this, and tough sanctions can achieve that. ▶PAGE 417

And let me finish by saying that the Starling *Compendium* has been integral to the industry's efforts to improve. I've always read it, and so I really appreciate being part of it this year. It's a tremendous job you're doing, for the banking community and society at large.

Axel A. Weber *was elected Chairman of UBS in 2012. He gained international recognition as the President of the Deutsche Bundesbank. During his six-year tenure there, he also served as a member of the Governing Council of the European Central Bank, a member of the Board of Directors of the Bank for International Settlements, German Governor of the International Monetary Fund and a member of the G7 and G20 Ministers and Governors.*

INTRODUCING DEEPER DIVE SUPPLEMENTS

The Costs of Misconduct

There is a difference between misconduct and poor performance.

But when it comes to evidencing an ability to avoid both, firm's are subject to ever closer scrutiny, from a widening number of stakeholders: regulators, shareholders, customers, and employees among others.

Culture and conduct governance failures have resulted in career-ending share price impairment, reputational and brand damage, and a broad range of other costs that have afflicted organizations as diverse as Activision, Rio Tinto, the UK's Metropolitan Police, Big Four accountancies, and Credit Suisse, among several other financial institutions.

Do firms operate through a 'directing mind and will'? Does 'tone from the top' drive culture and conduct? Are misconduct fines accepted as a 'cost of doing business,' effectively priced-in by the market? What next for individual accountability?

Learn more in a Deeper Dive supplement to this report, available later this year on Starling Insights, a membership-based platform that will feature all of our *Compendium*, thought leadership, video, podcast, and event-driven content.

Ground Breakers

Culture & Conduct Risk Management: The Evolution of a Critical Management Function

By NANCY HARRINGTON JONES

Nancy Harrington Jones

SOCIETE GENERALE

Q: An increasing number of financial institutions have established a new function, devoted to addressing questions of culture and conduct risk management. Société Générale was early in this trend. Can you say a bit about how your role came to be? What drove that? And how was the role initially envisioned?

A: Société Générale (SG) is a 155-year-old financial services group headquartered in France. Here in the America's, our main business is Global Banking, Investor Solutions, Investment Banking, and Sales and Trading. For the last few years, it has been my pleasure to help the organization I grew up in — I have been here for over 30 years! — to change, to reconsider its purpose, and to value the *How* in our work as much so as the *What* in all we do.

Honestly, at the beginning, it was not a huge lift to stand up this new role:

- Management that knew we needed to change;
- SG had very strong cornerstones for our culture: core values, a leadership model that defined what we expect of ourselves in accordance with our values and a clear code of conduct;
- All banks (maybe all companies) were being pushed by a social environment that was changing. Clients, potential employees, and the general public were thinking about purpose — theirs and that of the institutions in which they worked or with which they did business;
- And we were in a regulatory environment that said to the Banking Community — "Hey, you big bad greedy banks, your culture led to a financial crisis and that can never happen again — fix it!"

You may remember that, in 2008, SG was on the front page of newspapers around the world as we had suffered the biggest rogue trading scandal of all time — six times that of Nick Leeson from Barings. We still to this day call it "The Kerviel Affair". Just about a week or so later, we were bumped from the from headlines by news that Bear Sterns had collapsed. And so began the financial crisis.

I was the Chief Human Resources Officer at this time. The whole industry was utterly consumed by crisis management. But at SG we had twin challenges: addressing our rogue trader fallout and taking steps demanded by the global financial crisis. We all know disruption is the Mother of Change, and banking was facing a major disruption:

- Regulators started changing everything for all banks including the businesses we could be in and the rules under which we operated.
- At SG, we changed our business models and were aspiring to become known as The Relationship Focused Bank.

- We laid off records amounts of staff, across the industry and at SG, losing and enormous amount of institutional knowledge.

- All financial institutions changed their compensation policies. In part due to European regulations but also due to our own interest in ensuring that we were incentivizing good behavior and sanctioning bad behavior.

- Investment Banking was no longer the top career choice for business school grads — and still isn't.

- And yet the scandals and fines continued … it was like, as an industry, we didn't learn.

Many projects were launched and changes made. A few years into those changes our management committee said, "OK, what are we going to do to sustain this transformation of our culture? And how can we once again feel pride in our jobs as bankers?" That led to a re-examination of our purpose:

- We aspire to be a relationship-focused bank, with the client at the center of all we do;

- We want to attract and keep talent who, today, look at their professional lives with a different set of lenses; and

- We have regulators who are saying "Address your culture!" And we were provided with some proposals to consider, for example, the G30's paper on culture reform in banking.

We read all the G30 report. The Head of Compliance and I started drafting a job-description for a Culture Officer and I floated it in the market for a few weeks to see who would apply. A few people did and, as I started interviewing them, it was apparent that the job-description was not on target: all the candidates were lawyers working in compliance. Nothing wrong with lawyers who work in compliance — I have one on my team now — but, honestly, it was not the point for this new role. We were building out our compliance function at the same time, and their role is vital, but it was not what we were looking to address in this cultural transformation role.

I started meeting people for coffee who worked in financial services and who had the words 'culture' or 'conduct' in their titles. These were usually people who worked on the whistleblower programs, or were in compliance, HR, or working or in the sub-businesses. They all shared with me a similar frustration: "This is a firm-wide transformation and I can only impact a piece of the pie. And even if we try to work across the organization as a whole, we all have our own individual priorities. This is just how organizations work."

It was like, as an industry, we didn't learn.

I also spent some time with our consulting partners and our principal regulator, discussing what they were seeing, thinking and expecting. And I distinctly recall one discussion, with a group of regulators, where one said, "Organizations that think this is only about compliance are missing the point." So, we knew that culture was a strategic issue and one that needed to be deliberately managed.

One weekend, after several coffee chats with industry colleagues, I went home with a very busy mind and spent the weekend drafting a business plan for culture transformation sustainability.

Monday morning, I met with the CEO of the Americas, who was my boss at the time, and presented the business plan. I also added, "I have a vision, a plan, a background in audit, IT, HR, experience in our Head Office, and I think that I should lead execution on that plan as our Chief Culture & Conduct Officer, reporting to you." And, of course, I had a succession plan ready to go for my CHRO role. He said, "I think your right — let's go."

Basically, we envisioned the role as managing the infrastructure of the house and ensuring that all the right bricks were in place and that any cracks in the mortar were fixed. This implied keeping up to date on new materials and methods, and continuing to update our house.

Voilà, the new role was born in SG Americas.

Q: Among different firms, there seems to be considerable variety in the reporting lines for those carrying titles like "Chief Behavioral Officer," or "Head of Culture & Conduct." What were the discussions around reporting lines as your own role was being contemplated? Who should "own" culture and conduct risk management?

A: As I mentioned, the role was born in SG Americas after a lot of market discussions, research and thinking about what we needed in SG. For us, having this as part of the CEO Office — sponsored by the entire management committee and therefore all lines of defense — is what we felt was best. It seems to me that every organization deals with the topic in their own way, based upon their culture, the problems they are looking to solve, or the purpose to which they are aspiring. I don't think there is a one-size-fits-all solution and I do believe we should continually question if our approach is still serving our organization's needs.

Again, we had considered whether this function should sit in compliance, HR, enterprise risk, or among the first lines of defense. But we felt it was so all-encompassing, touching on every aspect of our work, that it needed to be overarching-role. So, we created this lean Culture & Conduct team (there are three of us) and we believe it is the responsibility of everyone in the organization to support our efforts. We operate as a project team — we call it a "Change the Bank" activity — embedding needed changes in the "Run the Bank" teams, processes, and systems. We work with all the stakeholders, helping them to own their part in this, to ensure that the overall 'house' is stable, and to consider new materials and update accordingly.

> For us, having this as part of the CEO Office — sponsored by the entire management committee and therefore all lines of defense — is what we felt was best

Q: Is your role today what you'd planned for it to be when it was established? How has the role evolved over time? What kinds of things occupy your attention most regularly?

A: I laugh when I think about this. The first day as Chief Culture & Conduct Officer, I walked to my new desk — in the middle of our fixed income trading floor — and I sat down and froze. I thought, "Now what?" As CHRO, I had dealt with a flood of emails, people in my office, the phone ringing, and a constant calendar of events. Now, I was creating something from nothing — we essentially made this up! Yes, there was a business plan, and as an organization we had been working on the topic for a while — there was even one project manager working full-time already. But we had to define everything.

We did two things immediately: first, we pored over the G30 Report on bank culture reform; and then we created a Target Operating Model, with a maturity matrix, to identify what we were already doing, what we could do quickly, and what we aspired to. Then we tapped 26 of the organization's key influencers and asked them to work with us in driving change. We trained them on our Core Values, our Leadership Model — which defines what we at SG mean and expect from everyone related to these values — and our Code of Conduct. These are what we consider the cornerstones of our culture. Then we asked ourselves, what are we doing today and what do we need to do to really live our values. This was our diagnostic phase.

We then presented this to the management committee and agreed the first year's action plan.

Those 26 people were the start of what we now call our "Culture and Conduct Champions". Today, there are over 200 Champions across the Americas. We call them the "effervescence" of the organization — the bubbles that move things in all directions, fizzing to the top. They are engaged volunteers who want to be part of making SG a place where:

- Employees are ethically excellence driven, proud, and unified as a team;
- Clients trust us, value us, and partner with us every step of the way;
- Peers consider us true and a healthy competitor;
- Shareholders trust us to deliver consistent growth in an ethical manner; and
- Society sees us as a responsible, vital member.

We still use this Target Operating Model, updating it regularly based on our accomplishments, and changes in the market — regulatory expectations, society, staff and candidate's expectations — all while staying true to our culture.

But our focus evolved over time. At the start, we were very focused on clear corporate governance, establishing a set of committees and processes that were transparent, systematic and under continuous improvement. Some may say that is bureaucracy, but I say it creates clarity for the organization, and allows us to understand how decisions are made.

We worked with the first line of defense to define their role in control and supervision. We worked to rethink the employee lifecycle and how we ensure that everyone understands, in the course of their day-to-day activities, that *How* you do your work matters as much as *What* you do. We embedded this in everything: recruiting, training, performance, reward and sanction. We defined our expected behaviors for all types of staff. Using that leadership model, what does that mean to IT staff, to traders, and all of our teams on a concrete level? These new ways of operating are constantly reviewed by the staff themselves and updated as needed. They use this to create behavioral objectives that are meaningful to them in their specific roles.

We must avoid trapping good people into situations where they make bad choices.

We trained the top of the house on how to talk about culture and conduct, and the *How* of what we do. We started measuring the impact of what we were doing and the changes we were seeing. We added reputational risk and conduct risk to our risk management framework in the same way as the traditional market and credit risk. Of late, we have been thinking about our purpose, our ESG and sustainability strategy, and how that impacts our culture. In addition, things like the #MeToo movement, the LIBOR Crisis, the pandemic, and the summer of social unrest are catalysts to change, causing us to rethink assumptions, targets and the way we work.

Q: As our *Compendium* series has chronicled over the last five years, regulators now view culture as a matter that warrants supervisory attention — as culture is believed to drive (mis-)conduct and, therefore, customer outcomes. While many firms appear to view culture questions in the context of risk governance, others seem to focus more so on culture and behavioral science in the context of driving desired performance. What's your view?

I think that in the banking environment we need to take both paths. We chose to put Culture and Conduct in the title and to discuss them together, as we believed that our culture drives our conduct and our conduct enhances our culture.

We cannot disconnect the two in a world where laws, regulations and decision-making are everything. We consider everyone that works in SG to be a risk manager. We all need the tools and skills to be able to do this. Culture and conduct considerations are the catalyst for raising the bar and remaining relevant in the long term. We aim to ensure that our culture instills the right conduct among our employees, in order to build a safe, sound and profitable business. ▶PAGE 71

Our culture drives our conduct and our conduct enhances our culture.

When we make a decision on a new product, analyze an operational issue or market event, we ask, "Do we have the right processes, policies, procedures, controls, systems and skills?" And I systematically ask whether the environment is set up for success, whether people understand our expectations and can meet them? We must avoid trapping good people into situations where they make bad choices. Give people the tools and paths to help them to make good decisions even when no one is looking. This is culture.

Q: I suspect you'll have some bias here, but would you say that a role like yours is a "nice to have" or a "need to have"? If you were advising a firm that was contemplating creating a role like yours today, what guidance would you offer?

A: We discussed the life-expectancy of my role. I thought it would be a point-in-time role that would end when we reached a certain end-state. The experts say it takes 7 to 10 years to address culture. I saw my role, and still see it, as a "Change the Bank" project that embeds things in a "Run the Bank" manner.

The CEO agreed with my "change and run" philosophy, but said the need for it would never end, as our aspirations and expectations would continue to grow and evolve. I described the role earlier as managing the house and ensuring all the right bricks are in place and fixing any cracking mortar. Our CEO saw things as a continued maintenance effort, over the life of the building. At the time I didn't agree. Today, I definitely do. Culture needs to be managed and cultivated deliberately and continuously.

If I were asked for guidance by other organizations, I would just share our journey. We had the advantage of having three very strong global cornerstones to our culture that still hold true today: our core values of Team Spirit, Innovation, Responsibility and Commitment, and a leadership model that defines what we expect, according to our values and a clear code of conduct. Our culture is clearly and explicitly integrated everywhere you look, in all our business and in all countries, in our ESG and stainability strategy, in having the client at the center of all we do. We strive every day to ensure that everyone understands what's needed, and we are deliberate and clear about how we value this, that we believe it is a business imperative, and about how we expect everyone to live this out.

Q: Do you expect to see roles like yours becoming more common, "mainstream,"? Or will it become more of a niche function among the relatively few?

A: Unfortunately, I don't see that many organizations have made the choice we did.

I know that many people I talk to and work with see the value in the model we have chosen in SG Americas. But they still talk about the frustrations I'd heard when researching the role some 7 years ago: "I cannot have the firm-wide impact that is needed when I am only working on one piece of the pie and we are not moving together and thinking holistically."

This said, many firms have come a long way and are doing amazing things. Many have created change and made genuine and sustainable impact through a more decentralized model. Again, I see culture as unique to an organization, so how they manage it and cultivate it will remain unique.

***Nancy Harrington Jones** is the Chief Culture & Conduct Officer for the Americas at Société Générale.*

The Value of Outsiders, Inside: How Organisations Can Better PRE-EMPT Unwanted, Unanticipated and Undesirable Outcomes

By ALEXANDRA CHESTERFIELD


Alexandra Chesterfield

NatWest

As part of the Edelman Trust Barometer[1], a global survey of 34,000 respondents in 28 markets, nearly six in 10 believed capitalism was doing more harm than good. The same survey shows most people not only expect but demand business to move beyond corporate decision-making and take a stance on broader issues including climate change, income inequality, diversity and immigration etc. Business is no longer seen as a distinct and separate domain but part of the social fabric.

The corollary is that it is no longer good enough simply to avoid creating problems — it is increasingly expected that businesses play an active role in driving positive change. Societal expectations of business mirror the tectonic shift in how business leaders are thinking about business — from putting investors first to putting all stakeholders first. From shareholder value to stakeholder value. And this was all before the global pandemic.

The pandemic has since sharpened focus on the fundamental purpose of business. If it's solely to make money, then you risk being on the wrong side of history. The pandemic has also shown businesses have the capacity to act in the service of the wider common good. My own organisation, NatWest Group, turned its Edinburgh HQ into a foodbank and led the way in lending money to businesses as part of the government lending schemes — living its purpose to champion potential, helping people, families and business to thrive.

But this begs the question: if the whole concept of why organisations exist is changing, and what value they are expected to provide, what does this mean for Audit? If value is about outcomes, how can we bring a more 'human' lens to assessing risk looking precisely at the customer and wider stakeholder outcomes we drive through the way we behave?

Behavioural risk...

Six years ago, sensing value in an independent, objective team with behavioural science expertise, NatWest Group Internal Audit established its Behavioural Risk team — a first for the industry.

The absence of a negative is hard to prove. But just as when your health fails, you notice it. It isn't a problem ... until it is one! History tells us that when organisations or systems fail — be it the financial crisis, oil rig disasters, aeroplane crashes, scandals, political crises — the root cause is often, at least partly, due to a human component. Either because we have (unintentionally) created the problem and/or because of how we've reacted to it.

Despite decades of behavioural science describing how and why real people do what they do, so much of how organisations — and markets — are designed rests on the notion humans are predictable, rational actors making cost-benefit analyses about risk and reward. This is the basis for law, economics, risk and compliance functions etc. ... and it is deeply flawed, as the financial crisis and events before and since have shown. ▶PAGE 143 Put another way, behavioural risk is the risk of poor outcomes for an organisation, customers, markets and society more widely — because of the way people actually think and behave. NOT how we want people to behave or how we think they behave. ▶PAGE 355

Traditionally, Behavioural Risk teams have focused on understanding behavioural norms (i.e., the considered acceptable behaviours in a particular group), and their drivers, in specific areas of an organisation[2]. It's where my team started. Approaches often involve triangulating across primary and secondary data, including qualitative (e.g., 1:1 discussions or observations) and quantitative data (e.g., Management Information data, strategies, policies, goals and survey data), and linking themes from the data with the theory from organisational and social psychology.

behavioural risk is the risk of poor outcomes for an organisation, customers, markets and society more widely

But unwanted outcomes can happen for other reasons too. Employees design products, journeys and touchpoints which influence customer behaviour and shape outcomes, sometimes sub-optimally. And this can be independent of the local sub-culture — you might have highly motivated, engaged and psychologically safe teams that are designing products, journeys or touchpoints that, unintentionally, may drive poor outcomes. For example, inequality, polarisation, financial distress. Put another way, healthy sub-cultures don't always lead to good customer or societal outcomes. In addition, we may miss other, more latent behavioural risks using a single approach focussed on a single stakeholder (i.e., employees).

What more could it be? Growth areas in behavioural risk...

As well as looking at specific organizational domains, behavioural risk teams can extend their impact to also review:

1. The (unintended) effects of how customer journeys are designed on customer behaviour. To what extent do features of a customer journey (inadvertently) negatively influence customers' decisions, leading to customers losing out or getting a poor experience? Decades of behavioural science[3] tell us that the context in which someone makes a decision can either help or hinder individuals in pursuit of their goals: there is rarely a 'neutral' design. But developers of products and services are more likely to see the benefits and less likely to see potential sludge[4] in what they design. In contrast to 'nudge' which makes things easy for end users and prompts thoughtfulness where needed, 'sludge' is the opposite. Sludge means features of the customer journey that get in the way of effective decision making and a positive customer experience. For example, we've asked:

- To what extent a payment journey reduces the risk of customers' being defrauded or scammed?
- How might the choice architecture of a particular journey influence customers' decision making?

'Sludge Audits' are likely to be seen more regularly, given the FCA's Consumer Duty and increasing digitisation of products and services.

2. The impact of specific events or decision processes on behaviours and outcomes we care about. For example, we've looked at:

- What is the impact of particular products and services on customers' financial health?
- To what extent performance and promotion decisions may be systematically biased by someone's gender or ethnicity.
- The (causal) impact of working from home on specific aspects of traders' mindsets and behaviours.

The *PRE-EMPT* framework

Behavioural risk teams have the potential to help create wider stakeholder value. Both at a macro level: financial and economic stability, integrity of the markets, improving trust, etc. But also at a micro level: helping to reduce problems for customers directly — saving them time, supporting decisions that increase financial wellbeing, etc. Behavioural risk management is still an extremely young field. In the spirit of sharing what we've learned, here's a framework sketching how organisations can PRE-EMPT future problems.

3. **Prevent** A core principle of our work is forward looking, not backwards looking. Think about a car or health MOT (Ministry of Transport), pinpointing and surfacing potential vulnerabilities and their root causes, rather than a policeman detecting problems that have already happened.

4. **Reach** Organisations are complex, dynamic systems involving employees, customers, and other stakeholders (e.g., investors) and all the ways in which they interact with one another, directly and indirectly, via journeys and touchpoints. Behavioural risk teams should have the remit to reach into every part of an organisation in effectively identify and diagnose potential behavioural risk issues.

5. **Evidence** High quality evidence and insight, underpinned by a scientific process, is key for credibility, driving impact and positive change in organisations. It also helps counter the perception of anything to do with behaviours as 'fluffy', relative to 'hard' risk management.

6. **Experimental** How do we know if something is working as desired? Or what the unintended impact of service/product X may imply for population Y? That the tectonic plates of business are shifting from shareholder value[5] to wider stakeholder value means it is more important to know if and what effect the organisation is having on all its stakeholders. This may help to guard against potential ESG-washing.

   This is where we need to use more experimental methods (e.g., randomised controlled trials or related approaches to establish cause and effect relationships). These methods are often used to evaluate the effectiveness of a particular policy or project, both the intended outcomes but also unintended outcomes. We have started using them to answer questions like: what is the impact of working from home; is a particular product or service driving the desired outcomes (and what are the undesired outcomes?). A well-designed experiment typically never fails as you always learn something! If organisations are not evaluating what works, what doesn't, and for whom, then how can they learn or get better?

7. **Multi-disciplinary** As the philosopher Mary Midgley said, there are many maps to understand the world. Equally, there are many ways to understand and identify behavioural risk. The benefits of cognitive diversity in a team cannot be understated. For example, in my team we have organisational and experimental

psychologists, behavioural economists, cognitive scientists and qualitative specialists as well as professionals with experience in regulation; innovation; public health; law; consultancy; banking; audit and risk. One discipline or method can be like a straight-jacket. The sum is greater than the parts. You get the gist.

8. **Partner** Our partnerships with academics make us better. They help to keep us at the forefront of cutting-edge methods used to identify and understand behavioural risk. As well as building internal capability. While we must be conscious of our required independence, sitting in Audit, we also collaborate with internal teams to drive value for the organisation. For example, our partnership with the NatWest Group commercial behavioural science team is invaluable in mitigating problems following our reviews and provides feedback loops to increase learning and overall impact.

9. **Track** Regular scanning should be done for behavioural 'smoke signals' to help in deciding: a) where deeper-dive diagnostic eviews are necessary, and b) as a source of insight in and of itself. ▶PAGE 441 Unstructured (typically textual) and unobtrusive (e.g., not asking people directly) data offers significant potential here. The explosion of textual data left behind by all of us provides social scientists with new ways to understand micro-interactions, emotional tone, group dynamics, and cultural shifts that may change in seconds or centuries.

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ENDNOTES

1 2020 Edelman Trust Barometer," Daniel J. Edelman Holdings, January 19, 2020, edelman.com.

2 E.g. What is the influence of collective beliefs within teams on the way individual team members act and think? What is doing the right thing in this team? See this HBR article on the team's work for more detail.

3 Imagine you have been diagnosed with an illness and offered two treatments. Treatment A is described as 90% patients surviving. Treatment B is descried as 10% patients dying. The treatments are actually identical but how they are framed significantly shapes your decision, with most people choosing A. See here for more. Tversky, A., & Kahneman, D. (1981). The framing of decisions and the psychology of choice. Science, 211(4481), 453-458. doi:10.1126/science.7455683

4 Watch this and read the white papers from Dilip Soman's Behavioural Economics group at University of Toronto on Sludge

5 E.g. see here and here

Ground Breakers

ABN AMRO: Curating the Context of Conduct

By WIES WAGENAAR

Introduction

Wies Wagenaar

The mere fact that you have the right to do something does not mean that actually doing it would be the right thing. Acting ethically involves more than just sticking to the rules. There's no universal agreement on what counts as "good": ask any number of people, and that's the number of different answers you'll get. What is considered "good" here in the Netherlands isn't necessarily "good" in Japan, say, or the Middle East. And to complicate matters further, the criteria involved in making such judgments are constantly changing with the times.

Determining what's right in a given situation requires dialog. We have to weigh up the rights, interests, and wishes of everyone involved, and carefully examine all sides of a given issue that is to be decided upon, based on a variety of viewpoints and frames of reference. And then comes the even trickier part: following through on whatever's been decided. As often as not, that's going to require gumption — the courage to stick necks out and go against the grain. And if there's a lot at stake, chances are the fix won't be easy. If it were, the issue probably wouldn't have arisen in the first place.

Now this rather general picture I've sketched could apply not only to you and me as private individuals, but also to staff and management in organizations, and to organizations as a whole. In what follows I'll offer two practical examples from ABN AMRO's recent past and, based on those, I will offer a number of key insights from behavioral science. In each of these cases, the level of trust that the bank enjoys with clients — and with Dutch society as a whole — took quite a hit.

> Ethics is knowing the difference between what you have a right to do and what is right to do.[1]

ABN AMRO always conducts a root-cause analyses after troubling incidents, focusing particularly on behavior and organizational culture. These root-cause analyses seek to ferret out obstacles to acting ethically and, by the same token, any unintended or unrecognized incentives to act unethically. In the process, these analyses yield specific insights into needed changes. I will also describe this in some detail. And I will conclude by considering how ethics can play a role in the banking in the future, and how we can work together to create a better world — now and for generations to come.

Banks and the Financial Crisis

In the twelve years since the global economic crisis, the financial industry has devoted considerable time and resources both to understanding what it was about the organizational culture of financial institutions that contributed to the crisis, and to deciding upon, and implementing, reforms required to address those causal factors. Despite these efforts, confidence in the trustworthiness of banks remains low, and contributing culture problems just aren't going away. Some futurists have predicted that the next banking crisis will be a crisis of ethics.

ABN AMRO is well aware that it has a huge economic and, thus, social impact. The bank is not just a commercial enterprise: it provides society with essential financial services, managing and lending considerable sums to individuals and businesses alike. It thus impacts the lives of millions of people. And those people's individual and collective expectations regarding ABN AMRO's business integrity keep rising. That's why, in everything we do, we're always on the lookout for ways to improve, using lessons from behavioral science and from ethics as a professional field.

> We know that the behavior of employees is influenced by the context in which they find themselves.

Of apples and barrels

I myself have learned lessons of the kind about which I write here. Before joining ABN AMRO in 2014, I worked for a number of years at KPMG's Forensic & Integrity practice. That gave me the unique opportunity to interview fraudsters from all kinds of organizations. I was asked to look at large-scale corporate fraud, corruption, and other undesirable behavior. My initial assumption was, "I'm going to catch some bad folks with their hand in the till." Boy was I wrong. In many of these investigations, we would find ordinary people with records of dedicated service as long as your arm, but who at a certain point felt so much pressure that they stumbled, made bad choices, and landed in hot water. Through their professional roles, they had been given opportunities to commit their crimes: they had access to knowledge, financial systems, power, or some combination thereof. But there was one other thing: the circumstances they were in allowed them to rationalize their poor choices.

> Behavioral science helps us get a better understanding of why employees do what they do.

I wanted to understand how it could be that good people sometimes make such bad choices. From the scientific research and lessons learned through corporate incidents, we know that the behavior of employees is influenced by the context in which they find themselves. Behavioral science helps us get a better understanding of why employees do what they do.

Research on unethical behavior, goes against the rules, or that leads to a failure to meet organizational objectives reveal that behavioral patterns, underlying drivers, and contextual factors all influence our behavior. These insights help us to understand undesirable behavior within organizations — behaviors that transgress widely accepted social norms of what is "right" and "wrong."

In these situational contexts, our decision-choices are influenced by factors such as unclear standards, heavy workload, setting unrealistic goals, an unsafe work environment, failures in supervision, and an organizational culture in which those who have breached rules in the past have not faced consequences. It's a matter, not of a few bad apples, but of bad barrels.

Focusing, then, on the environment and the culture in which individuals work is a more effective way to prevent undesirable behavior than focusing on the "bad" individuals who engage in it. Identifying obstacles to behaving ethically in the immediate work environment, and recognizing incentives to behave unethically, is a more effective means by which to mitigate or remove both. And being willing to learn lessons from the past is key.

A lack of clarity, and rules that fail to make a difference

Research has been done, in many industries and in social psychology, on the impact that rules have and how they are translated into policies that are intended to influence behavior. ▸PAGE 147

For instance, the well-known psychological researcher Robert Cialdini has done significant of research into factors that can influence our behavior. In one experiment, Cialdini and his colleagues observed visitors to a local library in Arizona. After each visitor had gotten out of their car and headed into the library, researchers placed a flyer under the windshield wiper on the driver's side. They then hid and waited until the visitor returned to the car. What would they do with the flyer? Would they throw it on the street, in violation of a clear norm, or do the "right" thing and take the flyer with them into the car, to be discarded elsewhere? The researchers had made sure there were no garbage cans nearby…

On average, 14% of people threw the flyer on the ground in the car park. Now, it's safe to say that everyone knows that you don't just throw things on the ground in a public place. Yet despite this clear standard, some of us do so all the same. Notably, Cialdini's research team ran the same experiment in a car park that was already covered in litter and found that as many as 36% of drivers littered it further, tossing away the flyer on their windshields.

Cialdini and his team concluded that norms are effective only if they come together at the decisive moment (in this case, the moment when the visitor decides whether or not to litter the car park). People can be quite flexible in how they perceive prevailing norms, basing their views in part on their immediate environment. So, it's important for organizations to establish values and communicate them clearly, but also to ensure that they will be brought to bear right when it counts.

Learnings at ABN AMRO

This brings me to one of the incidents at ABN AMRO mentioned above, where the standard involved was perfectly clear and had been endorsed by all employees, but was violated all the same by a small number of them.

CASE STUDY 1: FORGING CLIENTS' SIGNATURES IN CASES WHERE A MORTGAGE RECOMMENDATION HAS BEEN REVISED

A revised mortgage recommendation

Here's the scenario: once a recommendation on a given mortgage has been drafted, it is sent to an internal quality-control office for review. The key points here are that this additional check takes place after the client has signed an advisory report, and that a signed report is the basis for finalizing and implementing the mortgage offer in accordance with the standard processes and all the applicable rules.

Now, it can happen that the first mortgage recommendation, which is signed off on by the client when they sign the report, is not actually complete. Or it could be that a decision was made, in setting the initial recommendation, to accommodate a request from the client for some non-standard provision, and that the justification for this deviation has been inadequately recorded. In either of these cases, the adviser is asked to update the recommendation, share it with the client, and ask them for their signature all over again.

Forging signatures

Of 850 mortgage advisers at ABN AMRO, 114 failed to ask the client for their signature the second time round. Rather, they decided to forge the client's signature themselves after the mortgage recommendation had been revised. In the three years when this happened, from 2013 to 2016, 47,826 mortgage recommendations were made to clients. In 9,900 of these cases, the recommendations had to be revised, and in about 700 of these, a signature was found to have been forged. In the end, it turned out that in just 3 cases the client had suffered very limited financial loss because their signatures had been forged. In total, the losses came to less than EUR 1,000, and this has since been paid out to the clients thus affected.

Investigating the root causes

It quickly became clear to us, as we were investigating the facts, that we needed to get a thorough understanding of how this could have happened, so we could make sure it would not be repeated. We did a study with internal experts and behavioral scientists to try to understand why good employees had made bad choices — because, notwithstanding the small amounts involved, that's what these were. Forging client signatures is simply not acceptable, and these mortgage advisers knew that full well.

The project team interviewed 230 staff members who had been involved in the mortgage process across different departments. We also conducted a survey that was completed by some 500 colleagues who were involved in the process. Our team analyzed data, examined files, and sat with ABN AMRO mortgage advisers across the Netherlands as they did their jobs. This allowed us to form an in-depth picture of the entire mortgage-advice process, which turned out to be extremely complicated.

Because the signature forging was not limited to a single team, location, or specific group, we understood that something else must be going on. We discovered that the way the bank had translated the rules for mortgage advisers into policies, procedures, and work instructions was quite complicated. There were even contradictions.

Moreover, mortgage advisers were expected to safeguard a range of interests. First, there were the interests of the client, which could be met in part by offering them the right products. Ensuring client satisfaction, to include offering great service, was a part of this. And then there were the bank's commercial interests: the ambition was to sell a certain number of mortgages each month and to record each sale completely and correctly in compliance with laws and regulations.

These interests sometimes clashed. If compliance took too long, levels of client satisfaction would start to drop, and there would also be less time to sell new mortgages. So, advisers were constantly required to decide which interests were more immediately pressing, while under pressure from all sides to keep delivering. Trying to do justice to everyone's interest was quite a balancing act. And it wasn't always clear to advisers how they could keep that balance, which is why some of them stumbled. ▶PAGE 383

A number of methods were used during the period in question to try to ensure that everything was done by the book: new legislative and regulatory provisions were communicated, alongside existing policy, through various channels including newsletters and various intranet sites, and advice was provided as regards what the bank called "workarounds."

It turned out that advisers had a clear sense of what a good mortgage recommendation was, when it came to serving client's interests. But they were less clear about how to meet the requirement to deliver that recommendation in full and in accordance with policy. This often led to a lot of back-and-forthing between the adviser and the departments involved in quality control. Advisers had a hard time getting things right in the first recommendation. In addition, the standard for recording relevant information was unclear. This led to frustration among advisers, who felt that there was a measure of arbitrariness in how checks on their files were being done.

Poor role modelling — and being in with the in-crowd

Let's return for a moment to the case study on littering in car parks. Cialdini discovered that, when the car park was messy and visitors saw someone else throw their flyer on the ground, 56% of these observers elected to do the same thing. Our behavior, in other words, influences what others may choose to do. When another person seems to confirm a norm that someone else perceives to be the prevailing norm in their environment, more than half of us are strongly inclined to conform to that norm — even when it means violating rules about which we are fully aware.

This brings us to a second incident from ABN AMRO's history.

CASE STUDY 2: INCORRECT INFORMATION AND INCOMPLETE FILES

In October 2015, the Netherlands Authority for the Financial Markets (AFM) imposed an administrative fine of EUR 2,000,000 on ABN AMRO. For just over two years, starting in October 2010, the bank had not kept sufficient records of how it provided services to small and medium-sized enterprises regarding interest-rate derivatives. That meant the AFM was unable investigate whether the services offered were actually in line with what these clients wanted. The AFM was thus unable to carry out its supervisory function properly. The AFM ran an investigation into the services rendered in 2013, and requested five relevant client files. It found that, in four of these cases, ABN AMRO had not kept adequate records of the services it had offered. Hence, the fine.

Adequate record-keeping as a precondition for proper supervision

Under Dutch law, adequate records must be kept as to how investment services are provided and how investment activities are carried out, so that the AFM can carry out its supervisory functions. First, a file must show the exact nature of activities carried out, at the level of each individual transaction. Where investment services are provided, such as carrying out orders for clients and offering advice, an investment firm is subject to a large number of requirements related to a duty of care. In the case of investment activities that involve two equal parties, that duty of care is considerably lower for the investment firm. Especially in the case of banks, where several services and activities usually take place under one roof, it is important to be absolutely clear about the nature of those activities. That, in turn, will help make clear what duties of care the bank must fulfil.

It is also important for both the client and the bank itself that files are complete. And the bank must be able to reconstruct how activities came to be carried out in the first place. If client files are incomplete, discussions need to be held with the clients concerned, who may then be in a position to supply some or all of the missing information. An incomplete file does not necessarily mean, of course, that a client's interests have been prejudiced. It could still be the case that the products they were offered were appropriate to their needs. However, in cases where the client's interests have been prejudiced, and where the bank cannot say why, the AFM expects that a suitable solution will be offered to the client.When we do behavioral-science research at ABN AMRO, we always compare, for a given topic, those departments where things are going well with those where they're not. This helps us to explain the differences involved and to see which practices are effective, and which less so. In the case at hand, it turned out that the difference between the departments came down to managers. In departments where files were being well maintained, the manager kept a close eye on how files were being created: they would look in occasionally on employees and give them feedback, discuss in team meetings how files should be drawn up, and take into account during performance appraisals how well staff members had done on this score.

This was not the case in departments where the files were not in good shape. We even discovered situations where employees had not received any feedback on, or checks of, their files for years. This aspect of their work had inadvertently slipped between the cracks. And that, in turn, had the predictable consequence that they did not even realize they were not doing their jobs properly.

In the first case study, by the way, supervision by managers (or the lack thereof) also played a role. Following one or another reorganization, a mortgage adviser might have had a number of different managers within a short time, or perhaps no manager at all. No surprise, then, that they would find it difficult in these situations to discuss the contents of a recommendation file. In the normal course of things, that would have been advisable. But given a number of legislative and policy changes that were being made around that time, it was a must.

Mortgage advisers also had to meet specific targets and requirements related to quality. Those who did not manage to meet such targets were moved down a few notches in performance reviews. And reorganizations were also making some of the mortgage advisers who did have managers feel uncertain about their future, because those managers would call them to account if they did not meet their commercial targets.

We know from science that the actions of leaders and others in authority directly influence our behavior. The eminent American social psychologist, Stanley Milgram, conducted a now-infamous experiment in the 1960s. Subjects were asked to participate in a study of memory and learning. The aim was supposedly to investigate the effect of punishment on people's ability to learn. The experiment was observed by the researcher, dressed in a white lab coat. The subject was given the role of "teacher," and unbeknown to the subject, an actor played the part of the student.

The researcher tied the student to a chair and attached an electrode to his wrist. He also put gel on the wrist, explaining to the "teacher" that this prevented severe shocks from causing permanent tissue damage. The researcher and the teacher went to the adjoining room, where there was a machine. The student then had to answer questions. For each wrong answer, the teacher had to administer a shock, with increasing in intensity. The switches on the machine had labels such as "slight shock," "moderate shock", "strong shock", "very strong shock", "intense shock", "shock with extreme intensity" and "danger: severe shock." The last two switches were labelled "XXX (= dead)."

During the experiment, the teacher could not see the student, but could hear him. In fact, a tape was played, adjusted to the strength of the shocks administered: if the shocks were light, a faint sobbing could be heard. Gradually, the cries increased, as did the heated requests to stop ("Let me go, let me go!"). From 300 volts, there was a pounding, followed by a deadly scream. Switches that the teacher thought were delivering that voltage had the last three of the above labels: "shock with extreme intensity," "danger: severe shock," and "XXX (= dead)." The teacher was told by the researcher that this should be taken as a wrong answer and that the next higher shock should be administered. In cases where the teacher hesitated, or asked for advice, the researcher gave emotionless, standardized prompts such as "Please continue," or "The experiment requires that you continue."

> The essence of obedience consists in the fact that a person comes to view himself as the instrument for carrying out another person's wishes, and he therefore no longer sees himself as responsible for his actions.
>
> **STANLEY MILGRAM**

Milgram was curious to see how quickly the test subjects would drop out. What did he discover? All of Milgram's subjects administered shocks of at least 300 volts, the average shock delivered was 360 volts, and almost two-thirds of the subjects delivered the highest and lethal shock of 450 volts. The conclusion was that, in response to a perceived legitimate "authority" (remember the lab coat), people were willing to administer perhaps deadly shocks to the "students."

Many refused to believe Milgram's results, so the study was repeated many times, each time with roughly the same results. According to Milgram, the results show that "the essence of obedience consists in the fact that a person comes to view himself as the instrument for carrying out another person's wishes, and he therefore no longer sees himself as responsible for his actions." Almost everyone is obedient under certain circumstances and takes part in reprehensible, shameful acts.

According to Milgram, perfectly ordinary people can be intermediaries in a destructive process. Even when the effects of their behavior are clear, relatively few people have the wherewithal to resist authority when asked to continue. Under the pressure of authority, people tend to lose their moral compass. And why should employees in organizations be any different? The role of exemplary behavior, combined with clear standards, is crucial in order for employees to do the right thing.

Goals that are hard to meet and sometimes mutually conflicting, and the role of shame

Let's come back to the case study on the behavior of mortgage advisers. Here we see a third element that influenced the advisers' conduct. A large proportion of all mortgage advisers indicated that producing a complete and appropriate mortgage recommendation was a complex process. Many different parties within the bank were involved, and the process comprised many steps and had a lot of quality-control checkpoints. At that time, advisers were working with an IT system that did not support them in the best way, and with systems that did not always connect well with each other. As a result, the adviser regularly had to use manual solutions. This caused delays in producing recommendations. At the same time, of course, the adviser wanted to provide clients with the best and most comprehensive recommendations possible.

Organizations set goals. They impose these on their employees, and use performance indicators such as quality, sales, and client satisfaction to measure how employees meet those goals. If they are difficult to achieve because rules are not clear, employees often narrow their focus to only one set of interests. Or perhaps the processes are complex, laborious, or impose a high administrative burden. Obstacles regularly arise that hamper employees' ability both to do the right thing and to meet the performance goals that have been set for them. That, in turn can lead to stress, frustration, and in some cases even embarrassment in front of a client.

It's only human to want to put paid to this sense of frustration. That is why people use coping mechanisms, take the path of least resistance and, as a consequence, commitment to quality, customers and the firm flags. If we want employees to follow the rules, we must make it as easy as possible for them to do so. The systems they use, the procedures they must follow, and the processes they must go through have to be as user-friendly as possible.

We like to belong: it gives us a feeling of safety and security. And the same goes for employees in an organization.

Speaking out is hard. People like to be in with the in-crowd.

Of course, the mortgage advisers regularly raise concerns, either with their managers or in broader meetings, about the lack of clarity, the heavy workload, and how complex the work was. They also made suggestions for improvement. Speaking out against the prevailing norms takes courage and discipline, as we know only too well from the famous Asch conformity experiment, the first version of which Solomon Asch conducted in 1951. He placed an unwitting participant in a room with seven actors ("confederates"). The unwitting participant was told that they were taking part in a "vision test," and that everyone's task was simply to state in turn which of a set of three lines (B, C, and D) was closest in length to the reference line (A). The experiment was arranged so that the unwitting participant would give his answer last. (He and all the confederates were white male students from Swarthmore College.)

The unwitting participant thought that the other seven students were also real participants like himself. As the confederates were called upon, each gave the same obviously wrong answer. It was then up to the unwitting participant to either state the obvious or to give the same clearly incorrect answer as everyone who had gone before. On average, 32% of the unwitting participants went along with the others, giving the same and obviously incorrect answer. During the 12 such experiments Asch conducted, about 75% of the unwitting participants conformed at least once. Only 25% never conformed. Asch did the same experiment with a control group, in which no actors gave obviously wrong answers, so that there was no pressure to conform. In that group, less than 1% of participants gave the wrong answer. We humans like to be liked by the group we are part of. We like to belong: it gives us a feeling of safety and security. And the same goes for employees in an organization.

The organizational culture in ABN AMRO's mortgage business influenced the behavior of our mortgage advisers. The signals from the mortgage advisers did not come through to management as clearly as they should have. This was partly because there were many different parties involved, and because no single person had (or took) responsibility for the entire mortgage-recommendation process. There was also too much distance between those who devised existing or new mortgage policies, those who developed the supporting IT systems, and the advisers themselves, who had to counsel their clients on the basis of the prevailing policies. Moreover, as we noted above, ABN AMRO reorganized a number of times during the period in which the advisers were forging client signatures. This meant that advisers were often uncertain about whether they would be able to keep their jobs, would be given a different role, or would be forced out as a result of downsizing. As such, advisers did not always feel it was safe to speak up and suggest opportunities for improvement. They were skittish about causing irritation with their feedback, especially given their uncertainty about their future at the bank.

The box that created the rotten apples

If we look back at this case from ABN AMRO's past, we can see that a lack of clarity, inconsistent management practices, and the culture of the organization, came together to pile pressure on the mortgage advisers. In almost all cases, a subsequent quality check resulted in an adjustment that had little or no impact on the client. Many clients had already moved house, some did not want to sign again or did not respond to contact requests. And in cases where the new recommendation was late in coming, advisers were also loath to bother the client for a second signature. But, in the meantime, the adviser could not close the file without a signature — and that would mean failing to meet the internal quality requirements. This combination of factors meant that some of the advisers could tell themselves that there was no harm in simply copying over a signature.

Removing the root causes

Based on lessons learned and the results of root-cause analyses, ABN AMRO has made a number of changes in recent years. In addition, it regularly measures and monitors the behavioral risks that can come up, by way of ensuring continual improvement. In the rapidly changing regulatory environment in which the bank operates, and given the ever-increasing expectations regarding the integrity of its actions, this is a process that the firm will never regard as "done and dusted."

ABN AMRO has made explanations of its relevant policies more concise and easier to digest. The policies themselves are more closely attuned to day-to-day practices that staff follow, though of course they are still designed to ensure full compliance with legislative and regulatory frameworks. Systems and procedures have been made more user-friendly by directly involving end-users in new developments or other changes. And the management structure has been streamlined: in some business lines, as many as six management layers have been cut out.

There is also more talk of "self-organization." In a nutshell, this means that, instead of being shouldered by numerous individuals in disparate departments, primary ownership of the overall mortgage process, from initial application to final approval and acceptance, lies with the specialist who is in day-to-day contact with the client.

In addition, the bank has worked with stakeholder groups to put the need for ethical behavior and integrity at the top of the list of value-creating topics.

The bank no longer takes a preventive or punitive approach to ensuring integrity as a kind of minimum that is driven by the need to comply with laws and regulations. It is committed, rather, to thorough-going integrity, achieved through (among other things) focusing on ethical decision-making even when the going gets tough. Through what we call "dilemma dialogs," as well as "ethical-positioning processes," "ethics cafés," and a standing Ethics Committee, the bank examines whether decisions are appropriately in line with laws and regulations, and whether they withstand ethical scrutiny: Are we doing the right things? Are we taking into account the rights and interests of all stakeholders?

> One voice can change a room.
>
> BARACK OBAMA

BANKING FOR BETTER: Ethics as part of everyday business

ABN AMRO is determined to play its part in working towards a better and fairer world for all our stakeholders, for example by helping to reduce social inequality, contributing to the fair distribution of wealth where value is created, enhancing the stability of the economy, and combating attempts to undermine that stability. Autonomy and responsibility are key principles here: the bank helps its clients to make wise financial decisions by providing them with accurate and complete information on all options open to them. This means that it always puts the financial interests of its clients first, that it supports its employees in doing the right thing, and that it is committed to promoting and accelerating sustainability to ensure a viable future for future generations. The bank is fighting climate change and its impact, strives for affordable and sustainable energy for all, and promotes sustainable patterns of consumption and production through its financing decisions. ▸PAGE 341

With this shift towards sustainability and integrity, we have set up integrity-management systems. They help to ensure that ethical conduct and integrity are at the heart of the day-to-day work our employees do. Staff and management alike are given tools and incentives to act carefully and with integrity, taking into account the rights and interests of all stakeholders — clients, employees, shareholders, and society as a whole — with the primary focus being on the client.

We have thus set up what we call a learning process around ethics, and encourage and facilitate the aforementioned dilemma dialogs. Relevant internal and external rules and guidelines that set out the rights of all those involved play an important role here. But rules can never anticipate every possible situation. The learning process emphasizes what the rules and regulations are intended to achieve, and offers pointers on how to act in that spirit. And it offers staff and managers a set of tools to help them to become adept at using the methodology to make honest and careful decisions: an ethical step-by-step plan, an ethics framework, and an ethics test. All staff are encouraged to keep up their proficiency and to record the results of their dilemma dialogs (a sort of ethics case law). And policies are, of course, adjusted as needed.

Professional-integrity management helps prevent violations of laws and regulations by all employees, including management, by identifying the risks of dishonest behavior, and by highlighting the ethical challenges and opportunities that lie ahead. This creates a context beset by fewer obstacles to desirable and honest behavior, while removing temptations and other factors that are likely to increase the risk of dishonest behavior.

Finally, professional-integrity management takes carefully considered action to combat suspected violations. Our bank may be a small cog in the machine of the global economy, and individual bankers may be the smallest cogs, but even the smallest cogs can make a difference. If employees feel that procedures they are required to follow pose a behavioral risk, or that they are not in keeping with our goals or with the client's best interests, they know they can speak up without feeling they're sticking their neck out. If a client feels that our manner of working fails to put their interests first, they know they can share that with us.

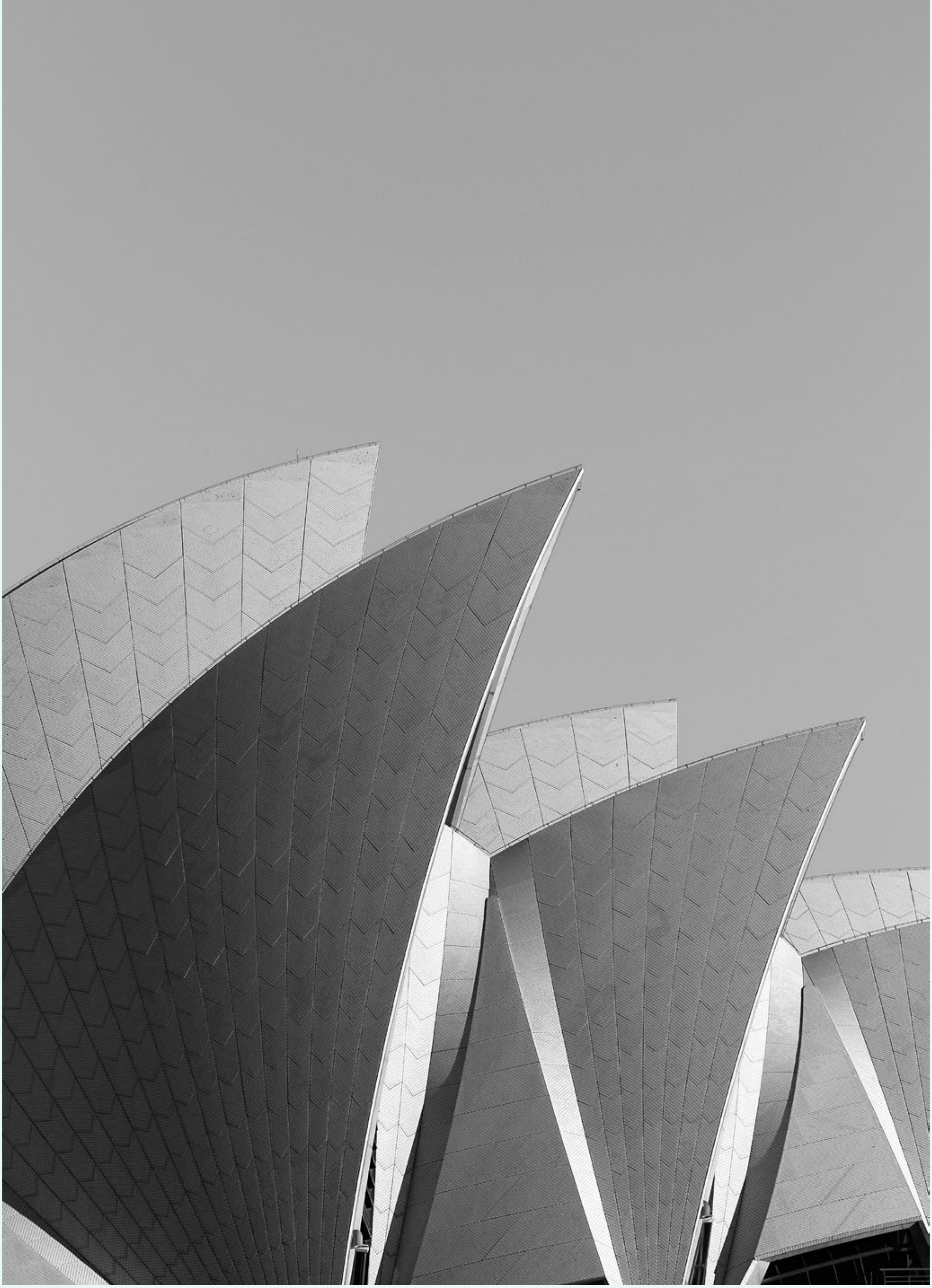
As Barack Obama put it so elegantly, "One voice can change a room." If a voice can change a room, it can change a team, and if it can change a team, it can change a policy, and if it can change a policy it can change the bank. And if the bank can change, it can change the professional and social networks to which we belong. Ultimately, if all of that can happen, it can change the world.

One voice, then, can change the world. It is only by speaking out, standing up for what's right, and working together to create a better world that the bank can fulfil our promise: "banking for better for generations to come."

Wies Wagenaar *is a social pscyhologist and serves as the Global Head of the Centre of Expertise for Behaviour, Ethics & Learning at ABN AMRO. She started her career as a crisis-management consultant. Having completed her training in forensic medical research, she worked as a consultant at KPMG Forensic & Integrity. She researched the root causes of fraud in business, and gave advice on integrity management and ethical business practices. In 2014, she was asked to create a new department at ABN AMRO that would focus on behavior, learning and ethics. Her team of behavioral scientists, philosophers and educational specialists identifies behavioral risks, leads projects that are designed to influence behavior, and facilitates ethical decision-making.*

ENDNOTES

1 United States Supreme Court Justice Potter Stewart.



Ground Breakers

An Interview with Les Matheson

Les Matheson

Q: The Hayne Commission (2017-19), and events leading up to it, put the topic of culture and conduct risk in the industry high on the agenda in Australia. Where do we stand today? How have understandings regarding the management of culture and conduct risk changed? What new operational realities are implied? And what more remains to be done?

A: A watershed event, like the Hayne Commission, was something that Financial Services in Australia needed. It required the whole industry to really reassess the way in which it was working with customers and indeed managing its way of doing business. That's something that you will have seen happening in different parts of the world at different times. I was in the UK when we had a similar event — in that case, it happened a few years after the Global Financial Crisis. But in different countries, this transformation has happened at different times.

It was important for Australia to have had that watershed moment where the whole industry can reassess how it's operating, and the reason that was necessary is because many things needed to change. And not just in the way that companies operate but also for regulators and in some cases, we needed changes to the law.

Today there is a much greater onus on the banking industry to put customer's interests first and to make sure the products and services they chose are suitable for them.

What this meant was a reassessment and a rebalancing. Organizations have lots of stakeholders: shareholders, customers, colleagues, and the communities in which they operate. Balancing the distinct interests of these very different stakeholders isn't always easy, in any industry. And I think that in financial services, we got to a place in many parts of the world where there was too much focus on shareholder returns and not enough focus on customers. So, this reset has enabled the industry to think again about how they make sure that their organizations are set up to enable people to deliver what customers truly need. This significantly increases the likelihood that we will achieve the right outcomes for the customer over the long term. Doing that requires the industry to take much more responsibility.

In terms of culture and conduct risk, the first thing to recognize is that the responsibility has to start with the Board. The Board needs to ensure that the culture of any bank is managed and that means measured. In the UK, an independent organization called the Banking Standards Board was set up to help Boards and management teams measure and track the culture in their organisations and to annually check progress. This gave Boards a comparative tool to measure relative performance.

Management then need to ensure that all the ways of guiding someone's behaviour were aligned with the goals of the organization. In particular, that reward and remuneration are set based on a balanced scorecard with positive customer outcomes at the top.

Q: You're a chief operating officer. From the operational perspective, what does all this imply? Is it just a lot more work, admin, costs? Or is there an upside that you see?

A: What you find when you start to focus more on the customer is that it motivates the whole organization. Starting, of course, with people who are dealing with customers every day. Whether you are in the corporate investment bank, the business bank, or the retail bank. If you know the whole organization is gearing up to provide you with the tools and capabilities needed to make a positive difference to the customers you are seeing every day, there's almost nothing more genuinely motivating than that over the medium to long term.

Let me bring this to life a bit. When I talk to frontline colleagues — about what they like about their jobs, what they don't like about the work that they're doing, what's exciting about it, what's motivating about it, etc. — they give me examples of times when they helped a customer, and the difference that that made in the customer's life.

Management needs to ensure that all the ways of guiding someone's behaviour is aligned with the goals of the organization.

It's an interesting thing about financial services. You can have a very simple conversation with a customer that is very impactful. We often talked about it in retail banking as a "kitchen table" chat, the kind of household balance sheet type of conversations that families have. You sit down with somebody at the kitchen table, and you draw a line down the middle of a sheet of paper and, on one side you make a note of whatever it is that people have coming in every week or every month. And then on the other side you make a note of all the things that are typically going out. And if you find that you've got a negative balance every month then you know that you are in some difficulty.

Just helping someone to think things through in that way is really valuable. Helping them reassess their spending, for example, to work out what is genuinely important to them and what's not. If you can then help that customer with their personal balance sheet, to make sure that it's a positive number every month, suddenly it can be quite transforming for people's lives. If they see a little positive every month, if they're paying down a little bit of debt every month, or if they're increasing their savings, that is a discipline that does not always come naturally to people.

When we go through that exercise with customers, we often find that people are paying for things that they've completely forgotten about. It's not unusual to find somebody who's got up to five different streaming subscriptions, two to three of which they aren't using. Many of them have got functionality that overlaps and people either haven't taken the time to rearrange their spending or they've found that it's just too hard. They can't figure out how to stop some direct debit from happening. So, we built a new feature in our mobile app that shows you all your standing orders, or direct debits, and you can then change them on your mobile in real-time.

Helping people to have a bit of discipline around this, making it easy for them and ensuring that every month they've got a positive household balance sheet is genuinely transforming for many customers.

Q: Questions about a firm's culture and conduct often receive attention only after there has been mishap. Once an *acute* problem arises — with sharp attention from regulators, shareholders, customers, or employees — these sorts of risk management questions get heightened attention from the board and C-suite. But regulators appear to view these risks as *chronic* in nature, and maybe even systemic. What's your own view in this regard?

A: I think the industry is complex. There are tens of thousands of people working across the industry and banks are built upon thousands of different operating systems. So, I think this is absolutely a multi-year change program the industry is undertaking. Not everyone gets their arms around all the aspects of this immediately. Much of the industry is on a path, moving from hardware and paper-based customer journeys, into digital software-based or cloud-based technologies. There's a good amount of technological change that still needs to happen to do two things: to make it really simple and easy for customers to understand what it is that they are buying; and making sure that the things that are most important to them are upfront, clear, and simple.

The simplicity of products and the communication around them is something that we need to continue to work on. But the other thing — and this goes back to what I was saying in terms of this onus of responsibility that we have — is that we can and should be using some of our monitoring systems to make sure that customers are using products in the right way. And that if they're not using the products in the right way for them, that we proactively let customers know that and tell them we think they may have the wrong product and that they should consider changing to something better.

And so that proactivity, to your question, is an area where we still have some work to do, to use our customer data and to communicate with customers as effectively as we would like to help them to make proactive change. Maybe they're paying too much for services that they're not using. Maybe their life has changed, and we can see that they're not making full use of what they're paying for. For instance, a customer might have a mobile phone insurance, travel insurance, household insurance. And if we see through their transactions that the customer isn't traveling, or that they don't have a mobile phone direct debit coming out of their account every month, then the bank should be able to deduce that the customer isn't going to be able to use a particular product package account fully or get good value out of it. In such circumstances we need to proactively say to the customer, "It doesn't look like you need this product, and you may be paying for something that isn't actually helpful for you. Here are three alternatives."

In terms of the proactive stance you've asked about, what we need to do is monitor both existing products and new products — and we need to have that monitoring in place and automated so we can see if a customer is taking out a product and then moving away from it after six months. If your attrition rate is high, I don't know 15%, 20%, 25%, well maybe that's a blunt metric but it tells you that a product probably isn't meeting the needs of customers if people are taking it out and then moving away from it quite quickly. So that would be a macro indicator that there may be something that's not quite working with the product. At NAB we have built a series of monitoring tools like that, particularly for new products but also for existing products, to make sure that if we see at a broad level that our customers are not using the product correctly or moving away from it, we use those indicators to let us know that there's likely something that isn't working for customers and that we need to make a change.

We can do that before these significant problems come along, before we get to the chronic stage, if you like. And, to your previous point, one of the things I think that hasn't been properly recognized more broadly is that very often the issue has not been bad intent by banks or by the industry. It's been that our systems and the processes haven't been able to alert the bank or the customer to things that aren't working as well as we all would like. It's those kinds of operational alerts that the industry needs to build into its operations. That operational capability often hasn't existed, and so we have not made adequate use of our data. Banks have had to consult many separate internal systems that, historically, haven't communicated with one another properly. So, one of the things that we — and everybody else — has had to do, is to make sure we understand our customers' needs and behavior.

BOARD CUSTOMER COMMITTEE AND CUSTOMER ADVOCATE

Board Customer Committee

The purpose of the Committee is to require and oversee a significant lift in the importance given to the voice of the customer and a more intense focus on customer outcomes. The Committee also assists the Board in fulfilling certain of its statutory, fiduciary, and regulatory responsibilities. The Committee is responsible for:

- Voice of Customer
- Product Governance
- Customer Outcomes, Complaints, and Remediation

Customer Advocate

The Advocate reports to the board on our performance with customers. An independent perspective from customers' point of view to guide the Board to ensure the organization is providing good customer outcomes. To help NAB achieve this, the Customer Advocate also works with the business to embed a culture of fairness across the bank, influencing our strategy and operations to be more customer centric.

Q: There has been much discussion in recent years around corporate 'purpose.' In your view, what is it to be a 'purpose led' organization? How is that established, in practical operational terms? Why is this important or valuable to a firm and its stakeholders?

A: This is a particularly appropriate question for financial services and one that has received a lot of thought and attention in recent years. For me, 'purpose led' means placing your reason for being at the center of everything you do. It means being very clear about how you are improving your customer lives.

Often when an organisation starts out, its purpose is very clear and obvious, otherwise it will just fail. But over the years and as people change, it is not uncommon for companies to lose their way. So, in terms of establishing a purpose, more often than not, what needs to happen is that a business goes back to its roots to rediscover its core purpose. Of course, as the world changes and people's needs change, sometimes a purpose needs to evolve too.

Then an organisation needs to regularly communicate a purpose and embed it in the fabric of that organisation. It needs to measure whether the company is meeting its purpose. It needs to integrate that purpose into the goal setting and the reward system. Most important, the people delivering that purpose need to feel motivated, excited, and passionate about achieving that purpose.

Q: In our 2021 *Compendium*, FINSIA's Chris Whitehead argued that "professionalism has never been formally instituted in the Australian banking industry," largely because "the formal structures that underpin and support professionalism have never been put in place." Do you share this view? How does Australia compare on the professionalism question, given your broad experience of the industry in other markets?

A: Yes, we need to help get the industry back to being a profession, not only from a practical perspective but also from a values and a behavioral perspective. So, one of the things that we've done at NAB is work with FINSIA, the professional standards body in Australia, to establish the Career Qualified in Banking course. We want exceptional bankers at NAB. This is a globally recognised professional qualification that our colleagues can own throughout their banking careers at NAB or elsewhere, that will raise the bar for professionalism within the financial services industry. What we're saying is that, across the whole organization, everyone needs to have solid foundations in terms of what's expected of them and required of the profession.

Over the next 5 years, all permanent NAB colleagues will complete the qualification, including our executive team. We've all done it. The Career Qualified in Banking course is aligned to NAB's strategy to invest heavily in our colleagues and customers.

So, I think Chris [Whitehead at FINSIA] is right that we have not had enough due regard for professional standards in our industry. Professionalism and professional qualifications are indeed also helpful for smaller and medium sized players but also for customers. It lets customers know what they can and should expect from the industry. Our industry still has some way to go to get there and I'm proud NAB is taking an industry leading position in this regard.

Q: Some have argued that the industry suffers from an over-reliance on surveillance and monitoring. We have systems and processes to catch bad actors in the act, so remedial measures can be applied after the fact. But is this 'detect and correct' approach adequate? What might be done to adopt more of a 'predict and prevent' capability such as you just described?

A: One of the things I think we've all now recognized is the importance of culture. And I think it is especially important in a service industry like banking and finance. That recognition has also coincided with another recognition, or renewed appreciation, for the importance of a firm's values and purpose. And culture and purpose are very much intertwined. Rightly so, a conversation in this regard began a few years ago — about making sure you have a clear purpose as a business and making sure the customer is central to that.

> 'Purpose led' means placing your reason for being at the center of everything you do. It means being very clear about how you are improving your customers' lives.

This is something the industry is now focused on. There are a lot of ways in which culture is set and there are good indicators in that regard. One is through the purpose, vision, and values that you engender as an organization. But if you look around at many big banks, in truth there isn't that much difference between many of them in this regard. So, the difference ends up being in execution — you've got to bake culture considerations into your ways of operating. I don't mean it only from a systems perspective, but from a people perspective. How do you help your people to know what's expected of them, what's rewarded and what's valued within the organization?

One of the things that we've had to do as an industry, and certainly at NAB, is change our goals and rewards systems. So right from the top, from the group CEO and from the executive team that I'm a part of, we have taken a balanced scorecard approach. That's something that many businesses have had for many years. But what you have to do is to genuinely bring it to life. In my experience, if I go back even ten years, we had a balanced scorecard but, at the end of the day, when it came to talking about performance, it was the financial performance that took up most of the conversation. Today that's no longer the case.

The first thing we talk about now is what's happening from a customer perspective. What's the net promoter score? What's the level of customer satisfaction? And you have to go beyond that to good customer outcomes, because customer satisfaction isn't sufficient. You have to find a way of measuring outcomes for customers because sometimes customers in a complex business can be quite happy with what they have and not realize that what they have is not providing them with the right outcomes.

How do you help your people to know what's expected of them, what's rewarded and what's valued within the organization?

Back in the UK, the FCA has been particularly proactive and progressive in this regard — in helping the industry to recognize that it's not sufficient for the customer to be satisfied. We need to make sure that they have an appropriate outcome.

Q: Late last year, ANZ CEO Shayne Elliot criticized the industry for "outsourcing" problems to regulators. The culture and conduct risk agenda was initiated by regulators, and many firms were left asking "what do you want us to do?" Does this remain the case, or has the industry taken adequate ownership of this matter?

A: I think that individual banks across the industry have taken ownership of this. I'm not convinced we're working together as effectively as we might, as an industry. I know for competitive reasons that can often be difficult. And we need to be appropriately careful in terms of how we work together as an industry. But I think there are a series of things we can do.

One would be the professionalization topic we just discussed. How do we work collectively to make sure that appropriate professional standards are in place? That is something we need to approach through an industry-wide lens.

But in terms of an individual firm's culture, that does need to be something that's driven at an individual bank level. We need to take up the challenge and get out ahead of where the regulators might be — or anyone else for that matter. It is primarily the responsibility of the industry to sort itself out, to work out how to genuinely build a culture that is nurturing, positive and focused on great outcomes for customers.

Q: Who is — or should be — accountable for leading culture causes within financial institutions? It often seems that fingers are pointed in every which direction. Some see this as an HR matter. Some point to risk and compliance staff, or to the legal department when litigation or regulatory action is involved. I appreciate that we want to see risk management capabilities embedded across a firm. But as behavioral science instructs us, when everyone is responsible, no one is. What are your thoughts here?

A: I would say the tone is set from the top and it is the Board and the senior executive team who need to lead this. A culture is lived through every member of an organization, every individual has a responsibility but, ultimately, it's the Board and the executive team who are accountable for the culture of an organization, for its vision and values. And the Board needs to make sure that the executive team are rewarded, and their performance assessed, based on how our behavior as a firm is consistent with the vision, values, and goals of the organization. They need to ensure that the views of customers and colleagues, as well as the community in which we operate, are firmly part of the assessment and reward process.

This is the view of the NAB Board, and you can see that. You can see that publicly, by looking at the reports, such as the annual report where we disclose how the executive team and our colleagues are rewarded. You can see the focus that we have on customers and the focus that we have on colleagues. That's all laid out in a lot of detail and then lived internally through NAB's Board Customer Committee and Executive Customer Committees.

> The board needs to make sure that the executive team are rewarded, and their performance assessed, based on how our behavior as a firm is consistent with the vision, values and goals of the organization.

But, in terms of then how this is executed, the operational teams and first line colleagues and our people leaders, we all have a responsibility to get this right. I think this idea is one that enjoys broad support across the industry. But I think the extent to which it's genuinely being executed effectively across the entire fabric of the industry, there I think we probably have still some way to go.

NAB'S GROUP PRODUCT IMPROVEMENT AND GOVERNANCE TEAM

An enterprise function that reports directly into NAB's Chief Operating Officer, Les Matheson. The team's core purpose is to continuously improve customer value by improving how NAB designs, manages, distributes and governs its products and services. Key capabilities delivered include:

1. The development of an enterprise product Management Framework (products@nab) which sets the standards across the end-to-end product lifecycle
2. A governance process for the introduction of new products, changes to existing, annual product reviews and the removal of products from sale
3. Monitoring customer value NAB's products provide through data-driven insights
4. Delivering product related regulatory change across the enterprise

The team have led several significant change projects that have delivered significant benefits for customers. In 2019, in response to the findings of NAB's APRA Self-Assessment and the Royal Commission into the Banking sector, a program of work was initiated to re-define and embed how NAB assess and provide valued outcomes to customers through its products and services.

Q: You've been in your current role for about a year and a half. Can I ask what you'd point to as your proudest accomplishment thus far? What have you done that's really moved the needle in a way that you're happy about, with reference to all you've shared here?

A: That's a great question. One of the areas I'm directly responsible for is a new area called Product Improvement and Governance. One of the responsibilities of that team is to review and make sure that we have good customer outcomes. Now, I don't know but I suspect that there are very few organizations that have that function and the requisite capability. Every day we've got a team of analysts working to better understand what our customers are really doing, that they're getting the right things from our products, the right outcomes. Having the data and making sure that we have the appropriate governance in place to ensure that good customer outcomes are happening, is probably something that is not happening across most of the industry. That's an area of work I'm particularly proud to be part of.

The team have led several significant change projects that have delivered significant benefits for customers. In 2019, in response to the findings of NAB's APRA Self-Assessment and the Royal Commission into the Banking sector, a program of work was initiated to re-define and embed how NAB assess and provide valued outcomes to customers through its products and services.

Les Matheson *was appointed Group Chief Operating Officer at the National Australia Bank Limited in January 2021. He has previously held several executive roles within the Royal Bank of Scotland (RBS), most recently as CEO of Personal and Business Banking (2014 — 2020), where he also assumed responsibility for Ulster Bank in Ireland from 2015.*

An Interview with Susan Axelrod

Susan Axelrod

Q: During your time there, FINRA was well out front in emphasizing the importance of firm culture in a supervisory context. Can you say a bit about that? How did that come about? What were some of the key lessons you took away from that experience?

A: Candidly, I think one of the organizations that helped ignite a lot of conversation around culture was the NY Federal Reserve Bank (FRB), under Bill Dudley. The culture conference that the NY FRB started included senior representatives from large financial institutions and members of their Boards, all being invited to speak and to lead on the topic of culture and how it effects conduct at a firm. From a broker-dealer perspective, at FINRA, we started to examine the ties between culture and conduct, and we thought that sitting down with a number of large firms to ignite the conversation was consistent with FINRA's mission.

Since there are reporting requirements for certain disciplinary actions and terminations, FINRA can monitor, on an industry wide basis, the level of conduct that was violative of firm policy, SRO rules and federal securities laws. Having that unique lens, we determined that understanding the tone, perspective and sense of accountability around the issue of culture would help us to identify conduct-related weaknesses which could potentially have an impact on the investing public.

We took a deeper dive into how firms thought about setting the tone for the conduct that would be tolerated, how that is messaged to employees, and then dove deeper into whether firms recognized that corporate culture, in turn, sets the tone for what acceptable level of conduct is within an institution.

The discussion with executive leadership at the firms sparked interesting realizations and helped us understand how the firms were thinking about that tie-in between conduct and culture. Some were quite sophisticated in their thinking around the topic, and clearly our inquiry was not the first time they had thought about this. Others were less advanced. Another interesting part of the dialogue was, when two firms merged, which culture dominated in the combined entity and what drove that result?

Q: During your time in regulation, did you form any specific views as to why misconduct seems so persistent in the industry? If so, now that you're addressing these very issues from the other side of the table, have your views changed?

A: My view, for a long time, has been that most professionals in the securities industry work hard to get it right. Broker-dealers are heavily regulated and many roles require obtaining certain licenses, which requires devoting time to studying. People who want to work in the industry have to be trained, take exams, are subject to continuing education requirements, and recognize that their careers and their reputation are on the line every day.

Working in the industry has refined the beliefs I had as a regulator. There are life circumstances that can change for someone which can result in a change of behavior due to stress. People can make a mistake, for instance, and then, by not immediately escalating discussion of the problem and dealing with the consequences, they instead compound and worsen the problem and get stuck in a series of lies. The cover-up can be worse than the underlying issue.

At my firm, having strong oversight and supervision remains a priority, as does a focus on individual conduct. When a problem is identified, working hard to close any gap that potentially allowed that to occur is one of the most important parts of the job.

Focusing on conduct and culture, and holding individuals accountable, can send the message that — regardless of who you are, the revenue you bring in, or the role you play — misconduct can be career-ending, or at least career-limiting. Demonstrating a focus on these issues can also result in a decrease in the amount of money paid in settlements to customers or regulators. Such settlements can have reputational impacts for the firm. And while not readily quantifiable in dollar-terms, there is certainly a financial and reputational impact for recidivist firms.

> Demonstrating a focus on these issues can also result in a decrease in the amount of money paid in settlements with customers or regulators.

Q: Many bank regulators are placing increased emphasis on the application of behavioral science in the context of governance and supervision of behavioral risk. How do you see this playing out going forward?

A: By participating in many discussions over the years related to conduct and culture, when I was a regulator, I was exposed to many international leaders at financial institutions and regulators across the globe. In my experience, there are different variations in the application of these ideas depending upon where you sit in the world and the focus and energy that your local regulator has around this topic.

Traditionally, the focus on conduct was always after-the-fact, when issues had resulted in potential terminations and disciplinary actions, as well as regulatory actions by state, federal and self-regulatory organizations. This can be quite costly. Being more proactive, in a behaviorally predictive manner, can have the benefit of freeing financial institutions to spend their time and energy on higher-risk matters. Resources are not unlimited.

In addition, the after-the-fact approach has not been demonstrably successful in decreasing enforcement actions. Training, coaching and getting ahead of potential trouble, when patterns of misconduct are observable, can provide a financial and reputational boost as such issues are caught, handled, reported and reviewed by the firms themselves, as opposed to receiving requests for information from regulators, hiring outside counsel, and trying to understand the underlying conduct being reviewed.

That being said, while predictive analytics and supervision of behavioral risk may play an important role in certain jurisdictions, it is important to note that not all human behavior can be predicted and that it is important to ensure that any evaluations or algorithms used to try and predict such behavior are free of any inherent bias that could adversely impact the models.

> The after-the fact-approach has not been demonstrably successful in decreasing enforcement actions.

Q: Who “owns” culture and conduct risk issues at most firms, and who should? We often hear that “everyone” is responsible, and that management of these issues needs to be pushed out to the first line. But, of course, when everyone is responsible, no one is. Where does the buck stop?

A: Well, my view is that culture and conduct risk issues should be owned at all levels of management to have the broadest impact on the organization. But the tone at the top is critical, starting with the board and executive leadership and continuing with business line leaders. The first line plays a fundamental role in setting the tone around what is acceptable and what is not. The second and third lines also play an important role in the process, but the buck stops with the first line.

We can't lose sight of the important role that middle management plays in setting the tone for employees.

We can't lose sight of the important role that middle management plays in setting the tone for employees who do not have regular exposure to senior or tenured leaders in the organization. It is impossible to hold C-Suite executives responsible for the conduct of a first-year analyst. It is the influence of those middle managers that will have the most significant organizational impact, establishing what it takes to be promoted. Employees will take their lead and imitate the behavior of those with whom they work most closely: middle managers. What often motivates people is how they will be paid. So, the question that organizations should ask is, "how do culture and conduct issues impact compensation and promotion in the organization?" If there is no impact, that sends a strong message that those things don't matter.

Q: We're seeing a shift in regulatory priorities away from reactive measures in the wake of misconduct event — a "detect and correct" mindset — and movement towards a more proactive stance — a "predict & prevent" standard of care. What are your views in this regard?

A: Human beings are not machines, and their behaviors are not entirely predictable. That being said, looking at prior behavior to predict future behavior has value. But everyone should have a fair shake. Employees can learn and be coached. Not everyone subject to discipline in an organization is a repeat offender.

Proactive oversight, coupled with a way to close the gaps on opportunities or ensure more enhanced oversight, can have its benefits. You always want to prevent misconduct from occurring, particularly where it impacts clients, but models used to do so must be free of bias and recalibrated as new predictive attributes are identified. It is an art and a science, not pure science. If it was clear to predict who would have conduct issues in an organization, they would never get hired in the first place.

Large financial institutions, by their nature, spend significant resources with respect to risk management and compliance. It is hard to measure the effectiveness of these programs unless you have the right metrics. When complaints and settlement amounts increase, everyone asks why this occurred and seeks to identify the root cause. Absent an issue with a particular product or volatile market, those answers may not be clear.

It is hard to measure the effectiveness of these programs unless you have the right metrics.

Identifying the root cause of misconduct across the industry, with a focus on where it is not occurring and why, would be interesting to evaluate. Are the drivers found in the compensation models, in the failure of a firm to recognize and reward the strong culture carriers who set the tone on getting it right? And how can predictive modeling and a focus on behavioral science help to cut down on issues of misconduct in the industry? These are all questions we need to continue to ask.

Q: There is much discussion of environmental, social & governance concerns (ESG) in this year's *Compendium*, with risks stemming from culture and conduct being seen as a critical governance concern. Any related thoughts you'd like to add?

Shifting the conversation to the focus on "G" is important. It is the part that's hardest to quantify and measure, but the part that will ensure that the right decisions are made.

A: I think we are at the beginning of the ESG revolution. It will dictate how generations of investors will invest their money to align with their personal beliefs.

The focus tends to be around environmental and social issues, which ties into what is important to people. Governance is a different type of concept that not every investor will think about in the same way. Effective governance could be evidenced through reporting that is required, from an ESG perspective. But what metrics are used to measure and report on the effectiveness of ESG components in an investment? Regulators will likely play a key role in determining the appropriate way to measure ESG, while investors will potentially make more emotional decisions around whether those metrics meet their own personal standards.

Shifting the conversation to the focus on "G" is important. It is the part that's hardest to quantify and measure, but the part that will ensure that the right decisions are made. It is also the part that currently gets the least scrutiny from the investing public. But, once something goes wrong, it will usually be the first area that gets criticized. Governance always plays an important role in how decisions are made, regardless of the topic.

In my view, ensuring that the right people are participating in the discussion is key. We want to see diversity in thinking and perspectives, and that the governing body is one where challenge and debate is accepted as routine, in order to ensure that a group does not become just a rubber stamp for decisions.

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Ground Breakers

An Interview with Sarah Dahlgren

Sarah Dahlgren

McKinsey & Company

Q: Sarah, the NY Fed has long been out front in emphasizing the importance of firm culture in a supervisory context. You became head of bank supervision there, not long after the 2008 Financial Crisis (2011 through 2015), when the Fed began its culture work. Can you say a bit about that? How did that come about?

A: The events of the 2008 Financial Crisis, together with several scandals that followed, made it clear that more work was needed to address some of the underlying issues that led to these events. We wanted to understand better what the drivers were — and wanted to work with the industry, academics, and others to take a closer look at culture as a potential driver of conduct within financial services. This led to the first of a series of conferences hosted by the Federal Reserve Bank of New York, starting in 2014.

This effort has now grown into the "Governance and Culture Reform" initiative — a multi-pronged approach that incorporates educational and training efforts, direct dialogue with the industry, and sharing of best practices across regulatory agencies, combined with the more public events like conferences, podcasts, etc. It's been great to see the evolution in this effort and the continued contributions to the dialogue on conduct and culture in financial services. ▸PAGE 199

Q: What are some of the key lessons you took away from your time in this policy-oriented role?

A: One of the most important lessons I took away from my time in this role was the importance of ensuring that multiple points of view are brought to bear on an issue. The culture initiative is a great example of where the FRBNY brought together a range of perspectives, including supervisory, regulatory, legal, academic, and industry. These multiple perspectives produced a much richer dialogue, prompted deeper questioning, enabled a more informed challenge of current thinking and solutions, and allowed for wider sharing of best practices and lessons learned.

Q: Work-from-Home (WFH) protocols have challenged us all in the past year, and the line between our work and personal life is more blurred than ever. How does this impact management of conduct risk?

A: As I think about the impact of WFH on managing conduct risk, I look at it through the lens of tools or mechanisms that are important to managing conduct risk — preventive tools, detective tools, and mechanisms to correct misconduct. As you look across these three areas, it's clear that WFH protocols introduced challenges that needed to be addressed quickly, as well as lessons learned for how we need to adapt our approaches to better prepare for the future. A couple of observations:

- Most control environments didn't anticipate that so many people would be working full-time from somewhere other than an office, where simple things like your boss looking over your shoulder, or simply having a lot of people around, served as a deterrent.

- The discipline of some control or oversight mechanisms, like committee processes/structures and core risk management procedures, didn't operate either as designed or as intended; in some cases, requirements were relaxed to accommodate WFH without appropriate compensating measures or controls put in place.

- For those companies that had been operating primarily in an office setting, the opportunities to "norm" with your team evaporated — at least initially. The ways that people learned about company values and culture, often by spending time with others and observing how leaders behave, suddenly changed — and particularly if you were relatively new, you didn't have role models, or lighthouses, to help guide you.

- One of the areas where I think there's an opportunity to advance our toolkit is through more forward-looking tools — those that allow firms to identify hotspots and take action to prevent future misconduct.

- While these efforts don't replace the ongoing need to be able to detect misconduct (though that's after it happens and has potentially already had some level of impact), there are opportunities to get in front and prevent — before the misconduct occurs. Innovations in technology are making it possible, for example, to look through vast amounts of data (structured and unstructured) and identify patterns of behavior that signal something is amiss in certain parts of the organization. Can you imagine getting a report that says that one of your teams is an outlier on a particular dimension? How great would it be to be able to jump on that issue — before something even bigger occurs?

One of the areas where I think there's an opportunity to advance our toolkit is through more forward-looking tools.

Q: The supervisors were also affected by the pandemic and, in most cases, implemented WFH protocols. How did this change the supervisory dynamic and what do you think the implications are for "post-pandemic supervision"?

A: One of the things that has struck me throughout the pandemic is how the supervisory process itself — which had relied, at least in part, on in-person evaluative processes like meetings, interviews, information sessions, demonstrations, "walk-throughs," etc. — abruptly changed as well. It may be too early to say what might have resulted from this change but, given some of the lessons learned from WFH experiences, it would be worth exploring more to understand what parts of the supervisory process worked well in a remote setting and which parts were less effective.

As a start, where firms already had an established relationship with their exam teams, including a regular cadence of interactions, that foundation was critical in ensuring an ongoing productive dialogue, even when those conversations moved to an entirely virtual setting. And many firms had already established secure electronic channels to share confidential information, which allowed for ongoing exchange of information between firms and supervisors. So, I think for most firms, remote engagement with supervisory teams — at all levels within the agencies — largely worked during the pandemic, and the supervisory teams and firms adapted quickly to the virtual model.

As we are moving to "the other side" of the pandemic, though, I think we need to consider moving back to at least some in-person interaction between firms and supervisors. Particularly with the turnover across bank management and within the supervisory staff, many bank managers are meeting their exam teams for the first time (and vice versa). Establishing and maintaining trust, which is foundational in the supervisory context, is very difficult in an entirely virtual environment — and even more so when you've never met the other person live.

Also, there are things that are missed in an entirely virtual environment — like the cues in meetings that you don't pick up in the gallery view, the pre-meeting "get to know you" portion of the engagement, body language that sometimes reveals other things (like, discomfort with the information being conveyed or lack of understanding of the answers provided). These "misses" go both ways in the supervisory relationship and often can be picked up and remedied more quickly in a live setting.

Establishing and maintaining trust, which is foundational in the supervisory context, is very difficult in an entirely virtual environment.

One of the lessons from the 2008 Financial Crisis that I learned during my days at the FRBNY was that we didn't have sufficient engagement between supervisory staff and senior management of firms. I worry that this problem may repeat itself if we don't make a concerted effort to reengage in person. As I've said before, supervisors are supervising firms that are led by people, and having the opportunity to engage in person is an important input into the overall evaluation of a firm's management and governance.

Q: Tells us more about how you are thinking about some other lessons from the pandemic?

A: One way I've teed up some of these conversations is to ask about events that occurred during this period — like the large losses experienced by some firms or the PPP loan fraud perpetrated by some bank employees (some of whom have now been banned from banking) — and whether WFH might have played a role in those events.

We need to consider whether culture was robust or resilient to the changes driven by the pandemic.

Were these events facilitated by — or exacerbated by — the WFH environment in any way? Was access to new and/or less monitored activities a factor? Alternatively, were there other factors, unique to the pandemic environment, that contributed to these events?

And what role did culture within the organization play in these events? We need to consider whether culture was robust or resilient to the changes driven by the pandemic, including the changes in how, where, and when we worked. And how "speaking up" and "say something when you see something" works in a virtual environment. How does challenge, or "speaking up," work when you aren't in person? I'm not sure we have an adequate understanding of such risk management issues as yet.

Q: There appears to be a marked shift in regulatory priorities away from reactive and corrective measures in the wake of misconduct events and towards developing a more proactive and preventative capability. What are your own views in that regard?

A: As I think about what changes are needed to prepare for the next crisis, I look back at our experiences during the 2008 Financial Crisis and the stress testing tools — for both capital and liquidity — that the banking agencies developed and deployed to assess financial resilience. Both aspects of the stress testing activities — the quantitative stress tests themselves, together with the qualitative reviews of risk management capabilities across both capital and liquidity — were essential to rebuilding levels of financial resilience and ensuring that the banking industry was well prepared for the most recent events. How do we take that learning and expand on it to incorporate other types of resilience to increase our preparedness — particularly from what we learned over the past two years.

For instance, one area we should explore is operational resilience. As the pandemic unfolded, global regulators significantly increased their scrutiny of operational resilience — including issuing additional guidance (like the Sound Practices to

Strengthen Operational Resilience, issued by the U.S. banking agencies in October 2020) and conducting reviews of firms' approaches to resilience. Building on this, a next step would be to consider tools, like stress testing, that would allow for a more systematic assessment of operational resilience — and allow us to "test" resilience across the different constituent elements beyond financial resilience — to include areas like operational resilience and organizational resilience.

> A next step would be to consider tools, like stress testing, that would allow for a more systematic assessment of operational resilience.

It's this last piece — organizational resilience — where I see the opportunity to draw the linkage between operational and organizational resilience, and more specifically to conduct and culture — and to consider questions like:

- Is your organization — your workforce/your people — resilient to the next crisis? How will the organization react to the next event — and will your organization be able to ensure that critical operations and activities continue to run as expected?
- Is your culture strong enough to withstand the types of changes that could come in the next type of crisis? What are the critical aspects of your culture that ensure that your organization can adapt — and what are the ways that you can reinforce and build that now?

In the same way that regulators were able to identify weaknesses in financial resilience — both quantitatively and qualitatively — and ensure that financial capacity was reinforced to withstand the stresses over the past couple of years, now would be a good time to focus attention on a similar approach to non-financial risks (e.g., operational, operational resilience, etc.).

Q: Now that we are moving into the next phase of the pandemic and firms are moving back to the office environment, what do you see as the challenges in this? What reflections do you have on the new "hybrid" work environment, and what do you see as the key challenges facing firms as the "return to office" phase is rolled out?

A: Firms are taking different approaches to "return to office" — some requiring employees to return to the office five days a week (back to "pre-pandemic" schedules), while others are offering flexibility — requiring only a certain number of days in the office, or even allowing complete flexibility to work from somewhere other than the office full-time. Many firms cite company "culture" and "working norms" as a rationale for their approaches.

It's hard to say that one or the other is better or worse for a particular firm. Different firms will have different cultures. It's critical to know what culture you have — and want to have — and to design how you work around that. Also, it is important to know your employees and prospective employees and to develop an informed sense of how they work with and react to changes in their day-to-day work environment. Who do we want to recruit, going forward? We need to be deliberate about setting our work environments and about our expectations for how people will work within a firm.

> We need to develop a means of checking on culture as something that is critical to ensuring that we are achieving what we set out to achieve.

Both remote and in office work can be right for a particular firm, but we need to keep tabs on how performance meets intentions. We need to develop a means of checking on culture as something that is critical to ensuring that we are achieving what we set out to achieve. Have the right safeguards been put in place? How do we test for this without waiting for control failures to teach us that we were not adequately prepared? Is the relational set-up the right one? That is, have we created the space needed for people to achieve the "togetherness" that is intended by the co-location environment? Similarly, have we set up a way to ensure that those who work entirely remotely are connected in the way(s) that we want them to be?

I'm personally excited about the transition back to the office — but also about the opportunities not to return to the "pre-pandemic" way of operating. The hybrid environment has provided opportunities to be more inclusive and more flexible in how we operate — which I would like to continue to see. At the same time, though, I do see a real need to continue development of our "hybrid muscles," to ensure that things like our models of apprenticeship and our ways of building corporate culture adjust to the new ways of working.

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GATES foundation

In Focus

An Interview with Kanwaljit Singh

Kanwaljit Singh

Any views expressed in this interview are personal and do not reflect the views of the Bill & Melinda Gates Foundation.

Q: You're a highly specialized technologist, with experience in quantum computing. And now you lead technology investments in the "Financial Services for the Poor" initiative with the Bill & Melinda Gates Foundation. That is perhaps a non-obvious career shift. Would you tell us about that?

A: If I look at my career path, it has always been driven by curiosity. My academic degree is in physical organic chemistry. And I made my first non-obvious career shift in choosing not to work on medicines, but rather to work in technology. I joined Intel, right after I received my PhD, and I really dove deep into physics, mathematics, electronic devices and stuff like that — which had very little to do with my doctoral research!

I had one of those moments of epiphany as I was moving to Netherlands to do quantum computing for Intel. I ended up at the passport office in Seattle, to apply for my US passport, and I had five hours before I could collect it. I thought, "Okay, what are the best free attractions in Seattle?" The top result was the Gates Foundation Discovery Center.

I visited the Discovery Center, and I was just struck by the work of the Foundation. How is it so hard to get a cold vaccine to the remote rural villages in Africa? How is it so hard to purify water in places where there are no purification plants? There's one exhibit there, which has two buckets with weights in them. You're asked to carry those buckets and walk 18 steps. And I did that. And at the end of the exhibit, it showed how much a child had to walk to get water. It was a sobering moment that made me reflect on what should be my purpose in life and endeavors.

I loved the work I was doing at Intel — I would never have quit. Doing quantum computing and exploring the very edge of all that humanity knows about nature and hopes to put to good use. But I suddenly contrasted that with the idea that there are these children who have to struggle just for water. There are children dying for lack of vaccines that are readily available.

Confronted with that big gulf, I felt that I needed to do more, to do something different. And that's when I started looking into jobs at the Foundation. When a position opened up for a technologist, I felt that despite having no background in finance, or development, I did feel comfortable around technology. I thought I could make a dent and, so, I applied. And here we are.

Q: That's powerful. Just by challenging people's preconceptions of things, you can create dramatic change. I wonder if you'd comment on that?

A: Absolutely. I hadn't noticed it early on, but on my way out of the office one day at the Gates Foundation Discovery Center, I spotted their tagline: "Arrive curious. Leave inspired."

And that's exactly what happened for me. I think, putting reality out there in a very visceral way, so you experience it personally, it just changes your mind in ways that no amount of reading, no amount of PowerPoint slides, no amount of video evidence does. You have to feel it, with your own muscles, your own brain. And when it sinks in, it sinks in at a depth that you'd not have experienced before.

Q: What is it that the "Financial Services for the Poor" initiative aims to accomplish? Why is this something that the Gates Foundation chose to champion?

A: Let me try to help build a conceptual bridge between technology, the poor, and financial services.

In the Financial Services for the Poor initiative, I manage a portfolio of technology investments for the team. But why does this team exist? Let's start with a simple number: 1.7 billion people in the world do not have any sort of a financial account.

You might ask why having a financial account is important? Well, for the same reason that you and I have one. We save, we stock our money for a rainy day. We get paid into our account. We pay out of our account. We earn interest on the money we make and hold in that account. We are offered very complex financial products like insurance, stocks, bonds, retirement savings etc.. In fact, I can do quantum physics, but am often perplexed by how finance and regulation come together to present an intractable mess that ends up creating wealth inequalities!

I can do quantum physics, but am often perplexed by how finance and regulation come together to present an intractable mess that ends up creating wealth inequalities!

Poor people need all of those things. They want to save for a future rainy day. They want to, weather consumption shocks. They want to have financial resilience so that, when a child goes sick, they have the money to take care of that child. They want to have money for education. They want to have money for assets. They have all the same needs that I do. But they are disenfranchised from financial systems, which are simply not designed to work for them.

It's very expensive to be poor.

One book that had a big impact on me was *Portfolios of the Poor*, which dug deep into the financial lives of the poor. Where do you borrow money when you're hungry? Where do you borrow money in an emergency, or when somebody's sick? What complex networks of humanity sustain these populations? They are cut off from the formal financial systems — which could offer this kind of help, but are unable to.

So, my portfolio now asks the question, "what will it take for a poor vegetable seller to be able to get a loan, so they don't have to pay 500% daily interest?" That's the reality for most of these populations. If you see a vegetable seller on the road, that person might have taken a loan, which is at a 200, 300% rate of interest, and needs to be repaid at the end of that very same day. How are you expected to save on that? Imagine that scenario in connection with a mortgage. The poor can't afford that.

So, FSP tries to bring financial services to these populations, to give them a chance at leading a more prosperous life. Finance is a very important part of this. Payments are a very important part of this. What does technology have to do with that? Well, what's the first thing you need to do to open an account? You need to prove who you are. But one billion people in the world have no way of proving who they are. They exist "off the grid."

So, as part of my portfolio, BMGF funds an open-source identity platform called MOSIP. If people in low-income countries have a good way of identifying themselves, they can have access to education. They can have access to health. They can have access to rights. They can will have access to finance. Identity is one of those core enablers, which allows you to function as a more productive member of society who can become more prosperous.

These platforms are rapidly transitioning towards digital, so costs can be lowered. Think about the brick-and-mortar world in which banks had a running cost of operations and compliance involved with Know-

Your-Customer (KYC) checks. They have to be able to confirm your identity, because that's required for anti-money laundering and preventing financing of terrorism purposes.

All of this is a cost, and this cost represents a threshold below which it is unprofitable to bank the poor. But going digital changes that. Many in Africa bank using mobile wallets in place of a bank account using mobile money. They're now a part of the digital ecosystem. Digital lowers the cost of serving these populations. It changes the nature of products that can be offered.

Q: Can you tell us a bit about some of the work you've led for the Foundation, about which you're most proud? What are the Big Wins to date? Any key struggles? Or critical learnings?

A: As I walk into my office lobby, it's right there: "All lives have equal value." But we don't see that in the world. So, everything that I do, at the core of all my work, is inspired by that one phrase.

I think we have 40-something strategies at the Foundation dealing with different parts of the human experience. All our efforts are geared towards making that statement as true as we possibly can; whether it is in connection with disease, whether it is about economic opportunity, or human rights. If there's a child dying in Africa from malaria, that child's life just did not experience equal value to a child who's born in the US.

When I was a kid growing up in India, I had never seen a shampoo bottle before. I didn't know something as expensive as shampoo came in big bottles. I only saw those little sachets, sold for the equivalent of about 10 cents. This was how the fast-moving consumer goods companies broke into low-income populations. There had to be innovation in the product that was being offered, tailored for local markets.

Digital technologies allow these mobile money products to serve the poor profitably. That's the power of digital. But the moment you start going digital, you have to worry about the risks. So I have a somewhat of a mixed portfolio of investments. On one hand, I try to make investments that break barriers to allow populations to become more financially resilient — to have a verifiable identity, for example. But then I also have investments in risk mitigation like cyber-security, data privacy. How do we explain data-usage to a population that's a first-time digital population? What does it mean for a rural village when a database gets hacked and misused? Gendered aspects of technology related harms can be quite varied in differing socio-economic environments. I make investments that help address those risk aspects of the digital technologies used in low-income populations.

And then, a third part of my portfolio is looking at how to make technology more accessible. We all talk about artificial intelligence and machine learning algorithms in some abstract sense. But for me, I look at it in very practical terms: what can it do for the poor?

We all talk about artificial intelligence and machine learning algorithms in some abstract sense. But for me, I look at it in very practical terms: what can it do for the poor?

I can speak to an Alexa device, or any of the many other voice-based digital assistants, and I can speak in English and many other mainstream languages. But these digital devices don't speak the languages of the poor. What about Kiswahili? How many people speak Kiswahili? What about Bhojpuri? How many people speak that? Bengali? Now, Bengali is supported today, for the urban populations. But we don't have dialects, accents, and colloquial data from rural villages where it is spoken.

Today, a woman in a village may not be able to engage with any of these assistants, because it has no idea what dialect she's speaking, or what accent she's speaking in, or what language she's speaking. So, making technology more accessible is another thing that I try to focus on as a part of my portfolio.

To sum up, I'm pursuing three big goals:

1. bringing technology closer to the populations we want to serve,

2. promoting the absolute enablers, which can be catalytic for prosperity — and not only finance — identity is one of those core enablers needed for healthcare, civil rights, really for everything, though it is absolutely essential for finance; and

3. helping to manage the risks that come along with all of this.

Now, as to what I'm proudest of, three or four years ago, one of the biggest problems many countries faced in the identity space was vendor lock-in: enrolling the entire population of a country onto a register used to facilitate their lives is a pretty big proposition for a government. And especially when that system is procured from the private sector, there's always a risk of vendor lock-in. This was one of the biggest complaints that we heard from the field: governments were impacted adversely by vendor lock-in.

BMGF funded an open-source digital ID system called MOSIP, Modular Open Source Identity Platform. There is an article in the Economist on that one. Many of these digital efforts come and go. They don't get deployed really effectively. But if we look at where MOSIP is today, it's part of the national ID program of the Philippines, where about 60 million people have already been on-boarded on to the platform. About seven or eight million new financial accounts have been opened for people who never had financial accounts before. Many of them were women, who were totally excluded from the financial system. That is my proudest moment. And, by the way, the Philippines is not alone. So many other countries are opting in. Ethiopia is piloting it. Morocco's deploying it. There are pilots going on in Togo, Guinea, Sri Lanka, and Sierra Leone. So, we're seeing a lot of traction — this is becoming a global movement, where many more people see that software can be used for good. The UN has launched the Digital Public Goods Alliance for things like MOSIP. There are products like Mojaloop in the payments vertical. There's DHIS2 in the health space. This whole idea of critical infrastructure being a public good — especially critical digital infrastructure — is gaining momentum.

Q: Before moving on, I'm curious: have you seen the traditional financial institutions embracing what it is that you're doing? Or do they see it as competitive with their role in the markets?

A: Traditional financial institutions are going to have to move with the times. It's not a question of whether they want to embrace these goals, the question is why would they not want to embrace them? And, quite simply, if they don't then they must recognize that they are going to be anachronistic at some point. I think that's what's driving consolidation among the traditional sector and so-called neo-banks. In FinTech, Fin wants to become Tech and Tech wants to become Fin. We see the finance companies buying the tech companies, or the tech companies buying the finance companies.

> This whole idea of critical infrastructure being a public good — especially critical digital infrastructure — is gaining momentum.

We really need to start doing some system level thinking. The commercial world is organized into verticals: health, finance, education, etc. But life does not move in verticals. Technologists are very good at doing system level thinking and thinking in terms of platforms that go way beyond their initial function to achieve extendibility. I think the development sector also needs to move with the times and start doing some systems level thinking about how we approach problems.

Q: Bob Wardrop, Executive Director of the Cambridge Centre for Alternative Finance, was good enough to share views in this report. ▶PAGE 375 I believe you support the Centre. Can you say a bit about how that ties to the priorities you're pursuing?

A: Between myself and my colleagues at the Foundation, we have a few grants at the Cambridge Center for Alternative Finance.

One of the grants was aimed at the creation of a shared regulatory intelligence platform. We saw that many regulators of the financial sector are curious about cryptocurrencies, about tiered KYC, and all these new things that are happening on the regulatory technology front that many regulators are not very well informed about. Particularly those in developing countries. And there's a problem in that regulators, as a community, tend to be adverse to risk — as they should be. They're responsible for assuring financial stability and soundness as one of their core mandates. So, it is natural for them to be circumspect about new things, and to ask the tough questions. But they weren't getting the answers from trusted sources.

Who do regulators trust? They trust other regulators. Who can help regulators? Other regulators. And then this idea came to me: why not have a stack overflow kind of thing for regulators, where they can come together and exchange questions and learnings, all mediated by a trusted intermediary? The Cambridge Center for Alternative Finance was a perfect entity to play that role. They were already offering courses on FinTech and innovation for a community of some 700 to 800 regulators. Why should regulators rely on one-on-one advice, when the problems they care about, once solved, can be solved for everyone? Or, at least, solutions should be out in the open so as to inspire still more innovative solutions.

Why should regulators rely on one-on-one advice, when the problems they care about, once solved, can be solved for everyone?

That regulatory knowledge exchange platform is what I helped fund at the Cambridge Center.

Q: One thing we see many regulators in the world are struggling with is bringing data-driven and quantitative metrics to the challenge of addressing qualitative non-financial risk issues.

A: Well, I'm glad you brought that up. Because it's not only the regulators. Remember, I came from Intel, where we measured everything. We had a discipline: no data, no decisions; good data, good decisions; bad data, bad decisions. It's as simple as that.

As I joined the development sector and started adding the identity stuff to my portfolio, I heard this thing called "trust" a lot: "we must build trusted systems!" And, for me, the question was, what does that even mean? When will I know that I can trust a system? How will I know? We hadn't defined it in any way or form. People say, "Oh it is secure by design, "or "It's private by design." That's a great aspiration but not practical. If we haven't defined what security and privacy are in this context, then you can't design for them.

When will I know that I can trust a system? How will I know?

So, one of the first things we needed was to have some of the best thinkers and designers of digital systems work on defining what trust means in the context of a digital system. The trustworthy digital infrastructure project, at the Alan Turing Institute, created a trust framework that involves six pillars of security, resilience, privacy, robustness, ethics and reliability. They aimed for every aspect of these issues mapped to a particular pillar in a way that was measurable. They asked, "In a given a system, how am I going to measure security? How am I going to measure resilience? How am I going to measure trustworthiness?"

In other words, they flipped the question. They weren't asking, "Do I trust the system?" They were asking, "What can the system do to prove it is trustworthy?" With this perspective, a trustworthiness framework is persistently a work in progress. We have to dig deeper into the definitions of whatever it is that we mean when using abstract terms that have the potential to have significant impacts on people's lives and society as a whole. ▸PAGE 161

Q: Our annual *Compendium* focuses on culture in the financial sector, how that may contribute to the success or failure of organizations, or create conditions that lead to misconduct. We've seen many examples of this in recent years, across the globe, and it does seem that the poor suffer most from these misconduct scandals. I wonder if you'd care to share your own views in this regard?

A: There seems to be a techno-utopian solutionism that basically says, "here's the most efficient way of doing something," leaving out the whole cultural context.

Local context is very important. What problem are we trying to solve? We need to take a more problem-centric view because, often, I just don't think we have clarity around what problem it is that we are trying to solve. And, so, we come up with these really inefficient solutions.

We need to reconcile the design phase of solutions with a cognizance of culture. Everyone wants to protect their privacy, for instance. But who bears the cost of that? Privacy has a cost. So, we must define privacy within a cultural context that considers things like, who should have the right to define these systems that have such impact on our lives? Where do individual rights stop and where does public benefit begin? We have seen that debate come up in connection with vaccinations. We have seen it in the debate around mask mandates. This line between individual rights and public benefit varies according to what cultural context you are in.

Now, can we measure cultural contexts? I would say there's a way to measure that, but it depends on what problem you're trying to solve and what it is that you're trying to measure. I think that culture, in an abstract sense, probably can't be measured. But culture in the context of a problem that you're trying to solve and the system that you're trying to design, that can very well be measured.

When a bank goes insolvent, the resilience of the poorer population is much, much lower than that of others. When a financial institution goes belly up, those who have savings, assets, or other resources will be able to better weather the shock. "Inclusion" is a word we often talk about, but inclusion is much more than having a bank account. We talked earlier about digital inclusion. But what happens if you don't have a mobile device? Or if you don't know how to use such a device? What happens if the device only works in a language that you don't speak? Around all these exacerbators of risk, it is the poorer populations who bear the brunt of it. Any harms that are propagated by a bank collapse hit these populations harder.

> We need to reconcile the design phase of solutions with a cognizance of culture.

As we see digital technologies proliferate, many populations won't even know when they're being subjected to fraud. They're not aware of the databases that hold their information. They're not aware of any hacks that have happened. They're not aware of how much personal information is being leaked. They're not aware of any of that. But yet, they're subjected to all the harms that follow from those things.

I look at poverty as an amplifier of bad things. Any harm you may suffer is going to be much worse if you're poor. Combatting that is the best battle I can think of to advance meaningful inclusion.

Q: A growing number of entrepreneurs in the regulatory technology (RegTech) space are working on some of these issues. Perhaps understandably, most aim to work with the largest financial institutions, and in the world's major financial centers. But these challenges exist in every market, including those that are less developed. Has the Foundation supported RegTech initiatives in those markets?

A: Before I joined the development sector and started working for the Gates Foundation, I wasn't even aware that there were different kinds of tech. Tech was tech. Nobody ever designed a laptop have to do only PowerPoint, right? Now we have all these divisions — RegTech, SupTech — and then we spend time trying to figure out whether something is a RegTech thing, a SupTech thing, a FinTech thing. What if it's all three? What if it's two of the three? And so, I think all these tech divisions, they're like a magician's sleight of hand, focusing us on the wrong thing.

> Technology is changing the ways that the world works — whether in regulation, in supervision, in finance.

What we should be paying attention to is that technology is changing the ways that the world works — whether in regulation, in supervision, in finance. And, as those changes happen, our existing institutions will have two options: continue down their path of least resistance and do whatever it is that they've been doing for the last century or longer.

There's an interesting graph I often refer to, plotting the time it takes between the creation of a new technology and when it becomes scaled. That timeframe used to be about 50 years, back in the day. Color TV was invented and, by the time I got it in my home, it was already 20 years in the market. The timeframes have shrunk, but our response to the pace of change has not.

I think about this in terms of coming up with new regulations. One simple question I ask is, how long does it take to make a new law? Years. And what's the probability that any given new technology is going to remain unchanged over, say, five years? Pretty low. It's likely going to be obsolete in or at least significantly different by five years. It's going to be replaced by something new and fancier. In the context of RegTech, SupTech, FinTech, what we are dealing with is a mismatched timescales problem. Technology is operating on a time scale that is way faster than our ability to respond to it.

For me, two guiding words that I always look at in understanding any intervention are incentives and intentions. The regulators intentions aim towards financial stability and soundness, customer protection, healthy markets. Those intentions are laid out by the law. But if I look at a tech company, their incentives may be profitability, growth, customer acquisition, etc. But they won't realize any of that unless they work well with the regulator. And we are coming up with new institutional structures to support that, like sandboxes. This is a first phase in a necessary evolution. ▸PAGE 317

A regulator understands the incentives and intentions of another regulator much better than I, or you, could. So why aren't they doing more to learn from one another? We have to figure out a way to empower the regulators to be able to do this. And we can't expect regulators to become technologists. That's probably not going to work. Nor can we expect the technologists to become regulators. We need to work together.

Q: Thanks so much for giving us your time for this. Any closing thoughts you'd like to share?

A: I'm happy to spend time thinking about these issues, because I think this is a very important argument to focus as part of your *Compendium*. Usually, these things are written in isolation and talked about with unhelpful fragmentation. I've read your other reports, and the different arguments that come from different stakeholders is an important part of getting the story right as to which way is the world moving.

What I've seen from many financial institutions is reactivity. They're reacting to the challenger banks. They are reacting to FinTech. And one of the reasons they're in this predicament is that their guiding principles are based on profitability rather than inclusivity. I'm not arguing against making money, but you can make the same amount of money in two ways: you can charge more per customer or you can just have more customers. I think changing the paradigm of the day is trying to work in a way that's more consumer-centric. There's a difference in mindset that distinguishes Fin from Tech. If I had to lay out one call to action, it would be to embrace this mindset of inclusion.

Dr. Kanwaljit Singh *is a Senior Program Officer at the Bill & Melinda Gates Foundation. He leads the "Financial Services for the Poor" team's efforts in developing a portfolio of investments in the areas of digital identity, cybersecurity risk mitigation in digital financial services and applications of emerging technologies to accelerate financial inclusion.*

Ground Breakers

An Interview with Charles Li

Charles Li

Q: Our 2021 *Compendium* featured much discussion of social capital — often defined as the networks of relationships that foster social cohesion and collaboration. Is this what Xi Jinping has been advocating for in China under the banner of 'Common Prosperity?'

A: The fundamental logic behind Mr. Xi's pronouncements on Common Prosperity is clear and there is broad support for them. What is not clear is how the government agencies charged with the related tasks are planning to execute them. There is a tendency in China: as senior-level policy priorities shift by an inch, the central and provincial governments may move things by a foot. And then, when it comes to the local government, that may go into a few yards. When that happens quickly, it can cause shocks to the system. Excesses may then require corrective or mediating actions.

Some argue that this may be the natural outcome of China's current model of governance particularly at the provincial and local levels, where responsibility sits upstairs while accountability sits downstairs. What we see on the ground may not necessarily reflect what policy has intended to achieve. In recent months, we've seen this play out in the form of aggressive corrections in the property sector and the internet sector, among others. This has caused some anxiety particularly in the markets.

The goal of Common Prosperity was part of China's 14th Five-year Plan, which suggests a new development paradigm. But to keep things in perspective, this rebalancing is not just about what's to happen in the next few years. Rather, it is to establish a vision for the next 100 years, so it may extend well beyond the leadership today.

In many ways, the Chinese system is much faster at creating rapid prosperity than the prosperity that has been accumulated in Western economies. That said, it is probably unfairly distributed. But, by the same token, China can move a lot more quickly than others to address the unintended excesses of 'selective prosperity' and we are seeing that play out now, whether in the internet sector, the banking sector, broader economic sectors such as real estate and online education, among others.

Q: So, is this economic rebalancing act just Mao re-heated, as some critics suggest? Or is there a more nuanced view that may be poorly understood in the West?

A: Well, to illustrate what I was just saying, consider the internet space. People see the big platform companies receiving the lion's share of the benefits that flowed either from past policy initiatives or vacuums of government regulation given the previous poor developments. As the government now wades in to correct imbalances, some people may see this as an attack on the private sector, on innovation, etc. But others see this as a necessary rebalancing to address the unintended excesses.

At the same time, keep in mind, China has to prioritize achieving advantage amidst a "technology war" with the US. The Chinese state-owned enterprises won't be able to achieve that. They can succeed in nuclear power and many of the things that require a large concentration of resources without ever having to consider cost or economic viability. But when it comes to consumer products and technologies that ultimately advance our standards of living more directly, you need to rely on the private sector. The corrective measures to combat excess are making this other priority more challenging — so it's harder now for those tech firms to achieve some common aspirations in China.

China is often very binary. The big tech players have absolutely improved and elevated efficiency in China to an entirely new level, creating and releasing levels of value to society that have never been seen before. But there's no 'natural predator' in the market to resist or to provide checks and balances in connection with the revolutionary changes that the internet giants have brought about in Chinese life. As a result, they're everywhere and everything.

> there's no 'natural predator' in the market to resist or to provide "checks and balances" in connection with the revolutionary changes that the internet giants have brought about in Chinese life.

The government has been reasonably happy to see the big tech players succeed to date. But this has allowed them to monopolize the '[surplus value](#)' that has been created by industrialization, to borrow from Marx. There are justifiable fears that the tech giants could squeeze the last dollar from laborers, from white collar employees like technologists, and even from management. And from competitors, because unless you are number one or two there's very little chance for you to succeed. This has allowed for many distortions to what otherwise would be 'taxable' market activities.

Common Prosperity should be viewed in this light. It's not about destroying China's successful innovation model. It is about restoring a proper and rightful allocation of that surplus value back to the laborers, the technologists a bit, to the management a bit, maybe back to the financial system a bit, and clearly back to the government.

Q: The way you just articulated that is not a million miles away from a debate that's been taking place in the West in the last few years, around shareholder capitalism versus stakeholder capitalism. There is a rebalancing happening in that connection as well — and not just in terms of where value should accrue, but also in terms of who should be responsible for 'negative externalities.' Your thoughts?

A: Because of its model of governance, the Chinese government is somewhat less subject to cyclical electoral popular pressures than what we experience in the West. But the Chinese government is also subject to popular pressures, and sometimes probably much stronger popular pressures, although the West has a harder time to tell how and from where. The government is aiming at a greater common sharing of the prosperity that has been created.

Obviously, we've seen some negatives and some extremes that have occurred. The media may have naturally been more focused on the 'chilling of innovation' aspect here. What they don't seem to cover as well is how much new innovation is happening in China as a result of the playing field being levelled a bit by all of these policy shifts.

There are a lot of government philosophies and regimes out there in the world. As we all know, some more autocratic systems, whether they face this kind of popular pressure or not, they don't do anything about it. To its credit, China is trying to do something about it.

Q: You've launched a new business, Micro Connect, which you've described as "a platform for distributing prosperity through transparency and trust." Can you say a bit about this, and how technology plays a central role?

A: When we look at today's China — massively digitalized, completely cashless — and then look at the financial system, it is not dissimilar from Wall Street in that most financial firms are still supporting the bigger enterprises. We've done a poor job in the last decades when it comes to helping the 'little guys' through the banking system — defined here literally as mom-and-pop shops.

We're trying to do something at Micro Connect to help smaller enterprises gain access to global capital. Instead of trying to pick stocks that we think will rise in value, we're trying to pick stores — small shops that promise to grow into businesses with steady revenues. Is it possible to do that successfully at scale? That's the core challenge we took upon ourselves in this venture.

The financial system essentially connects strangers on the capital side with strangers who need to use that capital. If you boil everything down, this requires two things: one, information integrity; and two, investment execution, meaning that you have to deliver results — raising capital and delivering returns on that.

For the needed information, we rely on entire generations of auditors and accountants, lawyers, broker-dealers, research analysts, asset managers, and other professional services. All are trying to come up with enough information to permit investors to make good decisions regarding capital allocation.

And then you have parties on the execution side of things: clearinghouses, custodian banks, etc. Delivering execution once the investment decision is made is extraordinarily expensive and, across entire markets, it involves hundreds of thousands, millions of professionals on the global scale. Anybody who wants access to that financial market has to be able to afford that cost.

That limits us to a relatively small number of large businesses. Hong Kong has only 2000 listed companies. China has only 5,000 and, even after 200 years, the US has only about 6,000 listed companies. So, between Tokyo, London, and every major market put together, we're talking about maybe tens of thousands of companies that have traveled the long distance to come to the market.

But there are tens of millions of little guys, who form the foundation of our economy, and unless they're organized by franchisors, like McDonald's and many others, those little shops are pretty much left to using their own savings and resources to support their businesses. The question we are asking is whether there is a better way in China today? And we believe we have found a way.

At the heart of our model is a means of solving the issue of information integrity and execution delivery, and a stripping out of much of the related costs.

At the heart of our model is a means of solving the issue of information integrity and execution delivery, and a stripping out of much of the related costs. For that we need a scalable equity-like product that distributes revenue share entitlements. And we need a mechanism for collecting cash reliably from that revenue flow. Through what we call Connect Partners, our gradual exit from our investments starts from day-one, when we start sharing the revenue from the small businesses. And this positions us to gather insights about each little shop. How is it doing today? Why is it doing better (or worse) than expected? That data alone is valuable and helps us to achieve real time financial risk management. And anybody can see it — it's all transparent.

Q: In all the major financial centers we've seen an explosion of financial technology (fintech), much of which aims to disintermediate or otherwise disrupt traditional banking. What do you see in China and Hong Kong?

A: In many ways, the Chinese financial system is completely backed by a sovereign guarantee. The government underwrites the banks and so the funding of the economy. The government is looking to say that the banking sector is as solid as a rock — there's never going to be a run on the bank. That creates some sense of self-righteousness and entitlement, which has played out in different ways over the last few decades.

Because many enjoy access to cheap capital, without having to confront market forces, some have been able to do extremely well. But, to gain that access, it's important to work closely with bankers and with government officials who have influence over the banks. That creates a lot of room for corruption that the government has to clean up. And because capital controls have meant that the Chinese people are largely restricted from putting money to work outside of China, they have very little sympathy for the system when they perceive it to be feeding parasites. The government is held to account in this regard, and you can see that in all the anti-corruption initiatives launched in the last couple of decades.

because capital controls have meant that the Chinese people are largely restricted from putting money to work outside of China, they have very little sympathy for the system when they perceive it to be feeding parasites.

So, essentially, the liability side of the Chinese banking system is rock solid, but the asset side historically has been very problematic. The private sector has worked to fill that big hole, and that's fed into the growth of China's fintech space. The big tech players have argued that they can operate better than the traditional banks, in terms of a more efficient mobilization of capital. This seemed like a good idea to those in the government, as they did not have to invest in some new national payment system or the like. The big tech players sorted it out and proved to be better than the banks.

Just look at the meteoric growth of the payment systems of the Big Tech in China. They should be credited with having successfully opened up the 'veins' of China's grassroot economy. In many ways, they have become critical to achieving Common Prosperity and to managing systemic risk in the Chinese economy. However, when they begin to immerse themselves into the financing side, leveraging their huge customer and data base, the government has become increasingly alarmed that they could cause a huge rise in 'moral hazard.' When they are able to create massive lending and reap huge interest spreads, without any meaningful constraints on their capital adequacy, liquidity controls and reserves, that's not something the government wants to see.

This is one of the reasons for the government's recent crackdown on Big Tech. The government today essentially seems to be saying, "We have the best banking system in the world. The liability side is solid as a rock because of a sovereign guarantee. And now, thanks to you Big Tech guys, we've got a great financial highway system. You can charge tolls on the traffic that access the highways but you shouldnt be able to make money on the value of the throughputs on the highway." In other words, without proper capital and liquidity constrains guarding against moral hazards, Big Tech shouldn't be allowed to engage in banking activities that leverage the financial highways they have helped build. So, you could argue China today finally has the best of both worlds — on the liability side being rock solid and on the asset distribution side being super-efficient.

Q: Among bank regulators globally, the HKMA has been at the fore, in promoting broader appreciation for and adoption of regtech, recently launching an AML RegTech Lab, for instance — a first among global peers. But what does an "AI Arms Race" between the US and China imply for Hong Kong as a global center for regtech innovation?

A: Hong Kong is such a small place, with only 7 million people across a thousand square kilometers. We don't really produce anything so our financial system, our English law tradition and all of that, that's really what's most important. But we're in a transitory period where people are torn between prioritizing the Chinese model or the US model. We need to find the right spot to fit into some new balance. In that context, I think Hong Kong may be losing some of its past relevance.

But I'm very optimistic about Hong Kong. The US and China are like a bitter old couple: they can't live with or without each other. But they have to co-exist and Hong Kong will continue to play the role for both, to deal with each of them more productively. Hong Kong's leadership needs to understand what is needed by both giants and take confidence from our unique role being in the middle. Hong Kong is part of China and there should never be any doubt about that. However, Hong Kong needs to be relevant to the world and remain highly international in order for it to be useful to China. There's a fine balance here.

Hong Kong needs to be relevant to the world and remain highly international in order for it to be useful to China.

In Hong Kong, we are now in kind of a no-man's-land in terms of regulation. In many ways, we're a follower of international standards, but we don't have the power to make big decisions the way we once did. The regulators in Hong Kong are increasingly more attuned to what's going on in Mainland China. I wouldn't say that bank regulators in Hong Kong are necessarily farther out in front of things than their Mainland counterparts. Maybe that was true 20-years ago, but not today. Back then, you had Mainland regulators coming to Hong Kong to learn. I think now it's the other way around, although it has not been apparent to many in Hong Kong.

As for AI, it means so many different things in different people's minds. But AI plays a part in so many startups and companies that say, "We use AI" is almost like saying, "We use the internet." And that's true both in China and the US. These two economies are so intertwined that it's hard to imagine that we would have a full separation of the two AI markets.

It seems to me that, in the US, AI is much more advanced in theoretical applications. It's about autonomous driving, or automated robotic manufacturing, or scientific discoveries of new materials. Chinese AI endeavors aim towards more immediately practical uses. This is simply because we have more business scenarios within which we can use AI the right way, because our economy and our payment systems are so deep and wide, and so fully digitalized. And our consumers are so digitally hooked that we have a much greater volume of underlying mass data to work with. So, you could argue that investment capital will find Chinese AI much more interesting, because you're able to really see how AI is transforming people's lives and economic activities so quickly.

But whatever achievements China has in AI will quickly travel and be used somewhere else. And any major breakthroughs achieved in the US will find their way to China, as it is just such a huge market. So, where the politicians are bickering, the scientists and the businessmen are still just working away and moving ahead.

Q: As this report details, financial sector regulators view culture and conduct risk as a central corporate governance concern. Last July, the HKEX adopted changes to its listing rules, disciplinary powers, and sanctions regime, identifying enforcement priorities that include responsibility, controls and culture. What drove this policy shift and what should we expect to see going forward?

A: When it comes to conduct risk and regulatory compliance, you have China on the one hand and the US on the other, with Hong Kong sort of in the middle.

In China the regulators have big guns — and they use those big guns very aggressively whenever they use them — but sometimes they don't use them consistently. Sometimes people seek to pay rent to those in power with the big guns. "Those big guns are going to fire randomly, and there's not a whole lot I can do to predict it. I can do bad things and never get caught, or play by all the rules and still get fired upon. So, I'm just going to do whatever I'm going to do." It's a reckless disregard. As a result, there is a level of fatalism that does not help foster a healthier culture of compliance.

In the US model, the government doesn't have the same huge guns. But the private sector and capital markets do. It's like the Texas cowboys and civilian militias that sometimes come in and keep people straight. People generally try to play by the rules because they know that they may face market discipline, reputational damage and more importantly, serious private enforcement actions, such as class action law suits.

And now back to Hong Kong. We sort of envy the Chinese big guns, the way the government can act to protect the moms and pops out there. Hong Kong shares that 'paternalistic instinct' a bit. But we don't have the tools to exercise aggressive parental discipline. On the other hand, we don't have the 'private militias with guns'. As a result, we have a different way of looking at the role of the regulators in our market. Perhaps HKEX is trying to play a role that accomplishes what big guns do in China and the cowboys do in the US, and it is not always easy for obvious reasons. The flip side is that the Hong Kong markets are more open and freer than the domestic markets in China; and we have greater Chinese characteristics when it comes to investing in China. In the end, nobody has a perfect total package.

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With thanks to discussants Howard Chao, Principal at Doon Capital and Managing Director at Doon Insights, and Anne Chiou, Director of the Economist Corporate Network Hong Kong at The Economist Intelligence Unit.

GOOD COUNSEL

"I do not think that there is any evidence that man ever existed as a non-social animal."

CHARLES DARWIN

LETTER TO JOHN MORLEY [1871]

Good Counsel

Lessons Learned from the Archegos Default: How Banks Can Better Identify Risk and Prevent Losses

By BRAD KARP

Brad Karp

Paul|Weiss

By all measures, the week of March 22, 2021, began as a hopeful week on Wall Street—the third wave of the COVID-19 pandemic had largely subsided, workers were returning to the office, and financial markets were at all-time highs. By the end of the week, however, the decline of just a few media and technology stocks, precipitating the default of a single hedge fund, led to losses of epic proportions across multiple prime brokers. Ultimately, Wall Street brokers incurred losses of over $10 billion due to the implosion of Archegos Capital Management, which had significant and highly leveraged exposure to only a handful of positions. Since the Archegos default, financial institutions across the globe have sought to evaluate their risk functions and insulate themselves from the type of concentrated credit risk the event had exposed. This article, prepared by the attorneys tasked with reviewing and evaluating the nearly $5.5 billion in losses incurred at Credit Suisse, discusses the key lessons learned from Archegos's downfall, and the steps financial institutions should take to protect themselves from similar credit risk exposure in the future.

> Despite his prior run-ins with the SEC and DOJ, Wall Street continued to do business with Hwang and Archegos.

Background

Archegos was a family office founded in 2013 by Sung Kook "Bill" Hwang. Archegos, formerly "Tiger Asia," was one of a group of hedge funds started by alumni of Tiger Management (so-called "Tiger Cubs"), one of the largest and most successful hedge funds of the 1990s. Following Archegos's defaults—and its ensuing loss of $20 billion in assets under management—Hwang has been characterized as "the greatest trader you'd never heard of." Compared to his cohort on Wall Street, Hwang cut an unusual figure. A reported pillar of his church for years, Hwang founded the Grace & Mercy Foundation, gave millions of dollars to mostly Christian causes, hosting Scripture readings at his foundation offices in Midtown Manhattan, and "invest[ing] according to the word of God and the power of the Holy Spirit."[1]

Hwang's early successes were largely due to an aggressive trading strategy, which attracted regulatory attention in 2012, when Tiger Asia and Hwang settled insider trading allegations with the U.S. Securities and Exchange Commission, and also pled guilty to wire fraud with the U.S. Department of Justice. Tiger Asia then returned its outside capital to investors and rebranded as Archegos, a family office with roughly $500 million in assets. In December 2013, Hwang was ordered to pay a penalty of HK $45 million (approximately USD $5.8 million) to 1,800 local and overseas investors affected by Tiger Asia's insider trading. In October

2014, a Hong Kong tribunal banned Hwang and Archegos from trading securities in Hong Kong for four years.

Despite his prior run-ins with the SEC and DOJ, Wall Street continued to do business with Hwang and Archegos, largely due to the fund's prior and continued success. Hwang's investment strategy focused on making highly-concentrated and highly-levered bets on single-name stocks in the financial services, telecommunications, and technology sectors, predominantly in the form of single-name equity swaps. His aggressive strategy had long appeared to be paying off. In just four years, Archegos's net asset value ("NAV") grew from the initial $500 million in 2012 to $3.9 billion in 2016. By the end of 2020, Archegos's NAV had reached $9.8 billion. By mid-March 2021, it grew to approximately $16 billion, and, just prior to Archegos's defaults, its NAV totaled approximately $20 billion.

A large and growing NAV is generally a very positive sign, but Archegos's overwhelmingly upward trajectory included periods of steep declines; the historic volatility of the portfolio should have underscored the importance of properly margining these positions, as the risk of loss grew commensurate with the growing value of the positions. In Credit Suisse's case, Archegos's positions were severely under-margined, in large part because Archegos's swap portfolio was "statically" margined, as opposed to "dynamically" margined. Dynamic margining means that the initial margin on swaps (the margin cushion taken by brokers to account for the risk of loss upon a counterparty's bankruptcy or failure to pay) changes over time, factoring in various portfolio characteristics, such as volatility, position concentration, or directional bias. By contrast, static margining means that initial margins are calculated based on the notional value of the swap at inception, and remain static in dollar terms over the life of the swap; thus, as the value of positions increases, the initial margin as a percentage of the total position erodes.

As a result, while the value of Archegos's positions increased exponentially in March 2021, the initial margin posted on those positions at Credit Suisse eroded precipitously in parallel. The failure to employ dynamic margining with respect to Archegos's swap portfolio—and the resulting insufficient margin amounts—was the single largest contributor to the ultimate losses.

By the end of the week of March 22, 2021, Archegos had defaulted on margin calls from, among others, Goldman Sachs, Morgan Stanley, Credit Suisse, Nomura, and UBS. The overall losses, of over $10 billion, raised significant questions as to how some of the world's most sophisticated and successful financial institutions incurred such enormous exposures to Archegos's positions, and whether adequate risk-reducing mechanisms were in place to mitigate those losses. Predictably, the answers to these questions are complicated. Many factors contributed to the losses, including Archegos's own actions and the lack of transparency surrounding family offices and their finances. Notably, the Archegos incident has reportedly prompted scrutiny and potential regulatory crackdown from the SEC regarding family offices.

Overall losses, of over $10 billion, raised significant questions as to how some of the world's most sophisticated and successful financial institutions incurred such enormous exposures to Archegos's positions.

The report commissioned by a Special Committee of the Credit Suisse Group Board of Directors provides a roadmap for changes the banking sector can make to improve risk management and culture to prevent similar losses from occurring in the future.

Transparency notwithstanding, there were multiple and mounting red flags that were readily apparent. The failure to properly deal with those red flags led to Credit Suisse's significant losses, as detailed in the report commissioned by a Special Committee of the Credit Suisse Group Board of Directors (the "Report"), which we prepared. The Report was the culmination of a comprehensive, three-month investigation, which included over 80 interviews of current and former Credit Suisse employees and the collection of more than 10 million documents and other data. It serves as a cautionary tale for risk teams everywhere, and, importantly, provides a roadmap for changes the banking sector can make to improve risk management and culture to prevent similar losses from occurring in the future.

It appears firms may have been overly focused on revenue generation, risk personnel failed to keep the business in check.

The Report details lessons learned from the Archegos default, broadly falling under three categories of missteps that are applicable to financial firms across the industry:

1. Failure to Act on Known Information

While much has been said—and continues to be litigated—about the likelihood that Archegos deceived its prime brokers as to the true extent of its positions, there was a fundamental failure to recognize the mounting risk of Archegos's portfolio, which ought to have prompted business and Risk personnel to mitigate those risks to the full extent possible, which they failed to do.

First, on the business side, senior managers across Wall Street had access to information showing that Archegos's risks were mounting, but did not prioritize reducing Archegos risk. Preliminarily, these firms should never have taken on this quantum of risk to Archegos, a family office with a checkered regulatory past that lacked mature internal risk processes and was dominated by a single decision-maker. Given that risk, however, the first line at each institution, at a minimum, should have ensured that its positions were properly margined. Instead, as was the case at Credit Suisse, it appears firms may have been overly focused on revenue generation and not losing Archegos's business to competitors.

Similarly, Risk personnel failed to keep the business in check. At Credit Suisse, for example, risk personnel failed to adequately police Archegos' limit breaches, failed to escalate non-public information from Archegos revealing that it had additional concentrated exposure to the same single-name positions across Wall Street, and failed to monitor the idiosyncratic risk in Archegos's concentrated portfolio with customized analyses, instead relying on a standard suite of scenario analyses that were ill-suited to Archegos's concentrated portfolio.

Perhaps the most important lesson for the banking sector is that a culture of strong risk discipline is crucial to avoiding a similar situation.

Perhaps the most important lesson for the banking sector is that a culture of strong risk discipline is crucial to avoiding a similar situation. This includes underscoring to business employees their responsibilities as the first line of defense, enforcing risk limits, clearly defining the roles of in-business Risk functions (versus Risk functions with access to non-public information), and emphasizing customized risk analysis where a portfolio's risks are non-standard.

2. Failure of Senior Management to Engage, Challenge, Oversee or Escalate

In instilling such a risk culture, senior managers across Wall Street have to be prepared to have difficult conversations, to challenge the business when it takes on outsized risk, and to instruct their first and second lines of defense to take commensurate risk-mitigating actions. Instead, senior managers across Wall Street too often seek to avoid confrontation, adopting a lackadaisical and overly business-friendly attitude.

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For example, in Credit Suisse's case, the bank created a Counterparty Oversight Committee ("CPOC") following a prior hedge fund default, intended to be a forum to evaluate counterparty risk in relation to the revenue generated by the counterparty. The Committee, which gathered together senior managers from the business and Risk, was precisely the place to address Archegos's outsized and growing risk profile. Yet, while Credit Suisse's counterparty risk to Archegos was discussed at two CPOC meetings, one in September 2020 and another in March 2021, senior managers failed to adopt concrete action items and firm deadlines to address the evident risks. For example, after the September CPOC meeting, the only action item for Archegos was for Risk to "notify of any changes with the counterparty and revisit the counterparty at a future meeting," with no fixed timetable. At the March meeting, CPOC concluded that Archegos should be moved to dynamic margining by a target date of April 2021 and, if there was no traction by March 15 on that front, to request an additional $250 million in margin from Archegos.

While more concrete, the action items and timelines determined at the March meeting were woefully inadequate. Indeed, the $250 million figure was a seemingly arbitrary amount, representing less than one-fifth of the approximately $1.27 billion in additional margin that would have been required as a day-one step up under the dynamic margining proposal sent to Archegos just two weeks earlier—which was itself overly accommodative. Moreover, there was no evidence that any senior executive at CPOC escalated any of the alarming information shared with the Committee, including the fact that, in March 2021, Archegos's gross portfolio value had skyrocketed to $21 billion and was highly concentrated, illiquid, and grossly under-margined.

These specific failings at Credit Suisse point to an important lesson for all investment banks. Creating the right risk architecture is not remotely sufficient. It is critical to create a strong risk culture so that the senior managers on risk committees are not only empowered to critically evaluate counterparty risk and escalate matters of concern to executive management or the Board of Directors, but that they do so. The members of such committees must understand that they are expected to impose concrete remediation action items and deadlines commensurate with that risk. They must also understand that they will be held accountable for these decisions.

It is critical to create a strong risk culture so that the senior managers on risk committees are not only empowered to evaluate counterparty risk and escalate matters of concern to management or the Board of Directors, but that they do so.

3. Failure to Adequately Invest in Risk Culture, Experience, Training, Personnel, and Technology

Wall Street firms must also be wary of cutting corners when it comes to sufficiently staffing their Risk teams or investing in the necessary technology to appropriately monitor risk. At Credit Suisse, for example, the various Risk teams had inadequate staffing at all levels to sufficiently manage and address the risks posed by Archegos (and other hedge fund clients). As employees left the in-business Risk function, they were replaced with less experienced personnel, which one witness referred to as the "juniorization" of the team. Junior employees became responsible for an ever-increasing number of clients, and senior employees reported wearing so many hats, receiving so many reports, and being inundated with so much data that it was difficult for them to digest all of the information and discharge their responsibilities effectively.

On the business side, there was an unwillingness to invest in necessary risk technology. For example, there was a relatively inexpensive technology fix that had been proposed to correct for bullet swap margin erosion, but the business never funded it. Additionally, and more importantly, the business failed to prioritize the technological investment necessary to bring dynamic margining capability to swaps held by all clients—an investment that not only would have prevented bullet swap erosion, but also would have allowed add-ons for concentration, bias, and volatility in a client's portfolio.

On the business side, there was an unwillingness to invest in necessary risk management technology.

Moreover, Credit Suisse's risk-related systems and infrastructure could not adequately support the Risk function to quickly and accurately assess risk at any given time. For example, potential exposure ("PE") is a critical measure used to estimate the potential loss related to a counterparty's credit risk. After Credit Suisse's calculation methodology for PE changed, Risk personnel developed concerns about the validity of PE numbers and the underlying methodology, causing employees to generally discount PE limit breaches—including Archegos's persistent breaches—as accurate or meaningful reflections of risk. Further, the various Risk Committees only had access to data that were four to six weeks old. As a consequence, Risk was unaware of, and unable to fully appreciate in real time, the magnitude and pace of the exponential growth in Archegos's positions and the attendant risk, even accounting for the outsized risk that Credit Suisse was sufficiently aware of, as discussed above.

There are multiple hard lessons here for the banking sector. Too often companies rely on outdated software and archaic technology, investment banks included. Sufficient funding for modern risk systems is critical for any bank seeking to improve its risk function. Similarly, in any cost-cutting exercise, control functions which do not clearly contribute to the bottom line are often disproportionately impacted. Yet, as Archegos reveals, it can be catastrophic when investment banks fail to sufficiently invest in experienced and capable risk managers, and ensure that they are not spread too thin so that they can meaningfully fulfill all such roles and responsibilities.

Sufficient funding for modern risk systems is critical for any bank seeking to improve its risk function.

Conclusion

While no one could have fully predicted what was going to happen that pivotal week of March 22, 2021, certain steps could have been taken to mitigate the risk posed by Archegos. As much as possible, financial institutions should equip and empower their risk functions to be able to avoid similar situations in the future, and should instill a strong culture of risk discipline so as to underscore the importance of risk measures firm-wide. While the bottom-line is always an important consideration, the Archegos debacle is a prime example of how prioritizing profit in the short-term—especially at the expense of risk—is a recipe for disaster in the long-term.

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Good Counsel

The Behavioral Code: What Behavioral Science Teaches about Compliance

By ADAM FINE & BENJAMIN VAN ROOIJ

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Our laws, including the intricate rules that govern the financial sector, are mostly made and operated by lawyers. These professionals have deep expertise in what the rules are, how they should be interpreted, and how to apply these rules to different sorts of fact patterns. However, legal training, both in academia and in practice, does little to prepare lawyers to ensure that the rules they design and operate are effective in guiding human behavior and in preventing and reducing misconduct.

There is an implicit assumption in traditional legal thinking, training, and practice about law's impact on human behavior. Lawyers are taught a law-centric view of human behavior. They are trained to believe that law matters, and that the language of legal rules comes to guide human conduct. The content of the law determines the costs of different behavioral options. And this is supposed to sway people's actions. The core implicit belief is that legal incentives drive human behavior.[1]

Empirical studies across the social and behavioral sciences, however, provide new insights in how legal rules come to shape human conduct. These studies allow us to understand why some legal rules have been so successful in reducing damaging behavior (such as seatbelt mandates[2], bans on smoking at work[3], or water pollution control laws[4]), while others have failed to prevent harm (such as speed limits[5], alcohol and drug prohibitions[6], and sexual and gender harassment rules[7]).

This body of empirical work fundamentally questions mainstream legal assumptions about the primacy of law in shaping human behavior. Studies from across legal domains have shown that people have a very poor understanding of the law. Average employees do not know their basic employment contract rights[8], for instance, citizens do not understand basic tenets of criminal law[9], and spouses do not understand family law[10]. Even highly trained professionals suffer from major legal knowledge deficits, as school administrators do not know education law[11], and doctors do not know key aspects of health law and medical liability rules.[12]

Given how large the body of law has become and how complex it is, these findings should be unsurprising. But they force us to question the traditional model of law and human conduct: How can people make an informed choice in response to legal incentives when they do not know or understand the applicable legal rules?

Empirical studies question whether legal incentives play a role in shaping human behavior. They find no conclusive evidence that stricter punishment acts as a deterrent against general criminal behavior.[13] There are similar findings for corporate crime, where the evidence is also frustratingly inconclusive.[14] Studies also find little evidence that the 'soft stick' of personal liability works to deter damaging or illegal behavior.[15]

Empirical studies question whether legal incentives play a role in shaping human behavior.

These are good examples of the behavioral revolution that the field of law is going through right now. They show how human responses to law are not solely based on a well-informed choice in response to legal rules. Other studies show how an admixture of people's own morality[16] and the social context in which they operate shapes their compliance or violation of legal rules.[17] ▶PAGE 147 Intrinsic motivation is a key aspect of enhancing compliance, and legal incentives can fail when they do not align properly with people's own motivations.

Behavioral studies also question the notion that people are free in deciding how to respond to the law. Compliance is not just a matter of motivation, but also of context. Some people are better able to follow the law, for instance because they do know it, or because they have better self-control,[18] or because they have better socio-economic circumstances or opportunities.[19] And some people have better opportunities to break the law, for instance because they have access to valuable targets,[20] or because they have the means and expertise necessary to break the rules.[21]

The field of behavioral jurisprudence is synthesizing these insights about law and behavior. It maps the behavioral code, consisting of the motivational and situational processes that shape human conduct and analyses how this is related to the legal code. And, like behavioral economics did for traditional economics ▶PAGE 355, behavioral jurisprudence assesses and corrects traditional legal thinking about human behavior.

Behavioral jurisprudence enables the training of a next generation of lawyers who can act as bilingual coders, with fluency in both legal and behavioral analysis. They will be able to use empirical knowledge and methods to design and operate rules that keep our society and markets safe from harm, at the lowest possible social and financial cost.

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Good Counsel

Value-Based Self-Regulation

By TOM TYLER

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When responding to a crisis rooted in individual transgressions, regulatory authorities — ranging from police officers to the leaders of major corporations and members of Congress — all tend to draw reflexively upon tools of coercion to compel compliance. This involves emphasizing surveillance and monitoring, aiming to catch bad actors, and the use of models of personal accountability and responsibility to judge and punish transgressors. They do this despite existing empirical evidence from past crises that such efforts, while effective in certain circumstances and with some people, are a generally poor model of regulation. There are, I will suggest, better ways to manage conduct — in particular the actions of employees in work settings.

A focus on surveillance and punishment fits with an emphasis on the goal of compliance, and the belief that people follow rules because they do not want to be sanctioned. This model has been found by researchers to influence behavior effectively, in situations within which it is realistic to monitor and sanction people's actions. For example, if companies can monitor employee computer usage, they can potentially use that capacity to sanction effectively the use of computers for personal tasks. This highlights that a coercive model can work, but also that it depends upon having the capacity to effectively implement a system of surveillance, as well as a system for adjudicating transgressions and sanctioning wrongdoers.

From a psychological perspective, this system has several disadvantages. One is that it fails to capture the powerful influence of social motivations that exists within most populations. Research continually highlights the finding that a majority of people are highly motivated by their own personal values, separate from their concerns about potential gain and loss. Among the general population, somewhere between 5 and 10% of people are found to be oriented toward gains and losses when dealing with law, and most other people balance values and gain/loss judgments when deciding what to do.

> Perhaps the most serious disadvantage of regulation via coercion, from the perspective of most work organizations, is that it does not promote willing engagement and active cooperation.

But a system that is built around sanctions treats everyone as if they were part of the small gain/loss focused group and frames their relationship to rules around sanctions. It does not engage people's values. Further, this sanction framing crowds out or diminishes the degree to which people base their actions upon their values. It facilitates thinking about following or breaking of rules as a cost-benefit calculation, rather than an ethical decision. Because a coercive approach does not build a value-based orientation toward rule-following, surveillance and sanctioning is forever. Organizations that use this model must to create and maintain a credible system of surveillance and sanctioning and utilize it in perpetuity.

Perhaps the most serious disadvantage of regulation via coercion, from the perspective of most work organizations, is that it does not promote willing engagement and active cooperation. Rule-following is only one aspect of what employers want from their workers. They also want their employees to work well, deploying their creativity and energy toward doing what is needed to help their organization succeed. This type of engagement is labelled extra-role behavior, and it reflects identification with one's organization and a personal investment in its success. A coercive approach does not encourage identification or promote this type of work performance. At best, it limits rule breaking.

A better model

Of course, highlighting the limits of a sanction-based model is only relevant if there is an alternative model. Fortunately, there is. Studies make clear that motivating rule-following by engaging employee values is as effective in promoting rule-following behavior than is a more coercive approach — and often more so.

> Highlighting the limits of a sanction-based model is only relevant if there is an alternative model. Fortunately, there is.

This more consensual approach has several advantages. The first is that, to the degree that people are motivated by their own values, they become more self-regulatory. Their behavior is more strongly governed by internal factors and is less responsive to gains and losses in the immediate environment. The second is that the same values that motivate rule-following can also promote desirable workplace identification and engagement. Of course, this depends upon the existence of values that motivate employees to act in desirable ways.

For instance, one important value is morality. Most people have moral/ethical values and studies show that adhering to those values is an important factor in shaping both their everyday and their workplace behavior. Research consistently shows that the desire to do what is morally right is the most powerful motivation for behavior in workplace settings and is more influential than evaluations of the potential gain or loss from rule-breaking.

Of course, that influence is not automatic. When a work organization promotes an ethical climate, it highlights a commitment to moral conduct and facilitates actions based upon judgments about what is right or wrong. Conversely, when an organization promotes a culture of success by any means, employees are more likely to engage in cognitive strategies of moral disengagement or ethical blindness, which separate their actions from their moral values.

Organizations can enhance the role of moral values in shaping employee conduct in a variety of ways. These might generally be described as creating an ethical workplace climate. As noted, research links the existence of such a climate directly to more ethical behavior by employees. In addition, many management schools now include ethical training for their students. This training is designed to point to the relevance of ethical values to problems faced in the work environment

The key factor limiting a moral value approach is that the actions being advocated by a company have to be consistent with an employee's moral values. This might seem straightforward if the issue is fraud or criminal conduct. However, just as colleges struggle with students cheating on their exams, and communities contend with with everyday transgressions that people do not view as immoral (even if they are illegal), there are grey areas in the company context. For example, "stealing" office supplies, using computers for personal reasons, or violating workplace policies to advance individual needs (e.g., fudging timesheets to tend a sick child, or to enjoy a longer vacation period). It is also important for an employee to see that the company itself is committed to acting ethically. All of this being said, there is clear evidence that employees want to work in ethical companies and, when they believe that they do, they respond to ethical appeals when shaping their behavior.

A second important value is legitimacy. People are more likely to follow rules when they believe the entities that create and implement them are entitled to direct their behavior within a particular arena (i.e., they are legitimate). In a work organization, this can involve the legitimacy of company leadership, or of workplace supervisors. It can also involve the legitimacy of any government regulations that seek to shape acceptable behavior. Again, studies show that employees defer to legitimate authorities, following their directives, everyday rules, and policies. This includes both internal rules and external obligations from government.

Legitimacy-based regulation is valuable for several reasons. One is that it is under the control of the relevant authorities. Engaging moral values requires acting in ways consistent with employee's values, something that, as noted, is challenging at times. If authorities are viewed as legitimate, they are effectively authorized by employees to make decisions about what is to be viewed as appropriate conduct, and employees feel an obligation to defer to such authorities. This makes it easier to implement policies that shape conduct.

A second reason for focusing on legitimacy is that a strong empirical literature explains how to create and maintain legitimacy. It is clear from research that the most important factor that employees consider when evaluating legitimacy, of either management or government authorities, is the way they exercise their authority when making and implementing rules and policies. This is referred to by psychologists as procedural justice.

It is repeatedly found that when employees personally deal with an authority, for example a supervisor, and when they evaluate the overall workplace climate of their organization, they are heavily (although not exclusively) concerned about the fairness of procedures. This focus is first important because it drives legitimacy, which shapes decision acceptance and rule following. In addition, procedural justice motivates identification with and engagement in one's job and organization. In other words, this model promotes both the goals of regulation and the objectives of management.

Procedural justice

What do people mean when they talk about a just procedure? In work settings, procedural justice refers to four aspects of the exercise of authority. The first two are related to the fairness of decision-making. The second set of factors are concerned with the fairness of interpersonal treatment.

- First, employees want voice. People want the relevant authority to allow them to express their views or tell their side of the story before determining policies or making decisions.

- Second, employees care about neutrality. People want management to act in a transparent and impartial manner, making decisions based upon facts, not prejudices. Neutrality is also related to whether the authorities explain what their policies are and how they are being applied.

- Third, people want interpersonal respect. The public wants authorities to treat people with courtesy and respect. This includes respect for people's rights as organization members and for their dignity as people. People care about whether the authorities treat them in ways that communicate that they are viewed as good employees, not suspect or marginal members of their community.

- Fourth, they are concerned about whether the authorities are acting out of trustworthy motives. It is important to employees to feel that authorities are motivated to do what is good for the people in their organization. They want to believe authorities are sincere and benevolent, focused on the needs and concerns of their organization, and willing to acknowledge and address employee's concerns.

These four elements — voice, neutrality, respect, and trustworthy motives — are central to public judgments about how fairly authority is being exercised in their organization. As noted, these elements of procedure matter at two levels. First, in dealings with the everyday authorities, i.e. supervisors, with whom employees interact in their work groups. And second, through the overall actions of company management. Even in a large corporation, with many employees and multiple sites, employees are still influenced by whether they think that management cares about employee concerns and listens to employee input.

Even in a large corporation, with many employees and multiple sites, employees are still influenced by whether they think that management cares about employee concerns and listens to employee input.

It is also important to highlight that there are two distinct aspects to procedural evaluations. One involves deciding who will have authority and what the rules will be. For example: How will workplace supervisors be chosen? Who will have input into organizational policies? Will there be opportunity to express employee feedback about what the rules will be? (etc.) Research in the managerial arena has often begun by accepting the existing authority structure and examining the implementation of existing rules by existing authorities. But studies that consider both issues find they have independent and parallel impacts on how employees react to rules and decisions.

Proactive organizational architecture & value-based regulation

If there are better models for regulation than coercion, why do organizations so often default to coercion? And, when the government seeks to regulate businesses, why does it so often try to do so through coercion? There are several possible explanations.

One is a lack of planning. A virtue of coercion is its immediacy. Flood a high crime area with police and crime drops. But while that drop may be immediate, it is also short term and dependent on the presence of those police, something that is often unsustainable. The value-based strategies outlined here do not have a similarly immediate impact. You cannot create an ethical climate or become a legitimate authority overnight. Hence, proactive organizational architecture is the key to using what are here presented as superior strategies. You need to implement a framework that creates and engages a value-based connection among employees — in advance of a crisis or emergency.

A second explanation is the mystique of instrumentalism. Corporate leaders and workgroup supervisors often share the belief that coercion is the most desirable approach to regulation and exaggerate evidence of its effectiveness. It is natural that they might think this because they have had the everyday experience of seeing coercion shape employee behavior effectively, in some circumstances and for some time. It is however less immediately obvious that such a sanction-based framework leads them to conceptualizing regulation as being solely or primarily about compliance. This leads to an implicit buy-in to a system with the advantages (and disadvantages) herein outlined.

To summarize, value-based regulation is often more desirable. It is equally effective in motivating compliance and has added advantages. It lessens the need to use organizational resources to surveille and sanction, with resulting morale costs. It does so because people buy into the organization and its rules more willingly. Further they buy into its goals, which enhances productivity and brings employee enthusiasm and creativity into the workplace.

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CHECK

Good Counsel

Times of Crisis: Arguing for a Public Health Model of Compliance

By TODD HAUGH

Todd Haugh

It is not always easy to see positives in times of crisis. One would be forgiven for failing to do so lately. Over the past two years we have lived through a centenary event, a global pandemic that has killed almost six million worldwide and set the global economy back some $16 trillion. As we emerge from the pandemic's grip, the world now faces an escalating war in Europe, the likes of which we have not seen since the Second World War.

Behavioral science tells us we are hardwired to focus on the negative, making it difficult to see past these catastrophic events. Yet there have been positives. We have done some incredible things amid the pandemic. Neighbors delivered food to those quarantined in their homes, donations poured in to support struggling small business owners, and people have volunteered in droves, making everything from homemade surgical masks to quarantine shelters for the homeless. The same is happening in Ukraine. Neighboring countries have opened their borders for those displaced by fighting, corporations have universally condemned Russian aggression, and average citizens are defending their countryman.

We have also innovated. Tech and manufacturing companies have been particularly impactful. Google selectively disabled its mapping tools to ensure the Russian army could not identify busy areas to shell, and SpaceX deployed its Starlink satellite broadband service to keep Ukrainians online. During the early days of the pandemic, Dyson, best known for making vacuum cleaners, designed and built a new coronavirus-specific ventilator in ten days; General Motors and Ford remade their assembly lines to produce hundreds of thousands of masks per day. The biomedical industry has done the same, creating testing kits able to diagnose Covid in as little as five minutes, not to mention developing life-saving vaccines at an unprecedented speed and scale. All of which demonstrates that moments of crisis can provide opportunities — to reorient, to see intractable problems anew, and to unify around values that promote the collective good.

Moments of crisis can provide opportunities — to reorient, to see intractable problems anew, and to unify around values that promote the collective good.

Compliance Crisis

While it may seem trivial to consider corporate compliance in times of war and disease, this is a field that knows a bit about crisis. Just recently, the head of the Financial Reporting Council, the UK's top audit and accounting regulator, said there is a "post-Covid organisational culture crisis" at UK companies and challenged their compliance and governance groups to do better.[1] PAGE 231 Similar sentiments have been raised with respect to U.S. companies, particularly in the wake of the 2008 financial collapse.

The modern era of compliance, in which we find ourselves, is in many ways a product of repeated crises: approximately once a decade, a highly publicized corporate scandal occurs, there is public outcry, then a broad legislative response, and finally a compliance boom.[2]

Indeed, few would argue that organizational wrongdoing—what compliance is aimed at eliminating—is a persistent and complex problem on the scale of major crises. Current estimates put the aggregate cost of corporate crime somewhere between $800 billion and $1.6 trillion per year, and that does not include human costs.[3] For a point of comparison, the estimated yearly costs to the global economy from the war in Ukraine is $400 billion, again excluding the human toll.[4] And at $1.6 trillion per year, each of those decade long cycles equates to another pandemic-sized drag on the economy.

Despite its long history with crisis, not much seems to have changed in compliance. The traditional response to corporate scandals has been for legislatures to criminalize more conduct and ratchet up penalties, with compliance departments following suit, yet this has not resulted in measurably less wrongdoing. At the same time, owing to changing political winds, we find ourselves in an era of historically low individual and corporate enforcement, but with severe corporate penalties at the disposal of regulators who now signal heightened enforcement priorities.

Despite its long history with crisis, not much seems to have changed in compliance.

Companies are therefore under increasing pressure to self-police their employees through compliance programs. Unfortunately, for a host of reasons, such efforts seem to be faltering. And as compliance costs continue to rise but wrongdoing remains, the entire endeavor is susceptible to attack from theoretical and practical quarters.[5] Some have even questioned whether compliance programs are a "million dollar waste of time."[6] A crisis indeed.

This state of affairs suggests a new approach is warranted. Instead of following the traditional approach to compliance, that of legalistic policies rendering compliance little more than the promulgation of and training on legal rules, corporate leaders should draw from the best lessons of public health. With its attention to data-driven risk mitigation and behaviorally cognizant processes, a public health model can more effectively foster ethical behavior in companies. Put simply, we can use lessons learned from current crises, where public health has provided important insights and innovations, to address those occurring in the corporate realm—an opportunity borne of upheaval.

Public Health Model

So what would a public health model of compliance entail? Interestingly, it begins not with health, but with behavior. Although we often think of public health in terms of medical care, it is as much about changing health behaviors as it is about the practice of medicine. There is a reason your doctor asks about exercise and smoking, as well as gun ownership, at your yearly check-up—all these behaviors significantly impact health risks.[7] This is the first lesson that public health can teach compliance: focus on behavior, because that is what matters.

In the context of organizational wrongdoing, this translates to employing the critical insights of behavioral ethics research. Behavioral ethics, with its roots in behavioral economics and moral psychology, is aimed at understanding how and why people make ethical and unethical decisions, and how they judge the ethical decisions of others. What numerous behavioral ethics studies have found is that there are "systematic and predictable ways" in which individuals make moral decisions, which are often "at odds with . . . our intuitive expectations and the goals of the broader society."[8] Put another way, behavioral ethics research provides a new understanding of why people act unethically, even illegally, and how we may be misperceiving their motivations for doing so. As one leading scholar puts it, behavioral ethics "analyzes how and why people are often unaware of their level of ethicality; it also uncovers the true motivations underlying their decisions."[9]

Included in these findings is a recognition that unethical and illegal behavior is influenced by a number of situational factors. Although most corporate crime and compliance models are predicated on offenders rationally weighing the costs and benefits of their wrongdoing, this is far from accurate. In fact, dozens of seemingly inconsequential inputs—everything from the time of day, to the posters on the wall, to the subtle actions of friends or colleagues—can greatly influence the ethicality of others. That means the abatement of corporate wrongdoing hinges on much more than applying legal rules to "bad actor" employees. In order to make real improvements in corporate compliance outcomes, policymakers and corporate leaders must take seriously the "skill [of] predicting human behavior."[10] If corporate leaders took even these broad insights to heart and reoriented their compliance programs accordingly, we would see appreciable gains in day-to-day compliance outcomes. Gains in positive culture would follow. ▶PAGE 143

> Numerous behavioral ethics studies have found is that there are "systematic and predictable ways" in which individuals make moral decisions

To be sure, some companies are beginning to use behavioral insights with the aim of "minimize[ing] the corruption of good people."[11] For example, one approach companies have adopted comes from the Giving Voice to Values curriculum, which focuses on creating scripts and implementation plans that business people can use when responding to requests by superiors to commit unethical acts;[12] another is the three-step REVISE framework that reminds employees to not justify their dishonesty by using cues that increase moral saliency, creates visibility for ethical decisions, and fosters self-engagement to reduce the gap between abstract notions of moral self-image and actual behavior.[13] A third approach is known as "behavioral ethics nudging."[14] This is when small changes are made to an employee's choice environment to influence their ethical decision making and behavior. Once the taxonomy of behavioral ethics nudges is understood, companies can develop their own firm-specific nudges targeted to their unique ethical risks. I have conducted these "nudge workshops" in large companies across the financial and healthcare sectors, providing a new behavioral lens through which corporate leaders can view compliance.

But even more comprehensive benefits to compliance can be achieved by considering the second lesson that public health teaches: behavioral change requires evidence-based practices. Good public health does not guess at what the causes of disease are; instead, it rigorously tests assumptions, constantly updating and developing new interventions based on aggregated data.[15]

Unfortunately, compliance has not yet fully embraced this scientific mindset, often settling for anecdotal notions of what works to lesson organizational wrongdoing. But this does not have to be the case. Compliance can adopt evidence-based practices being employed to fight the spread of disease to make organizations more ethical.

Consider research coming out of possibly the most important public health study conducted in the U.S., the Framingham Heart Study (FHS).[16] Since 1948, public health officials have collected detailed cardiovascular and other health data on thousands of residents living in and around Framingham, Massachusetts, as well as their children, and grandchildren. Every two years, study participants were examined by doctors and, critically, also provided information about those people in their social networks, such as family and friends, many of whom were also study participants.

While the FHS has provided "much of what we know about the determinants of cardiovascular disease," it has also provided a unique understanding of how social networks influence health behaviors, including smoking, eating, and lifestyle habits that lead to obesity.[17] This has allowed researchers to craft data-driven interventions that not only target study participants' behavior directly, but also seek to change their behavior by targeting the behavior of people in their networks who influence them. Such interventions draw from decades of research showing that health behavior change is dependent on individuals' perceptions of their risks, others' approval or disapproval of their behavior, and how widely adopted the behavior is—all of which are shaped by family and friend networks. Behavioral interventions focused on these types of social influence have been successful in mitigating a host of health risks.[18] ▸PAGE 445

We can take these ideas from public health and apply them to compliance—the pandemic helps us see how. Controlling the spread of a contagious disease is at its essence a behavioral compliance effort. Compliance, be it aimed at legal or organizational rules, is an exercise in channeling or changing individual decision making and behavior. Executives and other corporate employees often consider—sometimes deliberately, sometimes unconsciously—breaking rules to benefit themselves at the expense of others; public and private compliance efforts are designed to deter them. Getting an entire population to stay in their homes and refrain from physically interacting or consistently wearing masks is a similar type of compliance challenge: its goal is to change people's behavior when it is against their short-term interests but creates long term good for themselves and larger society. In order to do that well, compliance efforts cannot simply dictate rules, but rather must understand how human decision making and behavior operates and spreads.

Public health officials' efforts to encourage and enforce social distancing, mask wearing, and other healthy acts is behavioral compliance writ large, and it is the same approach the compliance community must take to effectively influence corporate employees to act ethically.

Once that is understood, it becomes clear that ethical behaviors and health behaviors share many features, most notably how they travel. Both spread along social networks, the ways in which we are connected to one another as human beings. Our thoughts, decisions, and behaviors are heavily influenced by those people to which we are socially linked.[19] Just as a virus or other risky health behavior will be passed among a group of friends more predictably than among relative strangers, so too are rule- and law-breaking behaviors.

Just as a virus or other risky health behavior will be passed among a group of friends more predictably than among relative strangers, so too are rule- and law-breaking behaviors.

Thus, social network dynamics and the theories underlying them, which have been used in public health to model the spread of disease, can also be used to better understand how corporate crime and organizational noncompliance occurs, is fostered, and spreads within companies and across industries. ▸PAGE 403

Such insights lead to innovative compliance strategies. For example, corporate monitoring and investigations—two mainstay functions of compliance—should include inquiries into who was involved in the problematic behavior and how they are connected to others within the organization, including those who may not have been involved in the misconduct. This is the approach of the FHS study, whereby researchers not only asked about the patient in front of them, but also about those people in the patient's larger network.

While any good compliance investigation will seek the root cause of a violation, most traditional investigations stop there, failing to understand the ties between violators; rarely does an investigation consider non-violators. But this level of inquiry is essential for understanding the true compliance risks facing the company, because wrongdoing is contagious.[20] If one or more of the wrongdoers is a well-connected, influential employee, compliance interventions may need to be much more aggressive and wide-ranging. The uncovered bad conduct may have already spread within the company or be lurking under the surface.

The methodological tools of public health research may be particularly helpful here because they use data-driven means to track behavioral spread. As was done with the FHS data, compliance leaders can create a map of the organization's social network that goes beyond the traditional org chart. Basic network analysis can show with mathematical precision what persons and groups are most central to a company's network. This allows the compliance team to determine who is ethically influential, who is psychologically close to whom, and ultimately where hidden risks may occur. ▶PAGE 445 Network analysis may even allow compliance to create a "sensor network" capable of identifying wrongdoing before it creates unmanageable ethical risk.[21] This approach, coopted from public health research, provides compliance an entirely new set of data-driven tools.

Network analysis may even allow compliance to create a "sensor network" capable of identifying wrongdoing before it creates unmanageable ethical risk.

Embracing Opportunity

President Kennedy once said, "When written in Chinese, the word 'crisis' is composed of two characters — one represents danger and one represents opportunity."[22] My knowledge of the Chinese language is nil, so I cannot comment on the accuracy of the statement, but I do believe wholeheartedly in its sentiment. Crisis provides us all with a chance to view the world differently and reconsider longstanding problems. The crises we are facing highlight the benefits of public health and acting for the collective good. We can use these ideas, and the methods that support their advancement, to remake compliance and foster positive cultures in our corporations. While there is certainly some danger in breaking from the status quo, there is also danger in doing compliance as usual. That is a danger we know; we might as well embrace a new opportunity.[23]

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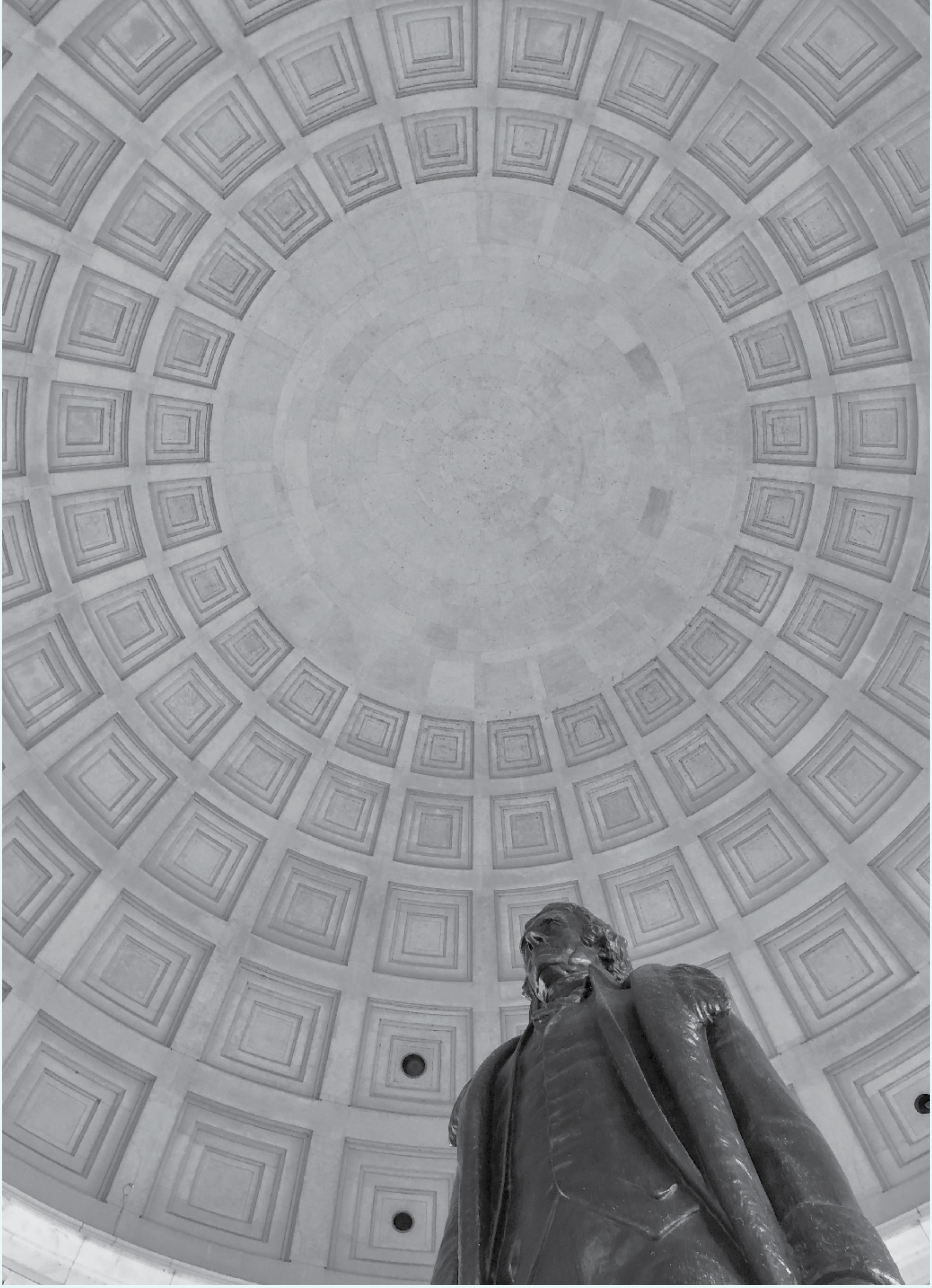

Good Counsel

Overcoming Hope and Fear in Compliance Practices

by BRANDON GARRETT
& GREGORY MITCHELL

Brandon Garrett

Gregory Mitchell

FROM: Microsoft office365 Team <office365@virginia.net>

SENT: Monday, January 24, 2022, 1:39 PM

TO: greg.mitchell@law.virginia.edu

SUBJECT: Mailbox Shutdown

Detected spams messages from your <greg.mitchell@law.virginia.edu> account. If you do not verify messages, we will be forced to block your account. Please Verify Now

Contact Microsoft office365 Team for further information

If you work in a large organization, you probably receive messages like the one at the top of this page on a regular basis.

Most of these messages come from cybercriminals, but a few are probably being sent by your information technology department to test how susceptible the organization is to malware attacks and phishing scams. Increasingly, IT departments are turning to in-house experiments of this kind to identify weaknesses in their technology systems and to educate users on the risks of infiltration.[1]

The use of experiments to assess vulnerabilities extends far beyond information security. For instance, to test the efficacy of airport security measures, the Transportation Security Administration "Red Team" now regularly conducts experiments in which it seeks to take banned items through airport security and customs checks.[2] The results of these tests have proved sobering: airport screening often fails to catch more than half the banned items, demonstrating that changes in training and procedures are necessary to enhance security.[3]

This rise in experimentation suggests that compliance departments and in-house legal departments are beginning to embrace the quality control principles adopted long ago by departments tasked with performing key manufacturing and service functions.[4]

Two major hurdles continue to exist, however, obstructing widescale adoption of experiments aimed at testing the efficacy of compliance procedures and controls: a continuing hope that adopting "best practices" will work, paired with a fear about how the results of this experimental testing may be used against the organization.

This hope and fear combine to create a "compliance trap" in which sticking with business as usual is rational. On the one hand, a large compliance industry exists to identify and implement practices that have shown promise in some settings and, most importantly, have satisfied regulators. Why not hope that the compliance experts and regulators are right? On the other hand, standing apart from the crowd and developing experiments to see if these practices actually work as intended poses the substantial risk of creating evidence that the measures are *not* in fact mitigating risks within your organization. Combine this hope with this fear and the end result is rational ignorance about the effectiveness of a compliance program.[5]

Combine this hope with this fear and the end result is rational ignorance about the effectiveness of a compliance program.

Current regulatory and market incentives perpetuate this hope-and-fear-based approach to compliance: regulators and the markets reward organizations for putting into place extensive compliance programs, never asking for evidence of the effects of these programs, yet when organizations proactively monitor compliance threats and disclose these efforts, politicians, regulators, lawyers, and investors may penalize the very companies that we should be rewarding.

Legal reforms could shift these incentives, but such reforms are likely to be met with opposition from the compliance industry that provides companies with off-the-shelf education programs and compliance packages and that investigate and audit *after* problems come to light. This is also the case for lawyers, who will see their roles as private attorneys general jeopardized, and for politicians and regulators, who do not trust companies to engage in good-faith testing of their own compliance operations.

Rather than wait on the regulatory climate to change, those frustrated with usual practices should make the business case for taking an experimental approach to compliance.

That case should be easy to make when the risk posed by a compliance failure is catastrophic. The next data breach,[6] ransomware attack,[7] rogue trader,[8] or bribery scandal[9] is likely to lead to organizational reorganization and tremendous losses, if not outright failure. Hence, it is no surprise that TSA is testing airport security to prevent the next 9/11 or that companies are launching cyberattacks on their own technology systems to identify weaknesses. But the benefits of experimentation apply to all aspects of compliance, not just those that involve existential threats.[10]

Beyond the very high-stakes settings where likely benefits should easily outweigh potential costs, four situations in particular create great opportunities to try out an experimental approach to compliance to determine how well your existing systems work.

First, using an experiment in the context of employee training poses little risk of negative evidence, because the experiment will involve simulated scenarios that are designed to educate employees on what *not* to do, while simultaneously allowing management to examine how their compliance measures performed in these simulated scenarios.

Second, where an aspect of the compliance system is involved in ongoing litigation, an experiment can be conducted in-house to examine the frequency with which unwanted behaviors are observed, under existing compliance measures, and whether a change in those measures might reduce the frequency of unwanted behaviors. Because these experiments can be performed in connection with the litigation process, the information generated should be protected from public disclosure by legal privileges.

Third, conducting experiments on aspects of a compliance system that regulate low-level behaviors that pose little risk of harm to the company can be a great way to demonstrate the power of the experimental approach. (e.g., the frequency with which food handlers fail to follow strict hand-washing rules, for instance, or the frequency of violations previously deemed *de minimis* during an OSHA inspection) Proving the benefits of trial-and-error in these low-level settings, where results of different compliance methods are systematically compared, can convince management to expand the use of such experiments.

Finally, persistent problem areas provide another excellent place to begin experimentation. Where following the standard playbook fails to produce positive change, then a systematic approach to identifying the source of the problem is needed. Experiments in these problem domains should go beyond trying different compliance mechanisms, to instead focus on assessing the psychological and sociological forces contributing to problems.

In most situations, designing an experiment to test compliance does not require great sophistication and will not require retention of an external consultant to develop the experiments (although a basic understanding of the scientific method and statistics, of the kind many managers will have learned during college or business school, will be helpful). However, where the goal is to understand why compliance measures are not working rather than testing whether the measures work at all, it may be necessary to retain a behavioral scientist, and ideally one with relevant industry experience.

Compliance programs are meant to reduce a wide variety of socially harmful conduct, from drug trafficking, money laundering, and public corruption to dangerous consumer products and dangerous working conditions. Devoting substantial resources to compliance provides no guarantee of compliance effectiveness. Implementing a compliance program without proof it works constitutes nothing more than a hope that the measures will protect workers, investors, and the general public from organizational misconduct. That hope is likely to go unfulfilled, at a tremendous monetary and opportunity cost in many cases.

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ENDNOTES

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Good Counsel

Value in Culture

By DAVID ROUCH

David Rouch

With war in Ukraine rocking the business world, attending to bank culture might seem like fiddling while Rome burns. Yet a firm's culture is essentially a form of institutional behavioural memory applied to the present. It represents the accumulated collective wisdom of those within the firm, or lack of it, about how to navigate reality successfully. The calamitous reality now pressing itself on firms therefore underscores the continued importance of sound culture.

At one level, a firm's success is defined by its goals — what outcomes the firm values. But success can only be realised within the firm's wider reality, the ultimate test of the value of the outcomes it pursues. Success, then, also depends on that wider reality and cannot be defined and achieved in a vacuum. Those who pursue goals that ignore social and natural reality eventually fail; repeatedly mistreat friends and they will desert you, step off the canyon's edge and disaster will ensue.

> What is the balance between financial goals and goals related to the wellbeing of others?

Finance firms have increasingly wrestled with this issue of goals in their work on culture but also in the context of 'corporate purpose' and sustainable finance. In all three cases, similar goals are in play. Attempts by some firms to articulate their corporate purpose increasingly recognise that and have begun to prompt greater integration. However, 'reality gaps' remain and, even where firms have renewed their understanding of their purpose, few would be bold enough to claim that the implications have been fully worked into all levels of their business decision-making, systems and controls. Deeper awareness of common goals across workstreams could make everyone's efforts more effective. Achieving a more coherent approach is nonetheless challenging, not least because some of the goals are not easy to reconcile, a tension sharpened by the dynamic of the financial ecosystem in which firms operate.

What sort of valued goals are involved? Finance firms are commercial organisations, so in all cases profit is a core goal. But there is a wider question of what other outcomes, if any, firms should pursue, and how they relate to profit: essentially, what is the balance between financial goals and goals related to the wellbeing of others (shareholders, staff, customers and counterparties, or wider society) and the planet? Climate change, Covid and now conflict make clear the interdependence between the two.

In the case of sustainable finance and work on corporate purpose it is obvious that goals referencing human and environmental wellbeing are already in the corporate values mix. A simple website search discloses how often firms reference the Paris Agreement and the Sustainable Development Goals in connection with sustainable finance activities. Meanwhile, taking the Business Roundtable revised 2019 Statement of the Purpose of a Corporation as a proxy for the burgeoning work on corporate purpose, signatories commit to, 'respect the people in our communities and protect the environment by embracing sustainable practices across our businesses.'[1]

However, a firm's culture also takes shape around its core valued goals. Goals focus, frame and form. They focus the aspirations of those within the organisation and frame decisions about how to pursue them. Over time this dual process of wanting and deciding how to pursue wants forms the character of individuals and the culture of their organisations: much like muscle memory, it creates dispositions to behave one way rather than another.[2]

The considerable attention to finance culture since the 2008 financial crisis and ensuing misconduct scandals recognises how prioritising short-term profit can damage organisational deep tissue. Firms generally want commercial sustainability and to avoid losses from conduct risk. They also want commercial success through providing trusted services and products. Their aspirations overlap with those of regulators here, although ultimate objectives may diverge.

All these outcomes depend in some way on the relationship between the firm and the wellbeing of customers and wider society and, especially in the case of the health of firms' markets, the natural environment as well. ▸PAGE 341 Firms therefore need to inculcate behaviour that, at some level, treats protecting or enhancing the wellbeing of people and planet as a valued goal; establishing cultures less likely to generate destructive behaviour involves firms pursuing goals that are not just narrowly financial.

Establishing cultures less likely to generate destructive behaviour involves firms pursuing goals that are not just narrowly financial.

So, there is a commercial case for firms to pursue a certain level of human and environmental wellbeing, or at least behave in ways aligned with it. However, that goal also resonates with potent human aspirations for financial activity that makes a positive difference beyond generating financial returns and providing products and services. In the case of the commercial imperative, taking steps aligned with positive social and environmental goals is instrumental since it is intended to help a firm achieve its commercial, and especially financial, goals. Aspirations in the second category tend to focus on human and environmental wellbeing as *ends in themselves*.[3]

Finance firms need to recognise and engage with both sorts of goals and the associated motivations in their work on culture, sustainability and corporate purpose. In all three cases, pursuing human and environmental goals goes beyond simply addressing firm-specific business risks and opportunities arising from sustainability challenges. For example, basic ESG investment manages investment performance risk by underweighting companies with poor ESG ratings. This can have the appearance of pursuing environmental and social sustainability goals, but it does not involve taking steps to reduce the underlying harms, with the aim of making an assessable difference to human or environmental outcomes. For instrumental reasons if no others, firms now need to negotiate that further step.

First, instrumentally, firms and their markets are threatened by interrelated systemic sustainability risks such as climate change, declining biodiversity, resource depletion, anti-microbial resistance, and social instability. These challenge the viability of whole systems on which everyone relies, including finance firms and the customers and counterparties they depend on for their business. Finance operators and the activities they support have contributed to these risks. However, firms can also be part of the solution by taking deliberate steps to address them (i.e. where relevant, treating that as a valued goal), for example, in their funding decisions and the way they steward client and investee relationships.[4] Of course, no single institution can change a whole system, hence the growing recognition among firms that an effective response requires coordination, whether by the state, or voluntarily through alliances such as the Net-Zero Banking Alliance.[5]

Second, finance firms' shareholders also have an instrumental need to tackle systemic sustainability risks. Shareholders are often institutional investors, tasked with generating financial returns over the long-term. Sustainability risks threaten that, especially as prevailing portfolio theory has driven investors to diversify their portfolios across the full range of economic activity. Once a portfolio is diversified, market performance is one of the most important drivers of return as compared with returns on individual investees relative to others. Investors have in view the performance of whole portfolios, not just individual companies. They are increasingly interested if one company's or sector's negative externalities damage the return on other parts of their portfolio and are coming to contemplate lower returns from some investee companies where necessary to address that. Finance firms are not a major direct source of negative sustainability outcomes, but those they finance can be and attention to this is intensifying among their shareholders.[6] Like the banks, investors have also recognised that, to be effective, their activities require coordination through groups like the Net-Zero Asset Owner Alliance or the Finance for Biodiversity Pledge.[7] [8]

Shareholders also have an instrumental need to tackle systemic sustainability risks.

Thirdly, however, there is a growing need for finance firms to focus on goals related to the wellbeing of people and planet because these are core socially valued ends in themselves, even if the firm's own purpose in doing so is instrumental in pursuing its financial goals. Indeed, firms may find that even instrumental success requires an authenticity that comes close to adopting human and environmental goals as ends in themselves. Doing that would, in any event, resonate with many in finance who have their own wider aspirations for people and planet, not least because their children will suffer if those aspirations remain unrealised. ▶PAGE 71

There is scope for these wider aspirations to influence corporate goals from the perspective of staff, those with whom firms deal and the wider public.

Taking the first, there is a popular idea that finance staff behave like characters in the movie The Wolf of Wall Street, cookie cuts of rational financial utility maximising homo economicus. However, plenty of evidence suggests otherwise; that their aspirations also focus on the wellbeing of others and the environment. Apart from the abundance of other-regardingness among finance staff if one only looks for it, most recently in responses to the Ukraine crisis, it ranges from the well-known work of Shalom Schwartz on human values to research on altruism, and from people's 'public service motivation' to their 'justice motivation'.[9] Similar aspirations show through in surveys of Millennial and Gen Z attitudes, which consistently highlight strong environmental and social concerns and scepticism about the adequacy of the business response.[10] In staff recruitment and retention, firms increasingly need to demonstrate a genuine commitment to pursuing these goals that does not run out as soon as financial incentives dry up. Doing so can also help to avoid adverse publicity if there is a perceived gap between cultural reality and espoused valued goals. The large IT firms have found employees increasingly willing to speak up, but professional services and finance firms are not immune.[11]

The picture is similar among firms' customers and clients. Many have an instrumental need for some sustainability goals to be met: as with institutional investors, pursuing and meeting these goals will be essential for commercial operations to flourish long-term or to retain their customers, and some may be willing to move from finance firms that are insufficiently aligned.[12] However, a steady stream of industry, government and academic surveys also suggests that a majority of individual investors (those whose money is invested by firms and who make deposits and use firms' other services) want finance to be aligned with achieving core socially valued goals as ends in themselves: they want to meet their financial needs, but they want it to happen in ways that have positive sustainability outcomes.[13] Especially with policymakers increasingly focused on transparency about the sustainability of finance firms and products, there are misselling risks where products have been touted as 'sustainable' but have no assessable positive sustainability impact (so-called 'greenwashing'), and the prospect of declining demand for firms that seem unresponsive.[14]

In view of the attitudes of staff and individual clients, it is unsurprising that finance firms are also under pressure from politicians and wider society to commit more clearly to core socially valued goals as ends in themselves. At least in relation to climate change, events surrounding COP26 should put that beyond doubt, and potential reputational damage and policy intervention awaits those who do not follow through. However, it is clearer still in the pressure on firms to respond appropriately to the invasion of Ukraine.[15]

> A steady stream of industry, government and academic surveys also suggests that a majority of individual investors want finance to be aligned with achieving core socially valued goals as ends in themselves.

These are compelling reasons for finance firms to engage deeply with widespread goals for human and environmental wellbeing. Yet, as noted, doing so is challenging and, when they do, the outcome can be susceptible to characterisation as virtue-signalling and risk management to achieve shorter-term financial goals, rather than addressing the underlying goals themselves.

Clearly, what firms can and should do in response may vary depending on the legal regimes they operate under. Where, for example, applicable laws say that a firm can do no more than pursue an increase in its individual financial value regardless of any negative externalities it generates or facilitates, then that limits its sphere of action.[16] Even so, it should not rule out the need to consider pursuing wider goals related to people and planet in the cases described above, where doing so is financially instrumental. Indeed, given the behavioural force, and potentially destructive power, of short-term financial incentives, it may be essential for firms to appeal to the wider aspirations of their staff even to achieve their financial goals.

How could firms respond more effectively? First, by going further in identifying a common core of valued goals underlying many of their activities, especially in the areas of culture, corporate purpose and sustainable finance and fostering cross-working across these spheres. Second, by recognising explicitly how far those goals necessarily concern or depend upon positive social and environmental outcomes. Third, by openly acknowledging that the firm's own management and staff are likely to have aspirations that concern the realisation of those outcomes as ends in themselves and that these are shared more widely, including by clients and customers. Fourth, by recognising explicitly that the firm's own activities and those it facilitates have an impact on how far those outcomes will be achieved and, where relevant, determining what practical steps the firm can take that would contribute to that end and how progress can be measured. Fifth, by being open about the potential tension between their financial goals and those wider outcomes but also the extent to which they overlap, seeking to understand where the wider outcomes may need to be pursued instrumentally and where doing so would go beyond that.

And finally, by actively seeking to navigate that tension in the way they set, communicate and pursue organisational goals, advancing frameworks that will help staff in the process mentioned previously of focusing and framing their activities, and so forming character and culture.

The last of these is especially challenging. The temptation is to ignore the tension or hold to the myth that somehow financial self-interest expressed through markets always aligns with achieving those wider goals. Clearly, it only does that up to a point, otherwise we would not be having the discussion.

It may be essential for firms to appeal to the wider aspirations of their staff even to achieve their financial goals.

So, what is the alternative? There is a sense in which we can only decide how to act once we have understood what story we are a part of.[17] Narratives are one of the main ways in which we seek to comprehend the reality around us, express what outcomes we consider valuable and coordinate ourselves to realise them. Indeed, the importance of narratives has long been recognised, not least by political leaders seeking to inspire action, because they can engage hearts and minds to change behaviour more than new laws ever can. Think of Lincoln and the Gettysburg Address.

Business and financial life is highly 'storied'. Perhaps the most influential group of stories about the purpose of finance was mentioned earlier under the label of The Wolf of Wall Street narrative, but it includes among others the idea of homo economicus, shareholder value and the invisible hand of the markets. The essence of these narratives, at least as they have come to be popularly understood, is that finance is about making money, and they are compelling because they do indeed highlight something about reality. However, they do not tell us everything needed to navigate that reality well. Among other things, that is because they allow little role for wider goals, except where it is assumed that these will be achieved by the play of financial self-interest. ▶PAGE 355

What other narratives are available to supplement them and provide additional coordinates? The idea of humanity, finance firms included, working to secure sustainability on which the future of firms themselves also depends is clearly powerful. However, the genius of 'sustainability' is that it is only loosely defined and, as a result, provides a space where those pursuing quite different goals can come to identify common ground, but not necessarily resolve inherent tensions. From experience, that is indeed what happens: it is easy for activity to progress on parallel tracks with little real meeting of minds as to what those involved are trying to achieve.[18] This is partly what lies behind current concerns about 'greenwashing' by finance firms.

However, a further narrative is available that can help with this. It is already present in the investment world and was picked up by Mark Carney, then Bank of England Governor, as a way of understanding and drawing together the financial goals and activities of finance operators and wider human goals: the social licence for financial markets.[19] Essentially, this articulates an understanding that there is a sense in which financial market activity relies on a kind of permission or trust being given to those in the markets by the members of society as a whole — a freedom to pursue financial goals, and to flourish in doing so, but in a way that is also connected with realising core socially valued goals. It highlights the presence both of firms' commercial goals and wider human aspirations (of individuals within finance and beyond) and the wider reality in which firms' commercial goals must be pursued. But it also identifies a meeting point between them, however

Financial market activity relies on a kind of permission or trust being given to those in the markets by the members of society as a whole.

challenging it might be to realise, providing a potential framework for navigating the relationship between the two in practice.

Critically, the recognition that there is a social licence speaks to the financial ecosystem as a whole and its constituent firms and individuals. Individual finance firms do not operate in a vacuum. How far and fast they can change also depends upon the ecosystem in which they operate. Firms must generate a profit to survive; they are engaged in competitive processes and ecosystem-wide pressures may constrain what they feel able to do. Further, as staff move between firms, they bring valued goals absorbed from elsewhere in the financial ecosystem with them. So, just as tackling system-wide sustainability challenges needs coordination, there is a very real sense in which individual finance firm change relies on change across the financial ecosystem, ▶PAGE 103 raising the question of what core valued goals are being pursued ecosystemically.[20] Because recognition of a social licence for financial markets concerns the purpose of the financial markets as a whole, it helps with that as well.

Critically, the recognition that there is a social licence speaks to the financial ecosystem as a whole and its constituent firms and individuals.

Whether it is in their work on firm culture, purpose, sustainable finance or beyond, firms across the financial markets could, then, do worse than pose for themselves this question: how do they align with the reality for finance operators visible in the light of recognition of a social licence?

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ENDNOTES

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2 David Rouch, *The Social Licence For Financial Markets: Reaching For The End And Why It Counts* (Palgrave Macmillan 2020), especially chapters 2 and 6.
3 For a discussion of the difference between pursuing core socially valued goals instrumentally and as ultimate ends specifically in an investment context see David Rouch and Juliane Hilf, *A Legal Framework For Impact: Sustainability Impact in Investor Decision-making* (Freshfields Bruckhaus Deringer LLP 2021), especially Part A.1. Similar principles apply in financial and commercial activity more broadly.
4 See Rouch and Hilf, *A Legal Framework For Impact*, especially Part A.1.
5 See https://www.unepfi.org/net-zero-banking/, accessed 19 March 2022.
6 See for example, *A Letter from our Senior Partner 2022*, Generation Investment Management, 10 March 2022, accessed 19 March 2022.
7 https://www.unepfi.org/net-zero-alliance/ and https://www.financeforbiodiversity.org respectively, accessed 19 March 2022.
8 Rouch and Hilf, *A Legal Framework For Impact* looks at the ways in which the law across 11 jurisdictions, including the major investment hubs, may require or permit institutional investors to seek to achieve positive changes in the sustainability impact of those in whom they invest, including through their stewardship activities.
9 For further discussion, see Rouch, *The Social Licence For Financial Markets*, especially chapters 3, 4 and 6.

10 For example, *A call for accountability and action*, the Deloitte Global 2021 Millennial and Gen Z survey, available at https://www2.deloitte.com/content/dam/Deloitte/global/Documents/2021-deloitte-global-millennial-survey-report.pdf, accessed 19 March 2022.

11 For example, in relation to McKinsey, see Michael Forsythe and Walt Bogdanich, 'At McKinsey, Widespread Furor Over Work with Planet's Biggest Polluters,' *New York Times*, 27 October 2021; in relation to Blackrock, see Tariq Fancy, *The Secret Diary of a 'Sustainable Investor*', available at https://medium.com/@sosofancy/the-secret-diary-of-a-sustainable-investor-part-1-70b6987fa139, accessed 19 March 2022; see also Olaf Storbeck, 'DoJ censures Deutsche Bank for late flagging of greenwashing claims', *Financial Times,* 11 March 2022.

12 Many finance firms recognise this and are attempting to position themselves accordingly. See, for example, *Reshaping Retail: How ethics and sustainability are changing retail's ecosystem*, Barclays Bank PLC, February 2022, available at https://www.barclayscorporate.com/content/dam/barclayscorporate-com/documents/insights/industry-expertise/Reshaping-retail.pdf (accessed 1 March 2022).

13 Rouch and Hilf, *A Legal Framework For Impact,* Part A.4.

14 For example, in relation to the US SEC, see https://www.sec.gov/news/press-release/2021-42; in relation to the UK FCA, see https://www.fca.org.uk/publication/discussion/dp21-4.pdf; and in relation to the European Securities and Markets Authority see https://www.esma.europa.eu/press-news/esma-news/esma-prioritises-fight-against-greenwashing-in-its-new-sustainable-finance (each accessed 19 March 2022).

15 For a survey of the political pressures coming to bear on business organisations, see Joe Zammit-Lucia, T*he New Political Capitalism: How business and societies can thrive in a deeply politicised world* (Bloomsbury Business 2022).

16 Another example is competition law. Ironically, while competition regulation seeks to facilitate competition in support of socially valued outcomes, there may be cases where it could inhibit some forms of collective action to achieve positive sustainability outcomes that reflect core socially valued goals. See, for example, Alastair Marsh, 'Net-Zero Insurers Uncover New Climate Adversary in Antitrust Law', *Bloomberg*, 19 January 2022. However, regulators recognise the issue and are taking steps not to impede good faith collaboration to achieve core sustainability goals.

17 Alasdair MacIntyre, After Virtue: *A Study in Moral Theory* (3rd edn, Bloomsbury 2007), 216.

18 Rouch, *The Social Licence for Financial Markets*, 21 et seq.

19 Mark Carney, B*uilding real markets for the good of the people*, speech at the Lord Mayor's Banquet for Bankers and Merchants of the City of London, 10 June 2015.

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Good Counsel

Agile Governance for a Better World: Japan's Perspective

An Interview with **HIROKI HABUKA**

Hiroki Habuka

KYOTO UNIVERSITY

Q: You've talked about "Society 5.0," which you describe as a human centered society that draws cyberspace together with physical space to promote economic development and solve societal issues. What does that mean, in practice?

A: In 2016, the Japanese government introduced the concept of "Society 5.0" and positioned it as the future vision of Japan. As you note, Society 5.0 is defined as "a human-centered society," one in which a high degree of integration between cyberspace and physical space works to promote economic development and to solve societal problems. We view this as the latest type of society, following from our past hunting society (Society 1.0), agricultural society (Society 2.0), industrial society (Society 3.0), and information society (Society 4.0).

There are three major points embedded in the goals of Society 5.0. First, we should understand that this concept is about "society", not just "industry." It is often compared to terms such as the Fourth Industrial Revolution, or Industry 4.0, but Society 5.0 aims to transform not only industry but also society as a whole, through the power of digital technology.

Secondly, the ultimate goal of Society 5.0 is to realize a "human-centered society." The intent here to create conditions that make people happier and freer, through the resolution of societal issues and the promotion of economic growth. In this context, "digitization" is not a goal itself but merely a means to this end. Therefore, for example, a society that uses digital technology to surveil and control people's behavior is the exact opposite of what Society 5.0 represents.

Third, Society 5.0 is based on systems which highly integrate cyberspace and physical space. Cyber space itself has existed since the era of Society 4.0, but there has always been a human interface between cyberspace and physical space. For example, even if a POS system manages customer purchase data, it is humans who input the data into the system and decide what to recommend to the customer. Likewise, even if a car navigation system calculates the route to the destination, it is humans who actually drive the car with due care. In Society 5.0, however, systems will operate without human intervention in a variety of situations, such as recommendation systems in e-commerce and the operation of self-driving cars. In other words, machines will be able to carry out a series of processes autonomously: data collection, analysis, and actuation in the real world.

To summarize, Society 5.0 is a society where every individual can pursue a happier and freer life through highly developed cyber-physical systems.

Q: In a recent interview, you argued that it was important for Japan to explore innovation not only in technology and the cyber-physical systems you describe above, but also in terms of improved "governance." Can you expand on that?

A: Before I talk about why innovation is necessary for governance, I would first like to talk about why governance is necessary for innovation.

In order to realize our vision for Society 5.0, we need to bring about innovation in various aspects of society. Innovation here involves a fundamental shift in the value creation model, Schumpeter's "creative destruction." We need to move past mere improvement of existing technologies or business models. Innovation can occur only when it is implemented in society and brings fundamental shift in the value creation. Innovation in this meaning often conflicts with existing rules and, even if there are no such rules, it is often difficult to gain the trust of society. In order to overcome these challenges, it is necessary to design and implement rules, organizations, and technologies to form trust in innovation. The design and implementation of such measures is what we call governance.

So, why then does the governance of Society 5.0 require innovation? In other words, why can't the traditional command-and-control type of governance work well in Society 5.0? I believe that there are mainly two reasons. The first is related to the nature of Society 5.0. and the second is related to its goals.

First, our society is undergoing a fundamental change. Cyber space is increasingly integrated with physical space and has become an indispensable foundation of our lives. The fast pace of technology development in cyberspace has led to a rapidly changing society. Furthermore, in Society 5.0 various complex systems, operated by different actors, are connected and function together. Under these situations, predictability and controllability of risks become very low, and it becomes more difficult to identify a responsible actor once an accident happens. This presents us with a governance challenge with which we've had little experience heretofore.

We need to move past mere improvement of existing technologies or business models.

Second, the goals that we seek to pursue have become more diverse. Sustainable Development Goals (SDGs) and environmental, social and governance concerns (ESG) are current examples. Moreover, goals will continue to change in accordance with the development of technology and transformation of society. For example, the meaning of "privacy" expanded dramatically from defining a state in which one is not being specifically observed by other people, to include the more current view that one has the right to insist that others treat his/her personal information appropriately, even where this may imply a "right to be forgotten."

These changes impose difficulties on the traditional governance model — a model based on the belief that the objectives of governance can be accomplished by regulators, who define certain rules in advance, and by citizens who comply with those rules. (that is, a rigid vertical and rigid hierarchical approach).

The world has become too complex to be governed through a single rule or by a single actor, so we have to devise an innovative approach to governance. Instead of the traditional command-and-control model, it will be necessary to take a multi-stakeholder approach, where certain goals are shared among stakeholders and flexible solutions are implemented by each stakeholder (that is, a horizontal and agile approach). This is what we call "agile governance" model.

Q: Can you say a bit about this and Japan's 'agile governance' framework?

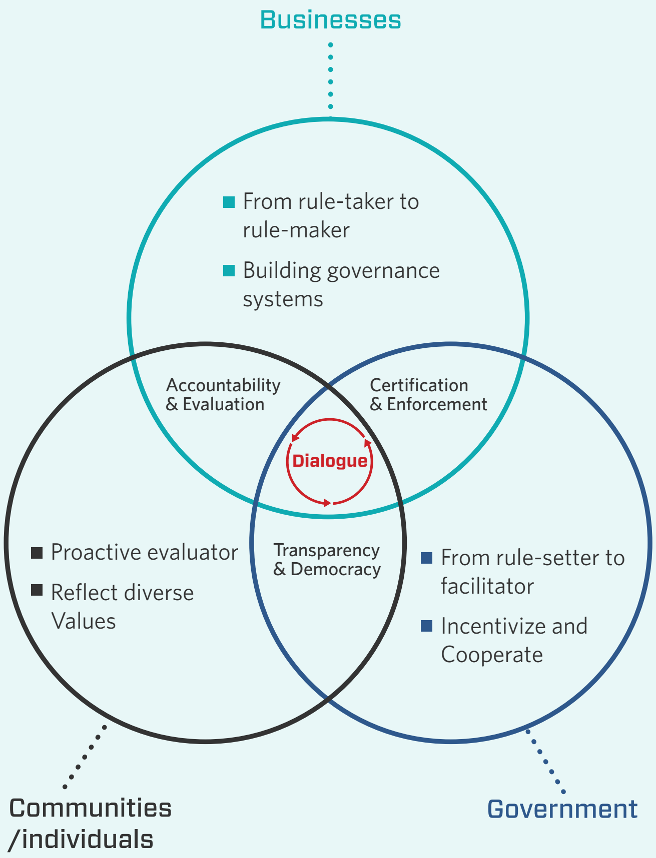
A: Our agile governance model consists of the following two essential factors:

Multi-stakeholder approach: The new governance model needs to be one in which multiple stakeholders formulate rules and solve problems co-jointly, rather than relying on a single entity to set uniform rules, ▶PAGE 375 and;

Agile update of governance systems (agile governance cycles): The new governance model needs to keep up with the ever-changing environment, risks, and goals of society.

As for the multi-stakeholder approach, in the traditional governance model, the government, as the name implies, plays a central role in establishing and enforcing rules. This vertical model is based on the assumption that society is relatively simple and predictable, and that a single entity can prescribe appropriate rules.

Roles of stakeholders in the new governance model



However, a society based on digital technology is extremely fast-changing, complex, and uncertain. In such a society, it is difficult for rules to keep up with the speed of change in technology and business models, and there is a limit to how much monitoring can (or should) be done by the government alone. In such a society, a decentralized governance model that emphasizes horizontal relationships among stakeholders is necessary, to include businesses, individuals, and communities.

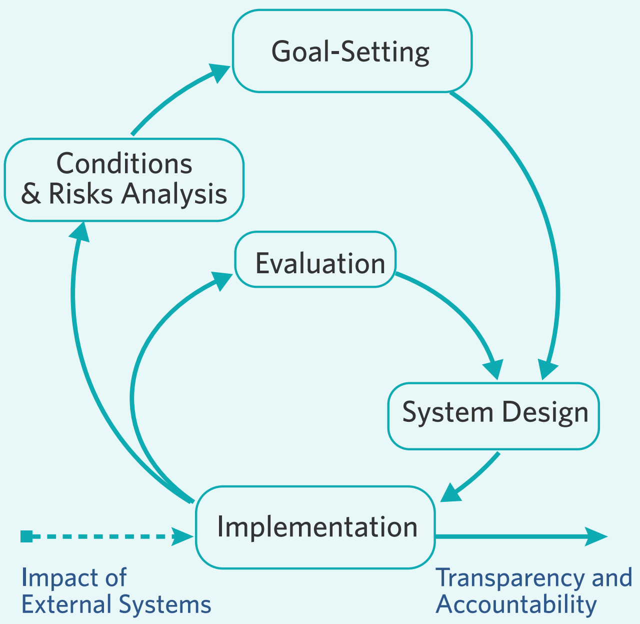
Second, with regard to agile governance cycles, I'd point to the model below. This is a model that contains PDCA (Plan-Do-Check-Act) as a part of the process (the elliptical cycle in the bottom half, starting from "System Design"). In addition, it requires (i) continuous "condition and risk analysis" and "goal-setting" prior to "system design" (the outer circular cycle), and (ii) sufficient transparency and accountability to external stakeholders (the right bottom line). These requirements are characteristics of the agile governance cycle, which is based on the premise that the environment, risks and goals are constantly changing, and a multi-stakeholder approach is necessary to achieve the goals.

Q: There is a lot of hype around AI today, with some arguing it will usher in a utopian future, while others fear a dystopian one. What's your view? And what needs to happen if we are to capture the promise of AI while successfully navigating relevant risks?

A: I think it is important for each and every one of us to understand the characteristics of AI. The term "Artificial Intelligence" makes it sound as if the machine has a personality just like ours, but the reality is that it is just a sophisticated computing system.

There are various attempts at formally defining AI. For example, the EU's proposed AI regulations include a very wide range of algorithms in AI. But below I will discuss deep learning, which was the driving force behind the AI revolution. The simple definition of deep learning is: (1) a machine learning

Agile governance cycles



technique that learns from data, and (2) uses functions with a deep hierarchy. These features of deep learning make it possible to generate nonlinear and complex analytical outputs with high accuracy, which was difficult to achieve with earlier and more conventional algorithms.

On the other hand, because it is an inductive system that learns from data, rather than a deductive system that prescribes arithmetic operations to be applied to input data, it is not possible to determine in advance what results should be expected for a given input set. This challenge to "predictability" is made even more complex by the fact that optimization of tens or hundreds of millions of parameters, embedded in "deep" layers, is generally performed by using thousands or millions of sample data points. It can thus be difficult for humans to explain why a certain machine output is obtained, as it is not always clear which features contributed to the result and by how much.

AI is just a computational tool with these unique characteristics. Therefore, the question we should be asking is not, "Will AI make society a utopia or a dystopia?" but "How can we use AI, as a tool, to bring about a better society?" With this objective in mind, various international organizations, countries and companies (e.g., the OECD, Japan, and Google, to name but a few) have issued guiding principles for the proper use of AI. ▶PAGE 337 However, principles are goals to be achieved, and just stating them does not imply that such principles will be realized immediately. (Just as wearing a virtue-signaling badge for the Sustainable Development Goals does not equate to the SDGs having been achieved).

Given the unique characteristics of AI — i.e., a lack of predictability and explainability — setting AI principles requires an agile and multi-stakeholder design for proper governance. Since achieving zero risk is impossible, stakeholders must decide together what risk levels are acceptable. And since it is impossible for regulators to provide specific ex-ante rules on how an AI algorithm should be designed and/or deployed, it is necessary that AI providers act to ensure the greatest degree of transparency and accountability, so that stakeholders can evaluate whether the risk criteria are met and take corrective action when necessary. Because AI algorithms are constantly changing as they're fed greater training data, assessment of acceptable risk levels will need to be an ongoing and evolving process.

How can we use AI, as a tool, to bring about a better society?

Q: How do you see ideas around transforming traditional governance mindsets and methods factoring in with heightened attention to ESG interests in global markets and policy making circles?

A: What every member of society needs to understand is that, in order to put ESG and SDGs into practice, it is not enough simply to update the conventional way of governance. Relevant goals should not be set behind closed doors, by governments and experts, but should instead be discussed openly to involve a diverse group of stakeholders. Then, and whether a private party or public party, actors working to achieve specific goals should be creative in designing the appropriate methods necessary to achieve such goals. For example, if a law mandates a specific technological method to reduce greenhouse gas emissions, this will only reduce the incentive to further reduce greenhouse gas emissions through innovative alternative technologies.

In most cases, it is the private sector, rather than government, that knows best how to solve problems. So, the law should serve to define the desired goals to be achieved, leaving it incumbent upon stakeholders to decide whether implemented solutions are appropriate and acceptable.

We should also consider a redesign of sanction mechanisms. While it is important to ensure that the government can issue impactful sanctions, with due process, in cases of inappropriate behavior, heavy punishments on individuals when unpredictable problems occur will stifle innovation and provide incentives for information concealment. For this reason, a new sanction mechanism is necessary, and we should consider amnesty when, in the event of an unpredictable accident, the involved parties promptly disclose detailed information regarding the accident, cooperate in investigating root causes, and help to design a means of improving things going forward.

In conclusion, the complexity, uncertainty and diversity of Society 5.0 will require of business greater transparency and accountability, of governments more proactive coordination and experimental approaches to innovation, and of citizens a greater ability to evaluate the benefits and risks inherent in innovation. The governance of Society 5.0 is not something that can be left to others; it is something that all of us must commit to as a matter of personal importance.

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Good Counsel

Accountability Regimes: Will They Succeed in Changing Behavior and Culture in Banking?

By CIARAN WALKER

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Introduction

The Senior Managers and Certification Regime (SMCR) has been in place in the UK since 2016. It has provided a model for the subsequent introduction of new individual accountability regimes in Hong Kong (the Manager-in-Charge regime, 2016), Australia (the Banking Executive Accountability Regime, 2018, soon to be replaced by a more extensive Financial Accountability Regime), and Singapore (Guidelines on individual accountability and conduct, 2021), together with anticipated new individual accountability regimes in Ireland and Malaysia.

The SMCR was "created against the backdrop of a clear — and shared — understanding that culture [in financial services] needed to change and a culture of personal responsibility had to be embedded".[1] A key question is: how successful are the SMCR and other similar new individual accountability regimes (IARs) likely to be in their aim of improving behaviours and culture in financial services?

It is too early, at this stage of the implementation of these new regimes, to reach any definitive conclusions on this question. In this brief article, however, we outline the key relevant features of these regimes and provide some pointers on this question.

The key features of the IARs

The SMCR was introduced in the UK on the basis of recommendations from the UK Parliamentary Commission on Banking Standards (PCBS) in its 2013 report, "Changing banking for good" (PCBS Report).[2] The PCBS was set up to consider and report on professional standards and the culture of the UK banking sector. The PCBS Report found that one of the core features giving rise to misconduct in the banking industry had been a "striking limitation on the sense of personal responsibility and accountability of the leaders within the industry for the widespread failings and abuses over which they presided. Ignorance was offered as the main excuse. It was not always accidental".[3] Its recommendations on individual accountability aimed to address this.

The key relevant features of the resulting SMCR are the following:

Allocation of individual accountability

The principle of ensuring clarity in relation to who is responsible for what at a senior level is a well-established principle of good corporate governance. Thus, for example, the non-binding Basel Corporate Governance Principles for Banks provides that there should be "clarity on the role, authority and responsibility of the various positions within senior management, including that of the CEO".[4] This principle has been implemented in various jurisdictions globally.

In the EU, for example, the Capital Requirements Directive (CRDIV),[5] which deals with the prudential supervision of credit institutions and investment firms, requires that within-scope firms have robust governance arrangements in place, "which include a clear organisational structure, with well-defined, transparent and consistent lines of responsibility."[6] The principle was also emphasised in the Financial Stability Board's 2018 paper on strengthening governance frameworks to mitigate misconduct risk, which noted that "The identification and assignment of key responsibilities may be achieved through legislative or regulatory requirements, firm-driven decisions on their preferred structure, or both".[7] The US Office of the Comptroller of the Currency's (OCC) April 2018 and September 2021 Consent Orders in relation to Wells Fargo are further examples of the application of this principle, where the Consent Orders included specific requirements in relation to clarification of roles and responsibilities.[8]

What is significant about the SMCR and other IARs, in this respect, is that they require firms to be very specific about who is responsible for what at a senior level across the firm. Under the SMCR, for example, the Financial Conduct Authority (FCA) or Prudential Regulation Authority (PRA) may designate a function as a Senior Management Function (SMF). The SMF roles that have been designated include the chief executive officer, chief financial officer, chair, chair of certain board committees (nominations, audit, remuneration, risk), senior independent director, compliance oversight, AML oversight, head of risk, and head of internal audit.

A documented individual Statement of Responsibilities must be in place for all persons in a SMF position in a regulated firm, setting out the responsibilities of the individual.[9] Also, the regulators may prescribe responsibilities that must be assigned to a person in an SMF. Examples of prescribed responsibilities include responsibility for the firm's performance of its obligations under the SMCR; acting as the firm's whistleblowers' champion.[10]

Certain types of firms, including banks, insurance companies and other so-called "enhanced firms", are also required to have a Management Responsibilities Map in place, which sets out their management and governance arrangements, including reporting lines, committee structures and all responsibilities described in the Statements of Responsibility of all SMFs to show how responsibilities within the firm are allocated across the firm.

Codification of individual conduct standards — addressing "wilful blindness"

The IARs typically codify business and individual conduct standards. Under the SMCR, for example, there are two tiers of individual conduct rules. The first tier of conduct rules applies to substantially all staff in regulated firms and includes, e.g., the obligation to "act with integrity" and "act with due skill, care and diligence". The second tier of conduct rules are a further set of rules that apply only to the more senior individuals (the SMFs). They require, for example, the senior managers to take "reasonable steps" to ensure that: the parts of the business for which the individual is responsible are controlled effectively, that they comply with regulatory requirements, and that any delegation of the individual's responsibilities are to an appropriate person and the delegating senior manager effectively oversees the discharge of the delegated responsibility. Very similar conduct standards are contained in the proposed IAR in Ireland.

The Banking Executive Accountability Regime (BEAR) in Australia, which codifies broadly similar conduct standards (a single tier of standards that applies to senior managers, who are described as "Accountable Persons") provides that the taking of "reasonable steps" in relation to a matter includes having "appropriate governance, control and risk management in relation to that matter"; and "safeguards against inappropriate delegations of responsibility in relation to that matter"; and "appropriate procedures for identifying and remediating problems that arise or may arise in relation to that matter".

Thus, senior managers who choose to turn a blind eye to misconduct or potential misconduct and fail to take "reasonable steps" to protect against this will be subject to potential sanctions under the UK, Australian and proposed Irish IARs. This principle is also contained in the Hong Kong, Singapore and proposed Malaysian IARs, although the details of these regimes vary.

Senior managers who choose to turn a blind eye to misconduct or potential misconduct and fail to take "reasonable steps" to protect against this will be subject to potential sanctions.

Onus on firms to review and certify the fitness & probity of individuals in their firm and investigate where there are concerns.

In effect, the IARs increase the onus on firms to carry out appropriate due diligence on individuals they employ, on an on-going basis, to ensure that they are fit and proper for their roles. Indeed, the SMCR includes a certification regime, whereby regulated firms cannot employ individuals in a role which might give rise to "significant harm" (these functions are less senior than SMF roles) unless the firm has certified the individual on hiring and on an annual basis thereafter, to be "fit and proper" for the role.

This requirement is not included in the other IARs (although a version of this certification is included in the proposed IAR in Ireland).[11]

Interestingly, however, whereas a person cannot take up an SMF position under SMCR without the prior approval of the regulator (a broadly similar pre-approval requirement currently exists in Ireland and will continue with the proposed Irish IAR), there is no such regulatory pre-approval under the BEAR, which is otherwise quite similar to the SMCR.

With regard to the use of any sanctioning powers to enforce the requirements of the IARs, it is interesting to note that in the UK, for example, since the introduction of the SMCR in 2016, there has only been one SMCR sanctions decision against an individual.[12] Also, in Australia, under the BEAR, the current BEAR powers do not include a power to fine individuals. The Australian regulator does, however, have powers to disqualify a senior individual and there are deferred variable remuneration provisions, pursuant to which such remuneration must be reduced by a firm, by a proportionate amount, where its senior manager breaches conduct requirements. The BEAR "anticipates that executive accountability will be achieved primarily through financial consequences imposed by the board."[13]

Are the IARs likely to be successful in improving behaviour and culture?

Overall, there are useful early indicators that the IARs have given rise to improvements in internal governance, giving rise to improved behaviours.

A 2019 industry survey report on the SMCR by the industry body UK Finance found that, since the introduction of SMCR, "there has been a meaningful and tangible change in culture, behaviour and attitudes towards risk in firms. For senior managers, the evidence shows that the SMCR has focused minds, with a clear emphasis on what each person is individually responsible for and how they could be held accountable".[14] Also, a December 2020 evaluation of the SMCR by the PRA found that, based on survey responses from the industry, the SMCR was "widely considered to have had a positive impact on culture and behaviour."[15]

In Australia, a December 2020 review by the Australian Prudential Regulation Authority (APRA) of the implementation of the BEAR found that it had delivered a stronger understanding of the end-to-end accountability obligations, sharpened challenge by boards of accountable individuals and facilitated more targeted engagement with the regulator to achieve regulatory outcomes.[16] Also, a December 2020 detailed review of the implementation of BEAR in Australia by the academics Sheedy and Canestrari-Soh indicates that this new regime has given rise to improvements in internal governance:

> *"Greater clarity around individual accountabilities brings numerous governance benefits. Accountability has an empowering effect so decisions get made, problems get resolved and there is greater care and diligence. Risk/compliance functions are getting a bigger say as their line one colleagues consult them more. Directors and assurance teams also find it easier to do their jobs because they can ascertain who is accountable when things go awry."*[17]

Measuring "success"

If the IARs are to be judged solely on the basis of the number of successful enforcement actions taken against senior executives, then the evidence to date might suggest that they have not been a success. Indeed, the paucity of sanctions against individuals under the SMCR has been the subject of criticism, including in the House of Lords, where one parliamentarian, who had sat on the PCBS, commented that the SMCR has been "holed below the waterline by decisions of the FCA not to pursue senior executives".[18]

Another potentially relevant metric is the number of disciplinary actions taken by firms against individuals for breaches of conduct standards, which are reported by firms to their regulator. This is an indicator of the extent to which firms are holding individuals within their firm accountable for misconduct. On this, the available data is not particularly encouraging, at least in the UK. In a December 2019 SMCR evaluation report, the PRA stated that "[i]n the approximately 4.5 years leading up to October 2020, the PRA received 16 [mis]conduct notifications in respect of senior managers, and 104 conduct notifications in respect of persons under the Certification Regime. To put this in context, there are approximately 7,850 PRA SMFs in total. It is difficult to form an estimate as to what constitutes an appropriate level of notifications but the number of notifications received to date appears modest."[19]

In our view, however, the significance of metrics in relation to successful cases against individuals, whether taken by firms or the regulator, should not be overestimated. The focus of the IARs is on bringing about improvements in behaviour and culture in regulated firms through requiring the above improvements in internal governance, rather than a "heads on spikes" aggressive sanctioning strategy against individuals. As noted by the Central Bank of Ireland's Derville Rowland, commenting on the role of sanctions in the context of the forthcoming Irish IAR, and noting that sanctions are not a "silver bullet", "the law alone cannot compel cultural change."[20]

A systemic failure by regulators to go after the most senior individuals in organisations in a jurisdiction where there is clear evidence of significant misconduct could, nevertheless, over time risk undermining the credibility of the IAR in that jurisdiction.

The extent of reliance on firms for the success of the IARs

Inevitably, regulators rely to an important extent on regulated firms to ensure the effective implementation of the IARs. With regard to carrying out on-going due diligence in relation to the fitness and probity of staff and looking into potential issues of misconduct by staff, for example, whilst the regulators typically provide some high-level requirements and guidance and will look into some instances of misconduct, much is left to firms to address, at least in the first instance.

This regulatory approach, of not prescribing in great detail how firms should comply with regulatory requirements and, instead, relying on regulated firms to develop their own systems for ensuring and demonstrating compliance is a well-established approach, that has been described in the regulatory literature as "management-based regulation" or "meta-regulation."[21] To a certain extent, it is a necessary and practical approach to achieving regulatory objectives, given that the resources of the regulator are limited and there are practical reasons for firms to develop systems and processes to vet the fitness and probity of their staff and directors that fit within their already-established human resources and other internal processes. This type of regulatory approach, however, as with any regulatory approach, has its Achilles heel. It is that firms' internal systems and controls are designed to achieve their own goals, not necessarily those of the regulator.[22]

> Firms' internal systems and controls are designed to achieve their own goals, not necessarily those of the regulator.

It will likely take some time before a clear overall picture emerges of the extent to which firms are internalising the norms of individual accountability and conduct standards under the IARs and taking seriously their responsibilities to monitor and take action against individuals at any level in their firm who fail to conform to these standards. In this regard, a December 2020 report by APRA into implementation of BEAR noted that more needed to be done by the regulated firms to monitor compliance with the conduct standards and to address breaches.[23] Also, an early indicator from the UK, outlined above, of the paucity of notifications from firms to the regulator of misconduct is not an encouraging sign.

What more needs to be done?

Whilst the IARs focus on firms and individuals in order to generate behavioural and culture change in the financial services industry, in my recent book, "New accountability in financial services: Changing individual behaviour and culture", co-authored with Dr Joe McGrath, we argue that more can be done at an industry-wide level to facilitate and encourage behavioural and culture change.

In this regard, to address how behaviours can be changed, one needs to look at what motivates the behaviours in the first place. Research shows that behaviours are shaped by a complex interplay of factors at the individual level (such as incentive structures), level of the firm (such as the firm's culture) and wider structural factors, including the industry in which the individual's firm operates.[24] Whilst the new IARs address influencing factors at the level of the individual and the firm, they're not really designed to address the wider industry/structural factors.

Accordingly, one of the arguments we make is for a "trajectory towards professionalism"[25] in financial services, with the aim of normalising good behaviours and using peer pressure to encourage change. ▶PAGE 103 As the Dutch regulator, the DNB, has argued, "peer pressure regulates behaviour".[26]

In our view, this could include:

- Further development of continuing professional development (CPD) requirements, particularly for senior executives and in areas related to ethical behaviours, beyond minimum requirements imposed by regulation.

- As noted in the UK PCBS Report, forcing more junior staff to obtain qualifications and meet CPD requirements, but giving a "free pass" to those at the more senior levels, "would ignore the lessons of the [2007-8 financial] crisis."[27]

- Work on this is already well underway in many jurisdictions. Banks in Malaysia, for example, have signed a commitment with the Asian Institute of Chartered Bankers (AICB) to enrol key staff, including board directors, on AICB programmes and to complete courses on ethics and professional standards.[28]

- Industry-generated codes of conduct that provide more detail on the conduct that is expected under the relevant conduct rules, including in relation to the "reasonable steps" that senior managers must take under the IARs. Such industry-generated codes might serve as a potential "safe harbour" for individuals, where they can demonstrate that they have acted in accordance with such codes (as in the UK),[29] or could be legally enforceable by the regulator (as is possible in Australia).[30]

- Industry-generated codes are an increasing feature of the financial services industry (e.g., the Global FX Code)[31] and could be a useful means of providing further valuable guidance to industry. ▶PAGE 329 In the UK, the industry-funded body, the Financial Services Culture Board for example has issued a number of SMCR-related good practice guidance documents[32] and industry-generated guidance such as this will likely assist in improving behaviours in the industry.

- There appears to be some reluctance on the part of regulators to provide very detailed guidance on the conduct standards under the IAR, perhaps on the basis of a concern that documented formal guidance might provide firms and their lawyers with scope for "gaming" the requirements. In this regard, a 2019 UK industry report, which assessed the impact of SMCR on the industry, recommended that further guidance should be made available on the conduct rules and that such guidance "is unlikely to be provided by the regulators and may be an action for industry to pursue itself".[33] Further industry-wide engagement on issues such as this may serve to increase engagement within the industry on ethical issues and, through this process of active engagement within the industry, facilitate an internalisation of the ethical norms that underpin the IARs.

More can be done at an industry-wide level to facilitate and encourage behavioural and culture change.

Conclusion

The available survey evidence, from the UK and Australia, indicates that the new IARs have given rise to some improvements in internal governance, in particular in terms of clarifying individual roles and responsibilities and concentrating the minds of senior individuals on the standards of conduct expected of them as individuals.

As to whether we can expect this to result in improvements in ethical behaviours and culture in the financial services industry, it is too early to tell. Also, as outlined above, whilst sanctioning senior individuals for misconduct or for turning a blind eye to misconduct is an important element of the overall toolkit for deterring misconduct under the IARs, there are also other constructive steps that regulators and the industry itself can and should take to normalise higher standards of behaviour and marginalise poor behaviours in the industry.

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ENDNOTES

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Good Counsel

Blockchain Intelligence and BSA/AML

by LINDA JENG & ARI REDBORD

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TRM

"How do we build a regulatory framework that creates the room to foster what's positive about innovation while at the same time ensuring that bad actors can't take advantage of innovations more effectively than the good guys?" —Him Das, Acting Director of FinCEN

Introduction

There is a common misconception that the crypto sector is unregulated and rife with illicit activities.[1] In fact, the risk controls inherent in blockchain technology make it far less likely for firms to engage in misconduct without being identified and traced. While we often hear crypto referred to as the Wild West, the truth of the matter is that most cryptocurrency businesses in the U.S. — from exchanges to brokers, custodians to ATMs — are regulated just like other money service businesses (MSBs). In fact, any transfer of value is subject to the Bank Secrecy Act (BSA), the U.S. anti-money laundering framework. The BSA was passed by Congress in 1970. It was perhaps the first law of its kind and designed to fight money laundering by organized crime. The BSA required that banks record and report transactions equal or greater than $10,000.

It is also a common misconception that the crypto sector attracts more illicit activities than traditional finance, including cash. While numbers differ, it is widely accepted that criminal activity represents less than one percent of the overall crypto economy, which is a small albeit swiftly growing sliver of global GDP.[2] By comparison, according to the United Nations, it is estimated that between 2% and 5% of global GDP annually ($1.6 to $4 trillion) is connected with money laundering and illicit activity.

This crypto economy is growing rapidly. Just in the last year we have seen an explosion of digital assets on blockchains. We have moved from a Bitcoin-only world to a landscape populated by myriad cryptocurrencies, stablecoins, central bank digital currencies (CBDCs), decentralized finance (DeFi) and non-fungible tokens (NFTs). We have seen a movement toward mainstream adoption by traditional financial institutions and investment by both sophisticated and novice investors. Remittances can now be sent home at the speed of the internet, and, in a growing number of countries, previously unbanked individuals can now engage with a new, more open financial system with only a cell phone.

The same qualities that make crypto a force for good — permissionless, programmable and instantaneous value transfer across borders — also make it attractive to illicit actors. Crypto can be used by cybercriminals, rogue nation state actors, and terrorist financiers to launder funds at unprecedented speed and scale.

Just as criminals use any form of value to launder money, using instruments ranging from cash to arts and antiquities, they can also use crypto. However, the extreme transparency feature of blockchain makes detection of illicit activities easier since there is a shared, immediate, and immutable record of all transactions.

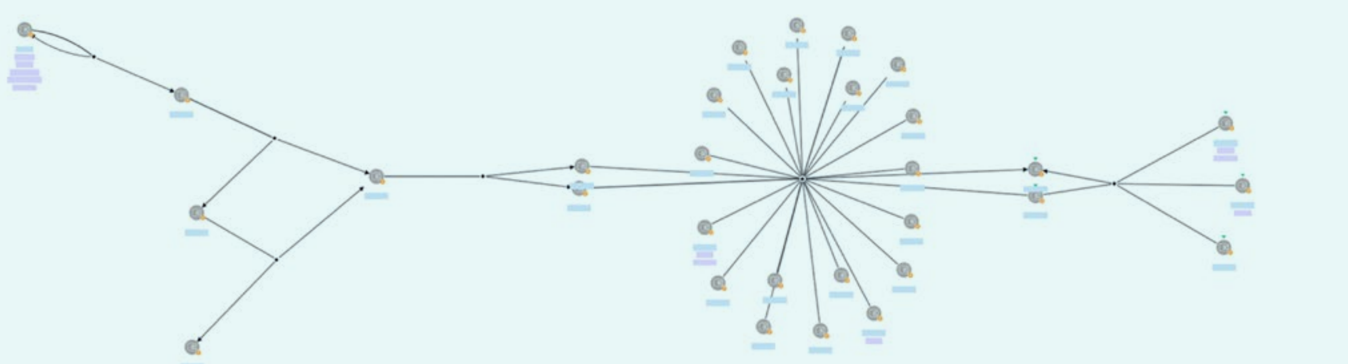
What is "Blockchain Intelligence"?

Thus, "blockchain intelligence" is the practice of organizing and analyzing on-chain data—by timestamp, currency, address, or the service used to conduct the transaction, for example—to map trends or patterns of activity, detect links to off-chain data points, or surface other attributes that might indicate risk. Blockchain intelligence takes the raw, accessible public blockchain data and layers it with threat intelligence.

Blockchain intelligence—also known as blockchain analytics—allows law enforcement, regulators, and compliance professionals more visibility on real-time financial flows then they ever had before. The nature of blockchain — the open and distributed ledger upon which tokens can be sent — means that each transaction is verified and logged in a shared, immutable record, along with the timestamp of the transaction and the addresses involved. This data from the public blockchain is accessible to anyone on the blockchain.

For example, when a terrorist organization posts a crypto address on social media to solicit donations, that address is tagged in a blockchain intelligence tool like TRM Labs as being connected to terrorist financing. This allows a cryptocurrency exchange, for example, to flag any transactions involving that address, assess the risk, and take any action that may be required of them based on regulatory requirements. In addition, blockchain intelligence is used to trace and track the movements of funds to and from an address associated with a hack, an NFT rug pull, or some other exploit against a crypto business in order to help investigators follow the money and, in certain circumstances, work to recover it.

For example, in the May 7, 2021 ransomware attack on Colonial Pipeline — an attack that shut down operations of the 5,500-mile pipeline that delivers 45% of the gasoline and jet fuel supplied to the U.S.'s east coast, causing gas lines closings and even school closings — law enforcement used blockchain intelligence to track, trace and investigate the movement of the Bitcoin ransom payment. Through the use of intelligence and excellent police work,



TRM

DarkSide Ransomware Payment

Following the Colonial Pipeline ransom payment with blockchain intelligence tool TRM Labs.

law enforcement was ultimately able to identify the destination of funds and seize the ransom payment. That recovery was possible only because cryptocurrency was the medium of payment.

Blockchain intelligence to support compliance and risk management

Blockchain intelligence is not only used by law enforcement as a tracing tool. It is also used by financial institutions and cryptocurrency businesses as part of their crypto compliance programs. Over the last few years, regulators across the globe have begun to piece together a framework for the way they intend to regulate cryptocurrencies. The Financial Action Task Force (FATF), the United States Financial Crimes Enforcement Network (FinCEN), and other financial regulators have issued guidelines on how Virtual Asset Service Providers (VASPs) should comply with Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) regulations.

FATF Guidance

In FATF's most recent guidance, the global standard setting body for anti-money laundering (AML) invoked the use of blockchain analytics over-and-over again, citing the technology as a way for regulators to gain visibility over their regulated ecosystems and for VASPs to comply with their AML obligations. Again, because of the unique visibility of the blockchain, financial institutions are able to screen wallets and monitor transactions in real time as well as trace the source and destination of funds connecting the alphanumeric cryptocurrency addresses to real-world entities.

Which businesses are classified as VASPs and what are a VASP's regulatory obligations? According to FATF, any business that transfers virtual assets; exchanges between virtual assets or between virtual assets and fiat currencies; administers the safekeeping and/or administration or virtual assets or instruments enabling control over virtual assets; or participates in and provisions financial services related to an issuer's offer and/or sale of a virtual asset, is a VASP. This definition encompasses a range of crypto businesses, including exchanges, asset issuers and crypto payment processors. VASPs are required to register or obtain a license in the appropriate jurisdictions; implement Know Your Customer (KYC), enhanced due diligence, and transaction monitoring procedures; and comply with the Travel Rule which requires VASPs to identify the originators and beneficiaries of certain transfers, and send that information to their VASP counterparty, where one exists. VASPs must develop compliance programs that include in-depth risk assessment, robust due diligence, and transaction monitoring controls.

The Cat and Mouse Game

As blockchain intelligence becomes more sophisticated, so do the threats from illicit actors. Just recently we have seen OFAC-sanctioned, nested exchanges — or "parasite" VASPS — SEUX and Chatex, which had no compliance controls and, therefore, facilitated ransom payments and other illicit activity. These types of entities, which live on the architecture of larger compliant exchanges, are becoming more and more common as threat actors look to engage with the illicit underbelly of a growing and overwhelmingly lawful crypto economy to evade law enforcement and regulators. Similarly, we have recently seen the U.S. Department of Justice charge darknet mixing services Helix and Bitcoin Fog for conspiring with operators of darknet markets to launder funds and evade detection. But, the Javert and Valjean cat and mouse game long predates cryptocurrencies. As law enforcement develops new, more sophisticated tools, criminals will continue to seek ways to avoid them.

Conclusion

In 2020, Congress passed the Anti-Money Laundering Act (AMLA). The changes introduced by the AMLA are broad and the most significant since the USA PATRIOT Act of 2001 with the goal of modernizing and improving BSA/AML compliance programs. Changes range from establishing a beneficial ownership database, broadening law enforcement subpoena powers to using new technologies for BSA compliance. AMLA also expands BSA/AML to antiquities, art, and virtual currencies. This expansion in scope and expanded definition of "money transmitting businesses" to include transfer of "value that substitutes for currency" requires that virtual currency businesses that qualify as "money transmitting businesses" register with FinCEN.

Acting FinCEN Director Him Das, in his inaugural speech at the American Bar Association on January 13, 2022, announced perhaps the dawn of a new era aimed at modernizing and streamlining BSA/AML compliance. His speech acknowledged the need to build a new regulatory framework that takes into account in a risk-based manner both the new threats as well as the new opportunities presented by innovations. He may be the first federal financial regulator to raise the possibility of regulatory sandboxes and to build new partnerships with the private sector through these sandboxes.

We think this balanced approach, that relies on emerging technology to mitigate risk, will go far in ushering in a regulatory framework that can sufficiently regulate the "digital world [that] increasingly becomes the financial world — and vice versa…"[3] — where blockchain technologies and blockchain intelligence can help deter and identify illicit activities, and ultimately enhance the risk and conduct culture of many participants in the financial system.

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ENDNOTES

1 See Treasury Secretary Yellen's remarks to the Senate Finance Committee (Jan. 19, 2021): "I think many (cyrptocurrencies) are used, at least in a transaction sense, mainly for illicit financing. And I think we really need to examine ways in which we can curtail their use, and make sure that anti-money laundering (sic) doesn't occur through those channels."

2 Financial Stability Board (FSB) Chair's Letter to the G20 (March 13, 2018): "The FSB's initial assessment is that crypto-assets do not pose risks to global financial stability at this time. This is in part because they are small relative to the financial system. Even at their recent peak, their combined global market value was less than 1% of global GDP. In comparison, just prior to the global financial crisis, the notational value of credit default swaps was 100% of global GDP."

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ANNUIT CŒPTIS
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NOVUS ORDO SECLORUM

A *Compendium* of Regulatory Priorities Aimed at Culture and Conduct Challenges in the Financial Sector

This section comprises the main body of our annual report — the "*Compendium*" proper. It is broken out by global regions and specific national jurisdictions in each. Where practicable, we have broken the information out further to highlight specific regulatory or supervisory agencies, standard-setting bodies, and other industry organizations of relevance.

We highlight here the activities and priorities that were in evidence over the last year, both with regard to the supervision of culture and conduct risk concerns and in terms of expectations for the governance thereof within firms. Some markets have experienced more significant public activity, often driven by scandal and public reaction to such. Others have featured less public activity, which may or may not mean that they are actually devoting less attention to issues of culture and conduct, as regulators often engage with firms outside public purview.

We are pleased, therefore, that our efforts to curate and collate relevant information have been complemented by the many **In Focus** contributions that we have received from regulators and leading industry figures from nearly every major financial market, worldwide. You will see that input incorporated throughout this section, significantly enriching it.

Please note that the following summary seeks not to make qualitative judgements but, rather, simply to provide our readers with some organized information concerning the global culture and conduct risk supervisory agenda, identifying trends and open questions.

Every year, in the course of writing this report, we pull out a list of ten key takeaways which represent the topics that received the greatest attention in the past year, or which serve to highlight new trends and developments of particular note. This list is never the same year to year. With that being said, it is perhaps useful to take note of the takeaways which remain on the list year-on-year, those new to the list, and those that dropped off.

The first key takeaway from this report, and one which was entirely unforeseen prior to the Russian invasion of Ukraine in February of this year, is that **financial sector integrity is a national security interest**. This theme emerges from the unprecedented sanctions levied against Russian banks, corporations, politicians, and oligarchs as penance for this act of unconscionable aggression. Firms across the globe have either elected to or been forced to cease their operations within Russia and to cut ties with Russian clients.

"In the face of mounting economic pressure on Russia, it is vitally important for US financial institutions to be vigilant about potential Russian sanctions evasion, including by both state actors and oligarchs," Him Das, acting director of the Financial Crimes Enforcement Network (FinCEN), the anti-money laundering bureau of the US Treasury, said. "Although we have not seen widespread evasion of our sanctions using methods such as cryptocurrency, prompt reporting of suspicious activity contributes to our national security and our efforts to support Ukraine and its people."[222] ▶PAGE 196

Another key takeaway from this report is the importance of operational resilience, and specifically how a firm's culture may impact it. **Business 'resilience' requires stable cultural girders**. In a November 2021 Speech, Peter Routledge, Canada's Superintendent of Financial Institutions, laid out his views on the importance of culture as a driver of sound decision-making and operational resilience:

> *Whether you are a regulated entity or the regulator, ensuring you have a responsible and forward-thinking organizational culture in place will not just help mitigate the impact of any future "black swan" events — and rest assured, COVID-19 will not be the last of these — it will also blunt any criticism that due consideration has not been given to acting responsibly and prudently.*[223] ▶PAGE 229

Among the key takeaways of our 2020 and 2021 reports was the importance of **social capital**. "Broad us-them antagonisms were replete in the past year, many exacerbated by the COVID-19 crisis, leading to a heightened demand that we rebuild our 'social capital,'" we wrote. "Many look to the business-sector to take the lead. Mitigating misconduct, and the social harm it may cause, is not enough — there is now insistence that firms demonstrate an ability to do social good."

This has become even more evident in the last twelve months, and it is now widely acknowledged that **social concerns are business concerns**. This has not only arisen in relation to firms' adherence to the sanctions regime, though that is a prime example, but also in pressure for firms to act as good corporate citizens more generally.

Another major theme of this report is that **culture and conduct challenges are governance issues**. As such, regulators and supervisors have sought to establish corporate governance requirements which would elevate culture to an executive and board-level concern. One way this has materialized is through enhanced reporting requirements surrounding Environment, Social, and Governance (ESG) concerns.

In December, for example, the Singapore Exchange (SGX) unveiled plans to mandate ESG disclosures related to climate and board diversity. Among these requirements are mandates that issuers set policies on board diversity that address gender, skill and experience and publish sustainability reports alongside their annual reports.[224] ▸PAGE 267

"Recent uncertainties have posed financial and governance challenges for boards. Having a broad set of perspectives will better enable companies to anticipate and face these challenges. It is therefore crucial that boards are diverse and have the necessary skill and experience to deal with the complexities of today's operating environment," Singapore Exchange Regulation CEO Tan Boon Gin said.

However, many well-informed observers have called for more focus on the G piece of ESG: **"G is Key,"** argues Blackrock co-founder Barbara Novick. ▸PAGE 427

Another way regulators are seeking to improve governance around conduct risk is by establishing formal regimes for **individual accountability**, which seek to hold executives accountable for culture and conduct failings within their organizations. This trend made its way onto the key takeaway list in both of the previous two editions of this report.

The work has continued in the past year, as evidenced by the impending expansions of formal accountability regimes in Australia, which has continued its work the Financial Accountability Regime (FAR) ▸PAGE 295, and Ireland, which has nearly passed the Senior Executive Accountability Regime (SEAR) ▸PAGE 260.

This specific theme does not appear on this year's key takeaways, as it seems the focus on accountability has intersected with another topic we discussed last year, the increasing emphasis on **outcomes over intent**, to drive a broader takeaway from this year's report.

The focus on individual accountability, alongside the increasing focus on outcomes, has brought us into an **era of accountability**, where firms and regulators are held to account by key stakeholders for the outcomes they achieve — or fail to achieve.

For example, the Australian government and its Parliament have established the Financial Regulator Assessment Authority (FRAA), which is tasked with evaluating the efficacy of the countries financial regulators: the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC), and the Australian Transaction Reports and Analysis Centre (AUSTRAC).[225] ▸PAGE 295

Employees have also sought to hold their firms accountable for their actions by **speaking up and speaking out**. In July of last year, *Bloomberg* reported that senior leaders at HSBC, the country's largest bank, had received a 48-page report with the results of a survey on diversity and perceptions of racism among the firm's employees. The report, produced by an employee of the firm, detailed examples of racism, discrimination, and harassment that employees had faced at work and work-related functions. The report concluded that HSBC sufferers from "abnormal levels of systemic discrimination."[226] ▸PAGE 237 When employees do not feel their concerns are being taken seriously, they have begun **voting with their time** by resigning and finding employers whose values align more closely with their own. This is evidenced by the "Great Resignation" challenging leaders in nearly every industry and jurisdiction globally.

As remarked upon in our past reports, the **regtech and suptech** space has continued to generate interest among regulators, central bankers and standard setters in the course of the last 12 months. We have also discussed the desire for **forward-looking metrics**, to "move beyond assessment of risk management systems and processes to examine the cultural norms and 'people dynamics' within a firm."

The convolution of these themes manifests as another key takeaway from this year's report, the desire for systems that help to **'predict & prevent'** misconduct, supplanting the traditional 'detect and correct' model of conduct risk management.

Jessica Rusu, the UK Financial Conduct Authority's chief data, information and intelligence officer, explained the value of data and other technologies to the regulators' efficacy in supervising financial institutions. "We're making the most of the data and intelligence we collect to anticipate and predict harm," Rusu said. "We regulate over 51 thousand firms — including thousands of small firms — and the data we collect from them helps us to understand, prioritise, and intervene more effectively than ever before."[227] ▶ PAGE 237

Among the key takeaways from 2021, there were several which are not present on this year's list: **work-life balance**, **psychological safety**, and **behavioral science**. This is not to say that efforts are not being made in these directions, or even to say that they have decreased. However, they have become so soundly baked-in to regulatory and industry priorities that they no longer warrant specific mention as key takeaways. They are now table-stakes.

The main body of our annual *Compendium* begins with the United States, where we have seen all the foregoing key themes at work, making the market a good starting point for this global tour of happenings relevant to culture and conduct in the financial sector.

United States

INDUSTRY AND REGULATORY BACKGROUND

Misconduct in the Industry

The past year has witnessed aggressive regulatory action to punish misconduct and failed risk management across the financial industry in nearly every jurisdiction. However, US financial institutions have faced some of the most costly misconduct fines and sanctions globally.

Wells Fargo, for example, has been plagued with crises since its false accounts scandal came to light in 2015. In the wake of this scandal, the Federal Reserve placed an asset cap on the bank, which had cost it around $4 billion in profits by August 2020.[228] In 2018, the OCC assessed a $500 million fine against Wells Fargo and issued a Consent Order, requiring that it improve its compliance risk management capabilities in response to entirely separate problems in its mortgage servicing business.[229]

The firm has since come under fire for failing to make the improvements required by this Consent Order, and other regulatory actions, swiftly enough in the years following. Wells Fargo CEO Charlie Scharf has requested patience and more time to satisfy the requirements set forth in the Order.[230] Nevertheless, the OCC levied another $250 million fine against Wells Fargo in September 2021, and imposed other restrictions on the bank's activities, until it demonstrates substantial change.[231]

That same month, U.S. Federal Reserve Chair Jerome Powell stated that the asset cap imposed on Wells Fargo would remain in place until the bank had made more progress resolving its "widespread and pervasive" problems, and indicated that the Fed would consider further action if it does not.[232] Later in the year, a federal judge ruled that the bank must face a shareholder lawsuit regarding false information

Culture & Conduct Risk Regulatory Landscape

Summary

For the third year, Starling offers its Culture and Conduct Risk Regulatory Landscape chart. The Landscape provides a means to compare the various strategies and approaches the global regulatory community has adopted with respect to the supervision of Culture and Conduct Risk.

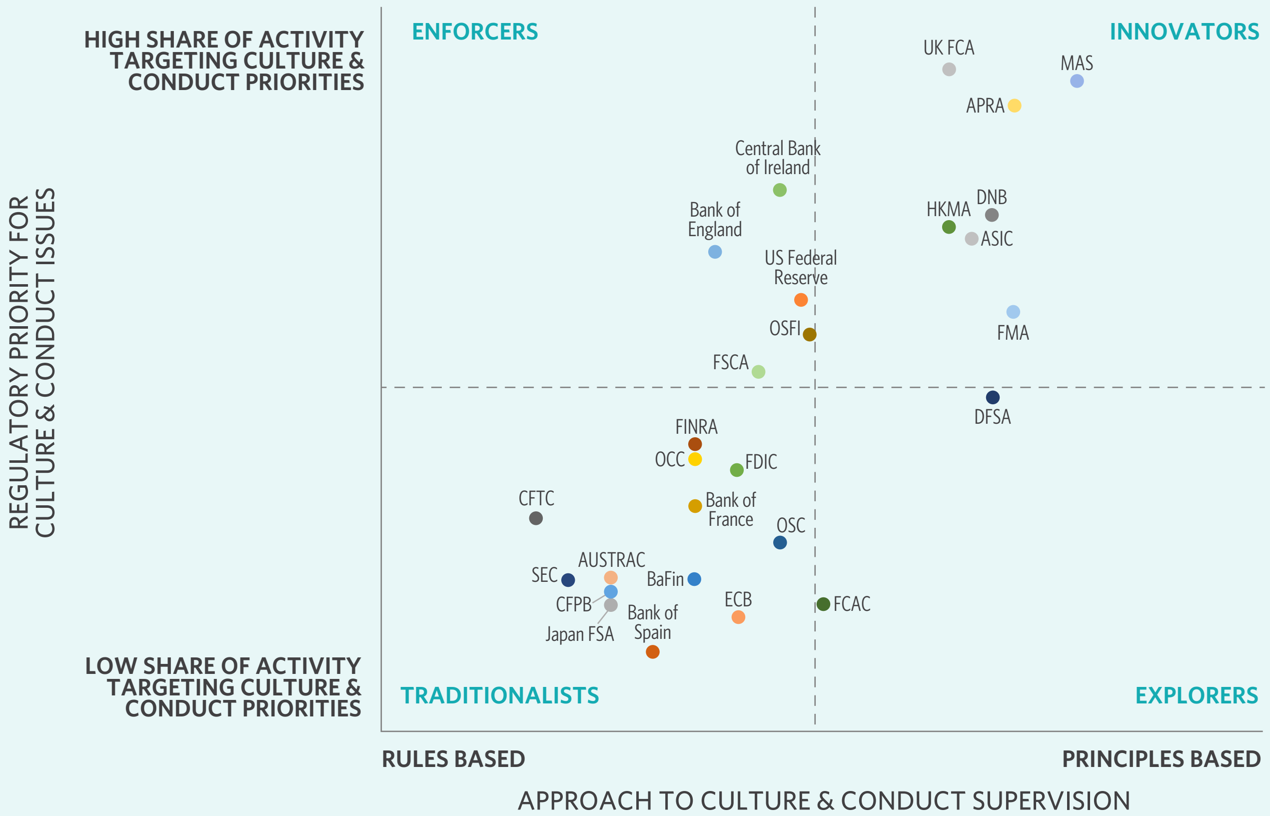
The X-axis describes the relative strategies regulators have taken to the supervision of Culture and Conduct risks and whether those strategies tend more towards a Rules-based vs a Principles-based approach.

The Y-axis reflects the relative prioritization of programs and activities targeting culture and conduct risk vs other regulatory priorities. This does not necessarily reflect total resource commitments. Rather, this measure captures each regulator's relative mix and range of activities and programs that are designed to support a Culture and Conduct agenda.

In producing this chart, we relied on responses to our annual Survey which we complemented with regulatory announcements, speeches, and other public information. As such, this analysis does not reflect any guidance regulators may have issued privately.

Our goal is not to make value judgements as to which approach is most effective. There are numerous factors that influence regulatory approaches which go beyond the scope of this exercise. Rather, our intent is to represent how various regulatory and supervisory bodies have positioned themselves publicly in an effort to identify forward-oriented trends. It is appropriate to assume that current events and politics will drive changes to the regulatory stances reflected herein.

Culture & Conduct Risk Regulatory Landscape



it shared with investors about the state of its transformation efforts and ability to recover from the numerous scandals it has faced since 2016.[233]

In July 2021, a former executive in the bank's investment banking division described the executive team as a 'mafia' which colluded to silence internal critics.[234] This paints the picture of an environment lacking psychological safety and a 'speak up culture,' greatly contributing to the likelihood of misconduct going unreported by employees.

In November, Wells Fargo's former head of consumer banking, Mary Mack, testified before the US Office of the Comptroller of the Currency (OCC) that the employees of the bank feared for their jobs and were afraid to speak up when they witnessed misconduct. Mack also stated that, before her tenure, promotions were based entirely on sales numbers, setting up an incentive to engage in the sort of behavior that got the bank into hot water.[235]

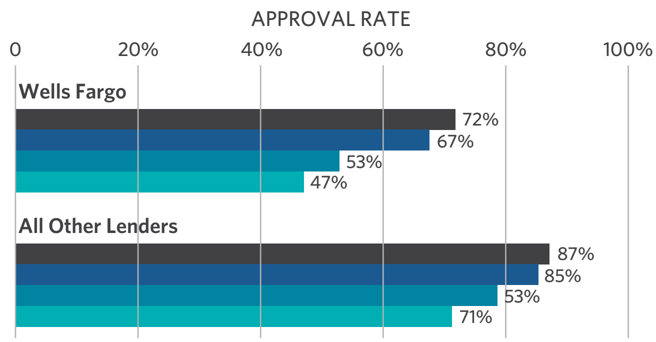
In January 2022, Wells Fargo's Chief Risk Officer, Amanda Norton, announced that she would be retiring from the firm. Norton joined in 2018, to help the firm recover from the rash of scandals it had encountered.[236] In the same month, the bank announced that the OCC had terminated a 2015 Consent Order stemming from faulty product marketing and billing practices.[237] This Order was unrelated to the 2018 Consent Order that the bank entered into as a result of the false accounts scandal, which remains in place today.

In February 2022, Wells Fargo was accused of unfair practices in its dispute resolution process. The judge wrote that the bank had manipulated a list of arbitrators to decide on a customer's claim that the bank had botched his investments, with the permission of the Financial Industry Regulatory Authority (FINRA), a private self-regulatory body, which has since faced scrutiny of its arbitration process.[238]

Wells Fargo was back in the news in March 2022, when *Bloomberg* reported that there were racial disparities in the bank's mortgage approval process that were greater than the already discrepant industry-wide statistics. In 2020, for instance, only 47% of black applicants were approved for refinancing versus 72% for white applicants. While Wells Fargo does not deny these statistics, it does deny that there are any racial motives in its decisions, instead citing differences in credit scores and other factors out of its control.[239]

Disparity by Lender

Wells Fargo approved fewer than half of Black homeowners' refinancing applications in 2020



Source: Bloomberg analysis of Home Mortgage Disclosure Act data for 8 million completed applications to refinance conventional loans in 2020.

Wells Fargo has faced scrutiny from all sides in the wake of the *Bloomberg* report. A class-action lawsuit alleges that the bank is engaging in "modern day 'redlining' practices."[240] Soon after, Senators Elizabeth Warren and Ron Wyden demanded that the bank provide data on its mortgage and refinancing approval process.[241] Then, New York City Mayor Eric Adams and Comptroller Brad Lander promised that the city would block Wells Fargo from obtaining any new contracts for banking services.[242]

"These disparate mortgage practices, layered upon a checkered history of steering homeowners of color into subprime mortgages, rejecting mortgages in redlined neighborhoods, and numerous outstanding consent decrees pertaining to mortgage practices, require a swift response by both your bank and stakeholders," the two officials said. "In light of this

Education and Ethics

By JAMES HENNESSY & THOMAS NOONE


James Hennessy


Thomas M. Noone

The views expressed in this article are the personal views of the authors, and may not necessarily reflect the views of the Federal Reserve Bank of New York or the Federal Reserve System. Thanks to Cameron Lawrence, Maureen O'Hara, Esra Ozer, Stephen Scott, and Celine Hwang for their comments.

Has this ever happened to you: You work diligently on a problem — week after week, perhaps year after year — and then one day, out of the blue, someone else offers an observation or solution that had never occurred to you? "Yes! Eureka! Serendipity!" But also, "Ugh — why didn't I think of that?"

If that has happened to you, you can sympathize with our position last month when we heard the following from Maureen O'Hara, the Robert W. Purcell Professor of Finance at Cornell University's Johnson Graduate School of Management. "Ethical behavior, if it exists, does so in clusters and only clusters of sufficient density can stop contagion of non-ethical behavior." That, in short, was the conclusion she and her co-author, David Easley, reached in a recent paper entitled "Market Ethics."[1] And that's what we wish we had said with equal brevity and insight. To behave ethically, it helps to have the support of others who also behave ethically. For ethics to persist in a market, the presence of other ethical people needs to be sufficiently dense to deflect pressure (profit opportunities) to behave unethically. ▸PAGE 445

O'Hara and Easley's theorem — which we'll explain in more detail below — underlies the New York Fed's attention to culture in the financial services industry. Starting seven years ago, we and our colleagues have attempted to shine a spotlight on industry norms and how they align with or depart from the public's expectations of banker conduct. One of us (Jim) leads the New York Fed's Culture Initiative. The other (Tom) coordinates one aspect of the Initiative: the Education and Industry Forum on Financial Services Culture — or "EIF," for short.

In this article, we will introduce you to the EIF. Perhaps more directly than any other aspect of the New York Fed's Culture Initiative, the EIF aims to build clusters of ethical bankers in numbers sufficient to deter bad practices from spreading through the industry. We want to move the development of ethics in finance upstream — into the classroom. We're doing this principally by developing educational tools that introduce ethical dilemmas to business students at the undergraduate and graduate levels. These tools are prepared by teams of professors and bankers, who supply pedagogical know-how with real world experience. What's more, the tools are available for free on the New York Fed's public website.

We want to move the development of ethics (i.e., good habits) in finance upstream — into the classroom.

If any of this sounds interesting, we'd love to work with you. Regardless of your availability or expertise, there is a way for you to help. One of the key lessons of our work on culture is that no one has all the answers. A diversity of views is not only helpful. It's essential. So, please: Hear us out. And, if you'd like to work with us, get in touch.

The EIF

If you're reading this article, chances are you know a bit about the New York Fed's Culture Initiative already. If not, here is a brief summary.

Following the global financial crisis, bank regulators around the world dedicated their best efforts to two goals: institutional resiliency and systemic stability — often referred to as "microprudential" and "macroprudential" objectives, respectively. The means of accomplishing these goals was to study how banks financed themselves and how they were interconnected. This was essential work to detect, diminish, and deter financial risk large enough to affect the real economy.

But, as Bill Dudley, then the New York Fed's President and CEO, remarked in 2013: "[C]ollectively these enhancements to our current regime may not solve another important problem evident within some large financial institutions — the apparent lack of respect for law, regulation and the public trust. There is evidence of deep-seated cultural and ethical failures at many large financial institutions."[2] While regulators and supervisors were improving resiliency and stability, they were also witnessing an unprecedented number of conduct scandals.

Two scandals in particular drew the attention of our colleagues at the New York Fed: LIBOR and FX manipulation. The misconduct in these cases depended on collusion by multiple bankers across banks. These were not just "a few bad apples" who managed to evade one institution's compliance systems. The bankers involved in these schemes used professional networks outside of their organizations to cheat. What's more, the bankers plotted in chat rooms that they knew were monitored. Even surveillance of their communications didn't stop them.

How can you explain their behavior? In our view, the problem was normative. The industry had developed habitual unwritten rules of conduct that prioritized short-term gain above long-term value, and that made adherence to law a cost that could be offset by sufficient gain. How did those norms develop? And how could they change? We had suspicions, but no firm answers. Our goal became to draw attention to the issue of behavioral norms in financial services — and banking, in particular.

Over the years, the New York Fed has gone about "shining a spotlight" in a number of ways. We've convened conferences that showcase expert learnings about culture in a variety of organizational settings. We created a forum for prudential supervisors to exchange views on industry norms and tools for measuring them, called the Supervisor's Roundtable. We built a public website that serves as a clearinghouse for information about culture in financial services. And, since the start of the pandemic, we've hosted a series of webinars and podcasts hosted by the New York Fed's President and CEO, John Williams. Those discussions focused on topics related to norms and ethics in finance.

The EIF is among our more recent projects, although its roots go back several years. In 2016, the New York Fed first proposed a collaboration between business schools and the official sector on the issues of culture and ethics. Several professors raised their hands to help. So did a number of bankers. Our first few meetings, though, were not especially productive. There was a fair bit of finger pointing. Some professors argued, in essence, "Banks get what they pay for. If they want better conduct, reward it!" Some bankers (and a few notable professors[3]) argued that economics education excelled at technical instruction but failed at inculcating good judgment. ▶PAGE 355

After several attempts, we found common ground. In 2019, the New York Fed launched the EIF. Roughly half of the group's members are business and legal academics with experience in ethics, finance, and administration. The other half are senior bankers who participate with the support of their employers. The New York Fed convenes and supports the committee, but the members do the hard work.

The EIF's first project was to publish a series of six case studies. In each, the protagonist is a junior banker facing one or more ethical dilemmas. Each of the dilemmas is based on real examples, often borrowed from public sources. For example, in "Bidding in an Auction," by Ingrid Keating from HSBC and Jeremy Kress of the University of Michigan, an analyst joins a firm that is struggling with its bottom line. She is staffed on a project to turn around an investment in "green" power plants — and quickly learns that the path to profitability will involve exploiting a loophole in a state-sponsored energy auction. The analyst has to wrestle with whether a bid that is arguably legal is ethically acceptable. Along the way, she considers questions like "Is it OK if everyone else is doing it?" "Who gets to decide what's right?" "What am I paid to do?" "Do the social costs of my decision matter?" "How do I explain a strategy that I don't really like?" "What do I do when my personal sense of right and wrong conflicts with my professional assessment of what's best for my employer?"

The six case studies vary in subject matter, length, style, and dilemmas — although a few common questions arise in multiple cases. For example, several cases present facts that do not make it easy to speak up — peer pressure, client demands, and supervisor expectations. Many cases, like "Bidding in an Auction," invite students to debate their personal responsibility for the ethics of a business decision. Several cases also contain multiple parts, which invite students to rethink their previous answers in light of new facts, and present questions that challenge their instincts and the rationalizations for their choices. And, in every case, the authors tried to make the examples as "real" as possible — incorporating time pressure, incomplete information, and risks to personal reputation. "The realism is extremely important," one of our academic members said. "These are not cases that faculty members have dreamt up themselves. They came from the workplace."

The six case studies were published in October 2020 are available on the EIF's public website. The authors of the case studies also prepared teaching guides that supply additional background information, ideas for classroom presentation, and supplemental questions. Those guides are available upon request to the New York Fed.

This year, the EIF is continuing to write and publish case studies and is developing supplemental digital content for use in the classroom. For example, we will be interviewing senior bankers, prosecutors, and policymakers about the importance of ethics in financial services. We hope to create a virtual speakers bureau of authoritative voices on industry norms, ethics, and the importance of trustworthiness. Organized in a database by issue, speaker, and duration, business professors can use these videos in a variety of classes to illustrate the ethical dimensions of business decisions. As we mentioned at the top of this article, it is our firm belief that having more voices contribute to a discussion is almost invariably helpful.

Market Ethics

Back to O'Hara and Easley.

Their paper is a sophisticated combination of psychological game theory and contagion-in-networks research. It involves charts, Greek letters, and copious citations to economic and behavioral science research. If you're up for the challenge, we highly recommend you read the original. If, on the other hand, you're anything like us — interested generalists — we offer below a summary of what we understand O'Hara and Easley to mean.

Whereas much of the New York Fed's work on culture has been about shared norms, O'Hara and Easley focus on one's personal individual sense of right and wrong — and, more particularly, the phenomenon of guilt. To O'Hara and Easley, ethics are really about guilt — the internal psychological cost of disappointing others by not behaving according to their expectations. The more people hold those expectations, and the more overlapping expectations we breach, the stronger the guilt. When we behave in line with the expectations of others (or, put another way, when we exhibit "disappointment aversion"), we behave ethically. When we depart from those expectations, we commit misconduct.[4]

What happens when one group's expectations conflict with those of another group? How do we decide which in-group status to maintain?

That sounds simple enough, but expectations and guilt can be tricky. For one thing, framing ethics as "disappointment aversion" is value-neutral. Members of the mafia, we suppose, are reluctant to disappoint their fellow mobsters. That doesn't mean their norms — omertà and worse — are ethical, does it? For another, each of us belongs to multiple, overlapping groups. What happens when one group's expectations conflict with those of another group? How do we decide which in-group status to maintain? ▸PAGE 361 How do we know what's ethical if we're bound to disappoint someone? (Our guess: The more immediate the group, the stronger the pull. If we're right, there are important consequences for a remote work environment.)

Some of these questions can be overcome by appealing to a broad set of social expectations that are not context-specific. These broad, social expectations are likely based on the principle of avoiding undue harm to others — what economists call "externalities." To get along in any group, we can't all do what we want. We have to pass up opportunities for personal gain where the cost to others is too high. In other words, ethics is about saying no to some opportunities for personal gain. It's about leaving money on the table. But at least you can sleep well at night. And, of course, there will be other opportunities for personal gain that align with social expectations.

You can see why the number of our connections to other ethical people — the density of our cluster — is important. It's those connections that give rise to social expectations. The more people hold expectations about our behavior, the greater our guilt when we disappoint people. (The quality of those expectations would certainly matter too. Not every expectation or disappointment is the same. But guilt is easier to model based on volume rather than mass.) Surrounding ourselves with other ethical people may also help make ethics more salient and encourage an active ethical identity among groups of employees — a lesson from the New York Fed's series of webinars and podcasts about culture.[5]

How dense does a cluster need to be? In O'Hara and Easley's model, that depends on the potential payoff. For rational actors, the benefits will need to outweigh the costs. Each of us may behave unethically for a price — and some may be dispositionally more likely than others to engage in "price discovery." But, if expectations and guilt are strong enough, that price may have to be unrealistically high. So, if we want a more ethical organization — or a more ethical industry — we will increase our chances of success by fortifying ourselves with good people.

That's why the work of the EIF is important: We're helping to increase the density of junior bankers with good ethical judgment. At least, we're helping to prepare job applicants. Banks decide whom to hire. As the Financial Stability Board observed in 2018, financial firms could use the recruiting process to communicate their ethical and behavioral expectations and design interviews to assess ethical and behavioral competencies. Indeed, not communicating or asking about ethics during recruiting could be problematic: "Silence as to expected employee conduct could signal that the issue is less important to the firm."[6]

O'Hara and Easley explore two sobering postulates beyond their basic, optimistic premise. First, if you map connections among a group, you may identify individuals that serve as gatekeepers — singular links to the broader world. These individuals may be critical in stopping contagion, but identifying them in the real world may be tricky and may only be accomplished in retrospect. That said, there may be technological solutions that could help. Second, a cluster of ethical nodes will only deflect unethical norms up to a point — a tipping point — after which they will rapidly lose influence. Misconduct may spread slowly and subtly, perhaps evading detection, and then suddenly and swiftly — faster than it can be contained. ▶PAGE 403

It's the tipping point that worries us. At the [New York Fed's 2015 culture conference], Stanley Fisher — then the Vice Chairman of the Board of Governors of the Federal Reserve System — asked Christine Lagarde a simple question: Are markets compatible with ethics? He referred her and the audience to a quote from *Phishing for Phools*, a book by Nobel Prize laureates George A. Akerlof and Robert J. Shiller:

> *Whether or not businessmen have good (or bad) morals is not the subject of this book, although sometimes both of these sides will appear. Instead, we see the basic problem as pressures for less than scrupulous behavior that is incentivized in competitive markets. They are terrific at incentivizing and rewarding businessmen heroes with innovative new products for which there is real need. However, unregulated free markets rarely reward a different kind of heroism, of those who restrain themselves from taking advantage of customers' psychological or informational weaknesses. Because of competitive pressures, managers who restrain themselves in this way tend to be replaced by others with fewer moral qualms. Civil society and social norms do place some brakes on such phishing; but in the resulting market equilibrium, if there is an opportunity to phish, even firms guided by those with real moral integrity will usually have to do so in order to compete and survive.*[7]

In other words, if, in a competitive market, there is always someone willing to say "yes" when you say "no" out of a sense of ethics, do markets invariably lead to a "race to the bottom" when it comes to ethics? And, at what point in that decline do we encounter a tipping point — a shortcut to the bottom?

Some might point out that a key word in Akerlof and Shiller's proposition is "unregulated." Is regulation the path to a more ethical market? What do you think? If you measure the Code of Federal Regulation by linear inch, Title 12 (Banks and Banking) is second in length only to Title 40 (Protection of the Environment). Are either banking or environmental practice characterized by ethics? Or are those fields characterized more by finding ways around rules?

Banking is characterized by abundant regulation. Regulation, though, has not assured us that banking is ethical. There are a number of inherent limitations that make it difficult to instill ethics via regulation — although we are watching with keen interest the experiments in other jurisdictions that

There are a number of inherent limitations that make it difficult to instill ethics via regulation

aim to show otherwise.[8] Regardless of jurisdiction, though, we think that O'Hara and Easley are on the right path: Ethics (or the lack of it) comes from the inside — inside the individual and inside the group. It depends on our sense of obligation to others, whether manifest as guilt or altruism or some other psychological phenomenon.

Ethics, at core, is a habit of considering the costs to others as well as the benefits to ourselves.[9] The earlier we develop that habit, the stronger it can become. And the more we surround ourselves with like-minded, ethical people, the easier it will be to preserve and develop our individual sense of ethics regardless of the setting. We hope that the EIF's attempt to "go upstream" on ethics — to work with the industry and the academy on good judgment alongside technical expertise — will help. We would very much appreciate your help, too.

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Thomas M. Noone *is Counsel and Assistant Vice President at the Federal Reserve Bank of New York. He works in the Bank Supervision and Markets division of the Legal Group and serves on the New York Fed's working group to reform the culture of financial services. As part of the culture initiative, he chairs the Education and Industry Forum on Financial Services Culture, a committee of academics and bankers sponsored by the New York Fed. He also serves as Secretary to the Financial Markets Lawyers Group, and as counsel for the New York Fed on the Foreign Exchange Committee — two New York Fed-sponsored committees focused on the global foreign exchange market.*

ENDNOTES

1 David Easley and Maureen O'Hara, "Market Ethics" (Aug. 26, 2019), forthcoming in the *Review of Financial Studies*, available at SSRN: https://ssrn.com/abstract=3415626 or http://dx.doi.org/10.2139/ssrn.3415626

2 William C. Dudley, "Ending Too Big to Fail," Remarks at the Global Economic Policy Forum, New York City (Nov. 7, 2013).

3 See, e.g., Luigi Zingales, "Presidential Address: Does Finance Benefit Society?" 70 The Journal of Finance 1327 (Aug. 2015).

4 One reader of a draft of this piece commented that an emphasis on guilt (self-opprobrium) may reflect a Euro-centric bias. Shame (the opprobrium of others) may be the more salient concept in Asian cultures. Point taken — although O'Hara and Easley's premise is grounded in the internalization of the views of others. Their idea may be more universal than our quick summary suggests.

5 See Toni Dechario, "Lessons on Culture: A Year in Review," Federal Reserve Bank of New York (Mar. 2022).

6 Financial Stability Board, "Strengthening Governance Frameworks to Mitigate Misconduct Risk: A Toolkit for Firms and Supervisors" (Apr. 20, 2018) 47.

7 George A. Akerlof & Robert J. Shiller, *Phishing for Phools: The Economics of Manipulation & Deception* xi-xii (2015).

8 See Michael Held and Thomas M. Noone, "Bank Culture and the Official Sector: A Spectrum of Options," 43 *Seattle U. L. Rev.* 683, 691-694 (2020) (discussing the limits of statutes and regulations in deterring banker misconduct and promoting ethical norms in the industry).

9 See Dan Awrey et al., "Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?" 38 Del. J. Corp. L. 191, 217 (2013) (The "norm of 'other regarding' behavior within financial services firms, [is] one which, to the fullest extent possible, attempts to induce firms to take into account the private and social costs of their decisions.")

persisting track record of discrimination, New York City will not be opening any new depository accounts with Wells Fargo Bank, N.A. as we continue to investigate these troubling findings."

These public scandals have caused significant volatility in the bank's stock price, indicating wavering public confidence in the bank's ability to serve its customers.[243] But it would not be at all fair to say that Wells Fargo is the only financial institution that has struggled with culture and conduct issues.

In late September of last year, the OCC issued a Cease and Desist order against MUFG Union Bank in response to what it described as "unsafe and unsound practices" in the bank's management of technological and operational risks. The Order required that MUFG improve its technological and operational risk governance, technological risk assessments, and other internal controls and practices, in order to address these deficiencies.[244]

This came right as MUFG reached a deal to sell its Union Bank subsidiary to U.S. Bancorp for $7.3 billion,[245] likely assuring yet closer scrutiny of the firm on the part of US regulators. The fate of this merger faced anti-trust concerns, despite the relative small size of both banks, as some regulators look unfavorably on consolidation in general.[246]

Goldman Sachs has also continued to face repercussions for its role in the 1MDB scandal in Malaysia over the course of the past year. In June 2021, a District Judge ruled that Goldman, alongside former executives, must face a shareholder lawsuit accusing them of misleading investors about the investment bank's work in connection with 1MDB.[247]

In February 2022, Goldman investment banker Roger Ng faced trial for his role in the 1MDB fraud. Ng was charged with conspiring to bribe officials and laundering billions of dollars. In his testimony during the trial, Tim Leissner, Ng's former boss, estimated that the bank made $700 million from its role in the scheme. Leissner, who pleaded guilty to charges relating to 1MDB, also said that the investment bankers involved in the scheme achieved "hero status" within the bank.[248] The trial was put on hold, however, after the prosecution revealed that it had failed to share more than 15,000 documents with the defense, calling it an "inexcusable" mistake.[249]

In April, Ng was found guilty of conspiring to violate anti-bribery laws, launder money, and contravene Goldman's internal controls. The investment banker faces up to 30 years in prison for these crimes.[250]

In November, a former compliance executive at JPMorgan Chase & Co. filed a lawsuit against the bank, alleging that she had been fired after raising concerns about the bank's anti-corruption controls and potentially misleading communications with regulators. Shaquala Williams, the plaintiff, was troubled by actions which she believed to be contrary to the bank's 2016 settlements reached with the US Justice Department and SEC, as well as what she saw as "guess work" in the bank's communications with the UK's Financial Conduct Authority. If these allegations are found to be true, it not only exposes the bank to civil and criminal liability, but also potential sanctions from the regulatory agencies named in the suit.[251]

In December 2021, it was reported by several outlets that JP Morgan could soon face a $200 million fine from the SEC for failures regarding its monitoring of employee communications.[252] A few days later, the SEC levied the fine as it found that the firm and its employees had failed to "preserve and maintain" written communications.[253]

JP Morgan was in the news again, in February 2022, for allegedly paying almost $900 million to a company run by a former Nigerian minister who had been convicted of money laundering. The bank is being sued for nearly $1.7 billion by the Nigerian

In Focus

Building a Healthy Anti-Money Laundering Culture

By CHARLES LITTRELL

Charles Littrell

It is obvious why the public sector cares about financial crime, in the context of criminal justice and national security efforts more generally. But why should the average bank or other firm care about reducing financial crime?

There are two answers to the "why should we care?" question.

1. Non-suicidal firms must care because failing to observe financial crime legislative and regulatory requirements will eventually lead to large penalties, and perhaps loss of their licenses to operate.

2. Healthy culture firms should care because dealing with financial criminals is often profitable in the short term, but terribly destructive in the long term.

Many firms confuse a basic issue in AML: they are facing two optimization problems, not one. The first is the compliance challenge: how can firms best balance AML compliance costs and benefits in a way that optimizes long term return on capital?

The second and more culturally interesting problem is the risk management challenge: how can firms ensure they are not facilitating financial crime and financial criminals?

Balancing realism and cynicism

The international research community has increasingly demonstrated that the global AML movement has succeeded in moving hundreds of jurisdictions to consistent and apparently robust laws and regulatory approaches. At the same time, however, this corpus of law and regulation is signally failing to reduce crime associated with money laundering noticeably, or to recover more than a very small fraction, probably less than 1 per cent, of the world's illicitly generated funds.

Financial institutions active in AML can see why this might be the case. They are faced with extensive and very expensive compliance requirements, which are not matched by equivalent results from the public sector. As one of many examples, it has become almost proverbial that the bulk of suspicious transaction reports are not only not actioned, they are not even read by their Financial Intelligence Unit recipients.

Such outcomes can lead to unhelpful cynicism. A healthier approach for each financial institution would be:

- First, to acknowledge that the global and possibly their national AML system is not necessarily working, in an aggregate sense — but this is not any individual firm's responsibility; and

- Second and more importantly, any firm sincerely and competently following the required rules is unlikely to materially contribute to financial crime. Furthermore, good compliance will produce useful benefits for the firms achieving this outcome, starting with much lower risks of sanctions.

The AML compliance challenge

Financial services and related firms in most countries are subject to extensive AML compliance requirements. Although these vary by jurisdiction, the broad approach is that financial services providers are required to identify all their clients accurately, and then monitor accounts, transactions, and any other relevant information for indicators of financial crime. Upon detecting these indicators above some threshold level, financial services providers are typically required to file a report with relevant law enforcement authorities, and in some circumstances to refuse to do business, or cease doing business, with a suspicious client. Financial services firms are also required to observe government mandates for financial sanctions, which have been imposed with increasing frequency.

> Over-compliance in this space will pointlessly reduce returns to capital without much likelihood of reducing aggregate financial crime.

To simplify, the optimization problem is to maximise income less expenses, divided by capital. The AML compliance regime will reduce return on capital, because:

- It lifts operational costs associated with compliance;
- It reduces a firm's ability to acquire and conduct business with clients; and
- It adds considerable risk of fines and other penalties for non-compliance, plus reputational damage, which increases the capital required for any given financial service.

Firms need to understand and accept that AML compliance is at some level non-negotiable. On the other hand, over-compliance in this space will pointlessly reduce returns to capital, without much likelihood of reducing aggregate financial crime.

There is also the consideration that as we better understand financial crime through empirical research, we are increasingly aware that the proceeds of much crime are not laundered, but instead deployed to cover criminal living expenses. Recent research papers separately examining British and Vancouver drug dealers, for example, estimate that a substantial majority of illicit fund-flows are directed to such mundane and untraceable ends as groceries and bar bills, not more formal laundering.

Individual firms would do well to survey the major penalties and sanctions that have applied to banks and other companies in the AML space. Nearly without exception, the really large sanctions have accrued to firms where at least some in management knew they were engaged in dubious practice — and proceeded anyway, often due to profit or budget pressures[1].

Finally, when setting an AML compliance balance, firms would sensibly understand that although most of the banks and other financial services providers in the global economy do not welcome financial criminals, there are at any given time several hundred firms open for illicit business, often in jurisdictions (such as many U.S. states) that have explicitly legislated to welcome and protect this business. This is unhappy news for the AML system, but very good news for jurisdictions and firms wishing to avoid engagement with financial crime. The "good guys" need not be perfect, merely reasonably competent in warding off financial criminals. The people who collectively move hundreds of billions of dollars in illicit assets annually understand they have many good choices — so they are unlikely to waste much time on intermediaries that are demonstrably unreceptive to their business.

This suggests the following optimal strategy to balance income, costs, and risks for a firm's AML compliance efforts:

1. Understand and scrupulously meet the minimum legislative and regulatory requirements applicable to customer identification, transaction monitoring, suspicious transaction reporting, and the like. This minimizes the odds of incurring large compliance penalties.

2. But try to avoid overkill beyond minimum requirements, as this adds to costs and decreases customer engagement. If for example the local rule is that a depositor needs a passport and a driver's license to open a bank account, then don't also ask for a copy of an electricity bill.

3. For large and complex banks and other firms, particularly firms operating across national boundaries, remember that staff, management, and business units far from head office can go rogue in an AML sense. A good corporate AML policy is not enough. The firm's second and third lines of defense must be effectively deployed to ensure that the AML policy is followed throughout the firm.

4. Above all: remember that your objective in AML compliance is neither to produce zero sanctions nor zero financial crime, but instead to produce the best return on capital consistent with sound AML compliance. This suggests you need to spend the time and money necessary to meet a reasonable minimum standard — but nothing more. In the next section, we will discuss how additional effort should flow to risk management, not black letter compliance.

Firms that adopt the above approach will minimize the profit and return on capital decreases associated with AML administrative requirements, while proceeding with the confidence that they are probably protected from an AML compliance or reputational disaster.

The AML risk management challenge

Beyond simple compliance with minimum AML requirements, what else should a bank or other financial services firm do to minimize financial crime? One reasonable answer: nothing. For firms with a "profits first, last and always" culture, this is probably the best answer. However, a great many observers — and sad experience — suggests that "profits first" is a poor foundation upon which to build a healthy culture. Large, unexpected losses will eventually emerge, and AML risks are just added to extant risks for credit, trading, mis-selling, and the like.

Financial crime risk is one among many risks that firms with healthy cultures will manage proactively.

The core element in a healthy firm culture is the idea of balance among stakeholders, including shareholders, customers, staff, and society. As a general observation, healthy cultures also display a longer time horizon for decisions than less healthy cultures. Financial crime risk is one among many risks that firms with healthy cultures will manage proactively.

Experience suggests that, once a firm meets its compliance obligations, financial crime risk management (as opposed to compliance) can be boiled down to one sentence: We are comfortable that all our customers are demonstrably low risk for financial crime.

How do customers demonstrate they are low risk for AML purposes? Broadly, they are not an outlier, or they can explain their outlier status. This applies to their balances, products, and transaction flows. It should also apply within firms below the whole of firm level. We have long known that unexpected upside performance in profit or business volume results should be reviewed carefully for extra risk, such as accepting undue credit risk. Exactly the same applies to branches, subsidiaries, or sales teams who are apparently outperformers in AML-relevant products.

"Only comfortable customers" sounds simple, but at the end of the day, financial services firms themselves seldom directly commit financial crimes. They instead facilitate customers who commit financial and other crimes. Firms that refuse to deal with customers who cannot provide reasonable assurance they are not financial criminals will seldom incur a material AML risk.

It is important to emphasize at this point that the great majority of financial services clients in most contexts can demonstrate they are most unlikely to be financial criminals, if given a fair (and generally cheap) chance to do so. A few clients exhibit rather obvious signs of high risk for financial crime, and even fewer clients are both licit, and have no way to demonstrate that they are licit. It is important in this context to consider materiality; we are not talking about, for example, a bank account holder who deposits $50 earned in a notionally illegal penny ante poker game. We are instead applying a risk management approach: clients need to be assessed based upon their large size and/or their display of high risk behavior.

A healthy risk management culture for AML purposes not only makes life harder on risky clients and ex-clients, but makes life easier on clients who are low risk. This trade-off is largely missing from AML compliance, but hopefully features in AML risk management.

Some admittedly impressionistic tests for a healthy AML culture

We are steadily building an empirical base upon which to self-test for a healthy AML risk management culture. We emphasize that these tests are incomplete and may vary quite a lot by jurisdiction. The following assumes that firms are already competently observing their relevant compliance requirements.

CURRENCY

Do you monitor currency flows across all your payment streams? Currency monitoring should consider not only aggregate amounts, but the composition of currency transactions by note denomination. Here is where a banker's ability to cross-check comes in very handy: which persons and firms are outliers, and how do you check outlier status?

We are steadily building an empirical base upon which to self-test for a healthy AML risk management culture.

As an example: if an individual check account holder has a job generating $50,000 in annual deposits (which are normally evident from regular pay cycles), they will usually deposit a lot less than $50,000 in extra currency. As another example: if independent auto dealer deposits normally comprise 80 per cent non-cash (most cars are financed, many repairs are paid for with credit cards) and 20 per cent with currency, what do you do about the dealer with 60 per cent of deposits in currency? What do you do about the hairdresser who is depositing $75,000 in cash per month?

Nowadays there are many in-house and third-party systems to closely examine cash deposit streams. If you are in a regime that requires transaction reporting above a certain amount, hopefully you are complying with that obligation. But if that is all you are doing, you are failing on an obvious AML risk management opportunity[2].

SUB-UNIT MONITORING

One question that flowed from the well-known Danske Bank Estonian matter: "how on earth did Danske Bank allow one obscure Estonian branch to process a quarter of a trillion Euro in dubious payments, and nobody in head office noticed until it was too late?" There are several answers, including apparent criminality in the Estonian branch, the usual confusions associated with an international acquisition, and simple cheapness in deploying audit and risk management teams.

A good risk management system across a firm will operate so as to monitor not only at the firm level and the customer level, but also across business units. This certainly includes branches, but also other sub-units such as sales and product portfolios. The salesman who generates five times the expected new funds under management may be a marketing genius — or he may be accepting clients who nobody else will touch.

> Healthy financial services cultures routinely sacrifice short term profit in favor of long-term soundness.

A healthy risk management culture will welcome unexpected good news on profits, business growth, and the like — but will carefully test this good news for unusual risks.

DO YOUR CUSTOMER CLASS EXCLUSIONS MAKE SENSE?

Many banks and other financial services providers refuse to deal with customer classes, due to perceived AML risk. A healthy AML risk management culture distinguishes between client classes that are excluded because they really are too risky to handle, client classes that are so toxic to relevant regulators that they are too risky to handle, or unfounded exclusions.

The first category includes, most obviously, people who have previously tried to rob or defraud the bank or other firm in question. Ditto for fraudsters more broadly, plus other classes of criminals with high recidivism rates.

The second class includes customers who are generally okay, but servicing some bad apples may lead to large compliance sanctions due to local sensitivities. Foreign students in some jurisdictions are an example: a few of them become money mules, so regulators will strongly penalize banks that facilitate this known behavior. If foreign students as a group are an unprofitable business line, then it may be sensible to simply refuse to bank this category.

In many jurisdictions there is ongoing tension between bank requirements to provide widespread transaction services and to meet AML compliance requirements appropriately. In such jurisdictions, banks will need to deploy risk-sensitive transaction monitoring systems to accept clients they might prefer to avoid en masse. At the same time, any sign of dubious behavior must be identified and responded to very quickly.

Other examples include diplomatic outposts, gaming operations, and money transmission businesses.

Healthy cultures will not brainlessly exclude customer classes based upon unfounded opinions. Banks should regularly test their assumptions about why they are excluding clients by class, with good answers surrounding actual and regulatory AML risk, plus actual lack of profitability.

WHAT HAPPENS WITH STRS?

Many regulatory regimes reward firms for over-filing Suspicious Transaction Reports — even if they are never read. In such a regime, a cynical but sensible firm will file as many STRs as is reasonably possible, as a compliance rather than a risk management tool.

But then we need to consider the risk management aspect. If a firm considers a client's activities sufficiently suspicious to file an official report — should it be removed from the firm's client base?

A healthy culture probably balances STR filings and customer de-risking somewhere between the extremes:

- Any STR filing leads to automatic de-risking; vs
- STR filings never lead to de-risking.

Remember the "single sentence solution" given earlier: are you comfortable that the customer, despite a filed STR, is demonstrably low risk for financial crime? If the answer is "no", then de-risking is the healthy response.

Many people will protest that de-risking a less than comfortable client is profit-reducing, and in any event the client will find a financial services provider elsewhere. Both these protests are true, but remain unpersuasive. Healthy financial services cultures routinely sacrifice short term profit in favor of long-term soundness. The fact that a suspect client can always find a new home in (to pick two examples not at random) South Dakota or London is simply not your problem. Remember that nothing an individual firm does can fix the global failings of the international AML framework; the firm can only ensure that it is not contributing to the problem.

Healthy AML cultures focus upon risk management rather than compliance.

WHAT IS A GOOD CLIENT?

The above question mainly applies in the wholesale or middle market spaces. Unhealthy AML cultures define a good client in terms of profit first and risk second. Healthy AML cultures define good clients in terms of comfort first, then profits and risks. This applies more broadly than to financial crime, to include the general sense of character that was the historical foundation of credit and insurance underwriting decisions.

Firms with healthy AML cultures will not feature the following statements by the head of sales to the Chief Compliance Officer or Chief Risk Officer:

- "Sure, nobody else will deal with him, but…"[3]
- "A Google search shows he is accused of crimes against humanity, but he's our most profitable client, and his lawyer assures us the claims are malicious."
- "Yes, a 19-year-old with $500 million in the bank and a kleptocrat father might look a little odd, but nothing has been proved against her."
- "She deals in cash because she doesn't like electronic banking, which is why she brought in seventy-two thousand hundred-dollar bills in a steamer trunk…".

We could go on. And on. The bottom line here is the classic "if it seems too good to be true, it isn't true." Or in the AML space: "If it looks too dubious for comfort, it's not our deal or our customer."

In summary

Effective AML compliance is expensive but necessary for a firm to survive. The best strategy is to ensure competent and comprehensive compliance, while avoiding compliance overkill.

Complex and particularly multinational firms need to remember that large AML problems can arise from small business units and business lines, so it is necessary to deploy the 2nd (risk management) and 3rd (audit and third-party expert) lines of defense on a comprehensive and regular basis.

Healthy AML cultures focus upon risk management rather than compliance. A healthy AML approach is to deal only with customers who can comfortably demonstrate they are not involved in material financial crime. This is an expensive approach in the short term, just as healthy approaches to credit, insurance, trading, and sales risks are expensive in the short term. As with these other risks, however, healthy AML cultures will sacrifice short term profits for long term strength.

Firms with healthy AML cultures only deal with clients who are demonstrably uninvolved in financial crime. Too many firms on this definition are not yet healthy — your firm need not be one of them.

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ENDNOTES

1 Danske Bank in Estonia, HSBC in Mexico, and Goldman Sachs in Malaysia are among many illustrative examples.

2 The Commonweath Bank of Australia's misadventures with "smart" ATMS is a good example here.

3 It is hard not to remember Deutsche Bank and the Trump Organization at this point, but that unfairly points out one errant bank among many candidates.

government, which has accused JP Morgan of being "grossly negligent" and ignoring red flags in connection with a 2011 oil deal.[254]

In December 2021, Citigroup indicated that it had hired 100 additional audit personnel to help it recover from recent regulatory sanctions.[255] For context, in late 2020, the US OCC levied a $400 million fine, and Citi was made to agree to a Consent Order to improve its operational risk practices.[256] The firm agreed to the fine in early 2021, two months after accidentally sending more that $900 million to its client's lenders, rather than the $9 million interest payment it had intended the lenders to receive.[257]

In January this year, a whistleblower sought to be awarded for the $400 million dollar fine collected by the government, which she believes was made possible thanks to information the OCC obtained from her. "She provided a wealth of insider information that allowed [the OCC] to look into things that they otherwise wouldn't have," the whistleblower's lawyer said. "I don't think the OCC was aware of the manipulation going on and how bank employees were able to bypass a rather robust internal control system."[258]

In early 2022, it was reported that Citigroup employees had become frustrated with delayed bonuses and tight budgets as the bank dealt with increased scrutiny from its regulators, and contended with the associated cost increases tied to efforts to improve its non-financial risk management capabilities. Reviews of complaints, filed through an anonymous internal complaint portal, dragged on for months, as HR struggled to deal with the volume of complaints it had received. Anonymous sources in the bank claimed that, while some employees were under investigation, their bonuses and performance reviews were frozen, without first having established the verity of the claims made against them.[259]

CIti also came under investigation by the SEC, in February 2022, over employee use of unapproved communication channels. This was part of a larger inquiry by the regulator into industry-wide record keeping compliance, which led to the $200 million fine levied against JP Morgan discussed previously. Firms are required to track and preserve records of all work-related conversations between employees. Their use of encrypted apps, such as Signal and WhatsApp, has made this substantially more difficult.[260]

In keeping with the Fed's 2020 consent order, Citi hired a new chief compliance officer to report to its general counsel. Historically, Citi's CCO has reported directly to the chief executive, which some fear may lead business lines to exert undue influence over compliance decisions, as seems to have been the case at other major financial institutions.[261] ▸PAGE 137

UK-based NatWest bank, pleaded guilty to one count of wire fraud and one count of securities fraud in December 2021, agreeing to pay a $35 million fine to US authorities. The bank was accused of "spoofing" US treasury and futures markets, causing $7 million in losses for market participants.[262]

It is unlikely that banks operating in the US will see much let up in regulatory scrutiny around non-financial risk issues in the coming years. Regardless of how successful President Biden is at implementing his legislative agenda, his ambitions for enhanced financial regulation are already becoming reality. As is discussed at length later in this section, federal financial regulators seem to be toughening up, signaling a return to the harsher fines and more aggressive supervision seen in Obama-era financial regulation.

As a result of this increased regulatory pressure, competition between financial institutions for compliance talent has heated up. The unemployment rate of compliance professionals decreased from 3.5% in 2020 to 2.4% in 2021, less than half of the national average.[263] "It's all hands on deck for corporations to attract the talent," said Paul C. McDonald, a human resources consulting firm executive.

Average annual unemployment rate for compliance officers

Source: U.S. Bureau of Labor Statistics' current population survey

Hiring and retaining effective compliance personnel became still more essential as banks sought to comply with the sanctions placed on Russia after its invasion of Ukraine in February 2022. Banks not only face legal ramifications if caught facilitating Russian nationals — intentionally or otherwise — in their efforts to evade sanctions[264], but also opprobrium from a public which overwhelmingly disapproves of the invasion.[265]

"In the face of mounting economic pressure on Russia, it is vitally important for US financial institutions to be vigilant about potential Russian sanctions evasion, including by both state actors and oligarchs," Him Das, acting director of the Financial Crimes Enforcement Network (FinCEN), said. "Although we have not seen widespread evasion of our sanctions using methods such as cryptocurrency, prompt reporting of suspicious activity contributes to our national security and our efforts to support Ukraine and its people."[266]

In early March, Goldman Sachs Group Inc. and JPMorgan Chase announced that they would be ceasing operations in Russia. This was one of Wall Street's first major departures from Russia, joining a growing list of companies from other sectors. "We are focused on supporting our clients around the world in managing or closing pre-existing obligations in the market and ensuring the well-being of our associates," a spokesperson for Goldman Sachs said.[267]

JPMorgan followed with their own statement: "As directed by governments around the world, we are in the process of divesting from our business in Russia and are not seeking new business." Citigroup and Deutsche Bank have also recently decided to join their Wall Street peers exiting operations in the country.

Later that month, House Financial Services Committee Chair Maxine Waters asked US Banks to detail their efforts to cease operations in and with Russia. "Even though multiple companies have voluntarily divested from Russia, the Committee currently lacks a clear picture of the extent of these divestments," Waters said in a letter to 31 banking industry associations and lobbying groups.[268]

While this report focuses on the financial services industry, it is sometimes instructive to look to other industries where a higher standard of care is required, and where the consequences of failures are much more significant. US defense and aircraft manufacturer Boeing has faced huge repercussions since its 737 Max was involved in two fatal crashes between 2018 and 2019. An automated flight control system on the planes, MCAS, was found to be at fault for the crashes. After it was discovered that Boeing had failed to properly report changes to MCAS to safety officials, the organization paid $2.5 billion to settle criminal charges.[269]

Then, in September 2021, a judge ruled that Boeing's board of directors must face a lawsuit from its shareholders over the crash, potentially exposing it to even greater financial penalties.

Individual Accountability

Regulators across the globe have increased efforts to punish individuals, as well as firms, when misconduct occurs. For example, as is discussed further below, the Department of Justice has stated that it will investigate, and potentially prosecute, all actors involved in corporate crime.[270]

However, individual accountability is not always reserved for those that participate actively in misconduct. Regulators have targeted sanctions at executives and compliance personnel who have been deemed negligent in the oversight of their firms. At Wells Fargo, for example, former executives have paid tens of millions in fines, and former-CEO John Stumpf was banned from the industry for life, in the wake of the firm's false accounts scandal.[271] Three former executives also faced trial, in September 2021, for failing to perform their duties adequately, contributing to "systemic sales practices misconduct."[272]

In October 2021, the SEC re-opened comment on a proposed rule requiring firms to clawback bonuses and other incentive-based compensation from the previous three years if the firm must issue an accounting restatement due to a material misstatement. The rule, which Congress originally ordered the SEC to adopt in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, has remained in limbo since it was proposed in 2015.[273]

However, some fear that this potential for personal liability, without a clear framework for when and where it is to be applied, could discourage new talent from becoming compliance officers. To avoid this, the National Society of Compliance Professionals has requested that regulators take a comprehensive look at the full context within which a compliance officer functions when determining any personal liability. For example, they suggested that regulators could investigate firms' policies, the role of the CCO, and whether or not senior management is involved inappropriately in the compliance decision making process.[274]

In March 2022, the Financial Industry Regulatory Authority (FINRA), a self-regulatory organization which oversees the broker-dealer industry, announced that it would only take action against compliance officers when they fail to carry out the supervisory responsibilities designated by their firm, and not in matters where they play an advisory role. "Chief compliance officers play an important role in facilitating compliance by promoting strong practices that protect investors and market integrity," said Jessica Hopper, head of enforcement at FINRA. "That does not automatically make them supervisors, subject to Finra's supervisory requirements."[275]

The Role of the Auditor

While much of the blame for the misconduct within banks falls on the firms themselves, many have questioned how this behavior is not discovered more frequently by the auditors banks are legally required to retain. While some have claimed that it is not within the purview of auditors to uncover fraud, others have contended that perhaps they fail to detect even obvious fraud — such as that at Wirecard — because the auditors themselves suffer from the very same ills that bedevil the firms they audit.

A June 2020 report by the London-based Institute for Public Policy Research (IPPR) concluded that a "culture of fear" dominates at accounting firms, preventing junior auditors from speaking up. Marco Meyer, a fellow at the University of Hamburg and co-author of the report, described the culture at accounting firms as one which focuses on 'getting the job done,' rather than doing the right thing.[276] Carsten Jung, a senior economist at the IPPR and lead author of the report, argued that incentives in the audit industry are too focused on providing good news rather than promptly relaying bad news.

"Audit firms need to be given a clear public purpose of comprehensively challenging businesses where challenge is needed," he said.

Collaborating on DE&I

As in many other jurisdictions, there has been a coordinated effort in the US to increase diversity and inclusion, with the ultimate goal of improving conduct and business outcomes.

In December 2020, Nasdaq filed a proposal with the SEC that would require listed companies to have at least one woman on their boards, in addition to at least one director representing a racial minority or who self-identifies as lesbian, gay, bisexual, transgender, or queer (LGBTQ). Companies that don't meet the standard would be required to justify their decision to remain listed on Nasdaq. In the review which precipitated this change, Nasdaq found that 80-90% of companies listed on its exchange had at least one female director, but that only about 25% would satisfy the second requirement.[277] PAGE 371

The OCC has also undertaken work surrounding diversity and inclusion in the financial industry. In a speech at the Women in Housing & Finance Public Policy Luncheon, Acting Comptroller Michael Hsu said, "Inclusion means more than just giving someone a seat at the table. It means giving them a voice. It is not their responsibility to speak up, it is ours — the others at the table — to invite their input and listen and react. Without inclusion and a sense of belonging, diversity over time becomes a box to be checked, not a value to be upheld."[278] In this speech, Hsu points to the efforts by NASDAQ and other organizations to set diversity requirements as models for how the OCC might begin its own foray into regulating diversity and inclusion.

Without inclusion and a sense of belonging, diversity over time becomes a box to be checked, not a value to be upheld.

US TREASURY

Included in the 2021 National Defense Authorization Act was an expansion of US anti-money laundering and combatting the financing of terrorism rules (AML/CFT). One significant change is that all US corporations will have to identify their beneficial owners so they may be registered with the Treasury Department's Financial Crimes Enforcement Network (FinCEN). This aims to reduce the ability of criminals to launder illicitly obtained funds through shell companies.[279]

In December 2021, FinCEN proposed a set of rules laying out which companies will be required to report on beneficial ownership. However, some have questioned the verification process for this ownership information. James Martinelli, the director of FinCEN's office of regulatory policy, has stated that this question of verification is still open. "We specifically highlight this very critical issue of verification," he said.[280]

Him Das, Acting Director of FinCEN, offered his views on innovation's role in AML/CFT risk supervision at the American Bankers Association/American Bar Association Financial Crimes Enforcement Conference in January 2022. In this speech, Das explained that advanced technologies, such as AI and machine learning, have potential to improve the process of identifying suspicious transactions.[281] PAGE 365

He stipulated, however, that these technologies are not plug and play. "There are a number of considerations," Das said. "First, it's not enough that these technologies make compliance more efficient; they also have to make it more effective — or at least, keep the new system on par with the old one. Many of these machine learning and AI systems can be black boxes, and we have to be sure that these systems can perform when it comes to key metrics — like how many alerts actually lead to SARs or whether law enforcement finds the information actionable."

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

There was much discussion surrounding the Federal Reserve during the transition from the Trump administration to the Biden administration. Many wanted to see the Fed shaken up, to bring in leaders who would utilize the agency's regulatory and supervisory powers more aggressively. Massachusetts Senator Elizabeth Warren accused Randal Quarles, then Vice Chair of Supervision at the Fed, of "cutting holes in the safety net," leading to crises like the Archegos collapse earlier in the year.[282]

Trump-nominated Fed chairman, Jerome Powell, said that he was open to allowing the new Vice Chair of Supervision to take the lead on the Fed's regulatory agenda.[283] In October 2021, the Fed announced that Quarles would be leaving his role at the helm of the Federal Reserve's Committee on Supervision and Regulation. Until Biden nominated a replacement, the Committee would meet as needed and would not have a chair.[284] Quarles received criticism from some for being too soft on the financial industry, leading some to speculate that he would be replaced by someone more inclined to see the Fed act as an active regulator and supervisor.[285]

In the months leading up to the close of Quarles's tenure as Vice Chair of Supervision, there was frequent speculation regarding who would be nominated to fill his seat. In January 2022, Biden nominated Sarah Bloom Raskin to lead the Fed's regulatory agenda. A former Fed Governor and first woman to serve as Deputy Treasurer, in Obama's Treasury Department, many felt her to be eminently qualified.

Yet others, particularly more conservative legislators, suspected that Raskin would seek to take a larger role in regulating financial institutions than her predecessor, and veer into directions where they felt the Fed should have no role. Most particularly, Raskin herself made it clear that fighting climate change would be a large priority for her.[286] During her nomination hearing, Raskin explained what she believes to be the role of bank supervisors:

> *I learned that — to be effective for all Americans — bank supervisors must make sure that the safety of banks and the resilience of our financial system are never compromised in favor of short-term political agendas or special interest groups. They must stay attentive to risks no matter where they come from: inside or outside the financial sector; well-identified asset bubbles or speculation; a set of threat actors that launch cyberattacks; or from nature and cataclysmic weather-related events.*[287]

Raskin withdrew herself from consideration in March 2022 after it became clear that she would not have the votes to be confirmed by the US Senate.[288]

In November, Biden reappointed Powell to lead the Fed, in large part to maintain consistency and stability while the Fed contended with economic challenges presented by the covid pandemic.[289] The path to confirmation was not an easy one for Powell, however. In October of last year, the Fed was forced to ban officials from trading, after several powerful members of the Fed made questionable trades and held stocks through the pandemic, including two regional presidents.[290] In fact, even Powell himself was accused of making illicit trades, though some have pointed out that, since his trades were made before the Fed's ban and did not seem to track with any insider information, they were above board.[291]

To make matters worse, Fed Vice Chair Richard Clarida was found to have moved between $1 and $5 million from a bond fund to a stock fund, in late

February 2020, one day before Powell announced that the Fed was preparing emergency measures to support the economy.[292] In November, Biden nominated Lael Brainard, who has been a member of the Board of Governors since 2014, to take over as Vice Chairwoman of the Fed, replacing Clarida.[293]

In January 2022, it was discovered that Clarida had performed more trades before the one which had originally landed him in hot water, and that these trades had not been properly disclosed in previous financial disclosures.[294] Clarida resigned shortly thereafter, several weeks before his term was due to end, and just one day before Powell's nomination hearings were set to begin in the Senate.[295]

This scandal has led some to doubt Powell's leadership. Massachusetts Senator Elizabeth Warren accused the Fed of having a "culture of corruption"[296] and called Jerome Powell a "a go-along-to-get-along leader who doesn't know or doesn't care when, on his watch, people with great responsibility advance their own interests over those of our nation, or someone who drags his feet in dealing with problems that shake the public's confidence in the institution he leads."[297] In his nomination hearings, however, Powell insisted that the Fed is implementing new ethics rules which would prevent this sort of situation in the future. "We've really made a complete change in the way we govern purchases and sales of securities," he said to the Senate Banking Committee.[298]

After Sarah Bloom Raskin withdrew her nomination, the Biden Administration nominated Michael Barr, former Assistant Secretary for Financial Institutions at the Treasury, to run the Fed's regulatory oversight. "Barr has spent his career protecting consumers, and during his time at Treasury, played a critical role in creating both the Consumer Financial Protection Bureau and the position for which I am nominating him," President Biden said. "He was instrumental in the passage of Dodd-Frank, to ensure a future financial crisis would not create devastating economic hardship for working families."[299]

Some have looked to Michael Barr's academic work as insight into how he views the role and responsibilities of regulators. For example, in a piece entitled "Behaviorally Informed Regulation," Barr and his coauthors advocated for a model of regulation which is informed by behavioral science.

"Behaviorally informed regulation is cognizant of the importance of framing and defaults, of the gap between information and understanding and between intention and action, and of the role of decisional conflict and other psychological factors that affect how people behave," they write. "At the same time, we argue, behaviorally informed regulation needs to take into account not only behavioral insights about individuals but also economic insights about markets."[300]

Future of Supervision

In September 2021, Governor Michelle W. Bowman discussed the future of the Fed's supervision of community banks, in a speech at the Community Banking in the 21st Century Research and Policy Conference. Bowman pointed to supervisory technology as a key part of the Fed's future plans.[301] "The goal of this initiative is to ensure our supervisory approaches accommodate a much broader range of activities while ensuring we don't create an unlevel playing field with unfair advantages, or unfair disadvantages, for some types of firms versus others," Bowman said. "This will include investigating technology and innovative business practices that increase our agility and efficiency."

FEDERAL RESERVE BANK OF NEW YORK

The Federal Reserve Bank of New York has been a leader in recognizing culture as a driver of conduct within financial institutions. New York Fed Senior Vice President James Hennessy has been the head of the institution's Governance and Culture Reform initiative since it began in 2014. ▶PAGE 199

As was discussed in previous issues of our annual *Compendium*, the NY Fed launched a series of webinars "highlighting current work and scholarship in this area" in order to continue this work in the remote environment necessitated by the covid pandemic.[302] One such webinar, "Culture Diagnosis and Behavior Change: Learnings from the Field," featured a panel discussion of proven and emerging approaches to understanding and influencing organizational culture. Taking place in September 2021, the panelists shared insights on how to collect useful data, develop evidence-based assessments, and design interventions to maximize impact.[303]

In July 2021, the NY Fed named Dianne Dobbeck head of the Supervision Group. Dobbeck previously ran the Supervision Group's Supervisory Policy and Strategy function. Prior to her appointment, the Supervision Group was run by Kevin Stiroh, who left the NY Fed in February 2021 to chair the Federal Reserve Board's Supervision Climate Committee.[304]

In a November 2021 paper titled "Why Do Supervisors Rate Banking Organizations?", Kevin Stiroh and the Fed's James Bergin, Senior Vice President of the Legal Group, explained the philosophy behind supervisory ratings. "Ratings provide discipline to the regulatory process and a means for clear communication of supervisory assessments to firms, regulators, and other stakeholders," they wrote. "If done well, ratings facilitate remediation among supervised firms while bolstering confidence in both the supervisory process and the banking system."[305]

James Hennessy, Senior Vice President at the NY Fed, spoke at the 1LoD Culture & Conduct Deep Dive in March 2022 about the emerging trends in culture reform. In this speech, Hennessey pointed to three emerging factors: the use of behavioral science, the expansion of culture data, and the growing adoption of culture assessments and audits. Hennessy explained that, with these developments, culture and conduct risks could potentially be measured and managed:

> *Given these advances in our understanding of human behaviour, the availability of new forms of data, and the maturing of culture audits, I do wonder why firms haven't started to govern culture more systematically. Most firms have departments to address all kinds of other risks, but very few (with some notable exceptions) have central teams to comprehensively assess, intervene, monitor and report on behavioural risk. If this approach became more widespread, maybe it could help the industry prevent issues from arising, rather than trying to fix them afterwards.*[306]

OFFICE OF THE COMPTROLLER OF THE CURRENCY

In our 2021 *Compendium*, we discussed the OCC's increased focus on operational and compliance risks, as a result of the remote work environment prompted by the covid pandemic, and the accelerating adoption of digital financial services in that time.[307] This focus continued in the past year.

In its Semiannual Risk Perspective for Fall 2021, the OCC explained that it communicates concerns to banks as Matters Requiring Attention (MRA), and

In Focus

An Interview with Peter Routledge

Peter Routledge

Q: The coronavirus pandemic has reoriented regulatory priorities. For instance, there is heightened concern for business resilience and risk governance in the hybrid work context. What changes to regulatory priorities do you expect will persist into the future? What additional priorities do you expect this to promote?

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A: Our priorities as a regulator are, first and foremost, derived from our mandate to contribute to public confidence in the Canadian financial system. To achieve that mandate, we must continuously monitor, assess and respond to risks on the near and long term horizon.

At the onset of COVID-19, extraordinary measures by financial regulators and governments across the globe focussed on lessening the financial risks for financial institutions (i.e., liquidity pressures, mortgage loan defaults, etc.) to help maintain a resilient financial system. These were generally quite effective, but not comprehensive in addressing emerging risks in the midst of the pandemic.

Beyond the traditional financial and operational risks related to the COVID-19 pandemic, broader societal shifts emerged more clearly. By that, I mean an increase in the public consciousness of Environment, Social, and Governance (ESG) issues and risks, here in Canada and abroad. Several international and national events — the murder of George Floyd in the U.S., the discovery of unmarked graves at former residential schools in Canada, and the "#MeToo" movement across the globe — had direct impacts on how OSFI-regulated institutions approached the Social component of ESG risks.

Canada's social fabric is unique, given a highly diverse and multicultural populace, which is driven primarily by significant immigration from all corners of the globe. Financial institutions operating in Canada, for example, must have a business model and approach that not only recognizes diversity, equity, and inclusion, but also incorporates those values into their corporate practices and culture. This is foundational to business success in Canada because these financial institutions' clients and employees expect demonstrable commitments to diversity, equity, and inclusion.

Q: The past year has focused attention on a need for ESG related disclosures. To date, much of this has focused on Environmental and Social Interest disclosures. Do you anticipate an increase in focus on Governance disclosures in 2022? If so, on which topics do you expect these disclosures to focus?

A: Shareholders, consumers and employees want to support organizations whose values resemble their own. The increase in environmental and social interest disclosures allows people to better understand the ethical and environmental repercussions of their investments and transactions. ▸PAGE 427

Accountability of financial institution Boards and their responsibility for oversight of strategy, innovation, and value creation continues to be a critical focus area in our supervision. Advancing governance disclosures to keep pace with growing market appetite for transparency will be a journey.

OSFI's recently released consultation on culture risk management contemplates related disclosures to support prudential outcomes.[1] Leaders are the beacons of an organization's culture, shaping and reinforcing behaviors and mindsets throughout the organization. Disclosures support accountability for actions, decisions and norms that should reflect organizational purpose and values. Clear, credible and comparable disclosures create sustained attention and monitoring for systemic change.

Proportionality is also an important consideration when dealing with financial institutions of various size and complexity, as there is no clear pass/fail on many of the evolving disclosures.

I think financial institutions' first concern is that of meeting the expectations of their shareholders and the public, both of which expect more and better disclosures. OSFI is happy to support work that results in better risk-based decision-making by all participants in the market, but the pace and outcomes of those disclosures is in the hands of many and not OSFI's alone.

Disclosures support accountability for actions, decisions and norms that should reflect organizational purpose and values. Clear, credible and comparable disclosures create sustained attention and monitoring for systemic change.

Q: You have stated that OSFI intends to focus on its own internal diversity "obsessively."[2] How do you think this will help OSFI to achieve its goals, in practical terms? Will diversity among the firms you oversee be a matter of supervisory priority? Some note that diversity is merely statistical without commensurate inclusion and equity. What are your views?

A: Diversity is not only a matter of having targets, or meeting a moral imperative. Diversity is a strategic imperative in building a more resilient organization, navigating change, and arriving at better decisions. We think commitment to diversity requires recognizing and liberating talent, and gaining value from a broader spectrum of perspectives. ▶PAGE 371

The current risk environment is full of complex and evolving issues where we need a more diverse understanding of risks and their related impacts. Decisions in this are not well served by narrowing the source of expertise available to address those risks. We, as a Canadian federal financial regulator, must hold ourselves accountable to higher standards for diversity.

The OSFI Blueprint, published in December 2021, includes the notion that culture is a core element of our successful organizational transformation, and at the heart of culture is the strategic need for diversity.[3]

To truly benefit from diversity, we must imbed a culture of equality and inclusion. Embracing our differences lays the groundwork for such a culture through collective learning, personal growth and behavioral change.

This can be easy to say and sometimes hard to practice, which is why our approach recognizes the need for psychological safety for employees where it is safe-to-fail and safe-to-be-different. We need to challenge our own assumptions and biases, and acknowledge that we all have blind spots. By building an organization that seeks the best from its people we will better be able to serve our mandate.

Q: In a December 2021 letter to Federally Regulated Financial Institutions, OSFI announced intent to issue a consultative document regarding culture and reputational risk.[4] What led to this and where do you hope this initiative to lead?

A: We see the strategic advantage of diversity. We look at culture and diversity as part of the composition of financial institution Boards but are also examining how that diversity exists in the rest of the organization.

Boards of financial institutions in Canada have become commendably more diverse. However, we are questioning why we are not seeing as robust a trend at the senior management level at those same institutions. As the Board is ultimately responsible for an institution's culture, these are the kinds of questions that should be on the minds of the Boards of OSFI-regulated financial institutions.

Our Culture & Compliance Risk Division has been leading the development of our approach to culture supervision, to better understand how institutions assess and manage their behavioural risks, and assure effective promotion of desired culture.

The Board is ultimately responsible for an institution's culture.

In the culture taxonomy that we have created, diversity of thought, leadership and group dynamics are examples of areas where we can begin to assess effective culture practices. Future work includes looking more closely at senior executive compensation structures and related measurement to support and reinforce a culture of integrity and effective risk management at all levels.

Our recent letter proposes issuing principles-based, outcomes-focused culture risk management guidelines for consultation by the end of the year.[5]

Q: Lastly, as you are relatively new in your current role, perhaps you might share a bit about what led you to OSFI. Can you share any initial learnings achieved since becoming Superintendent? What else would you like to share?

A: A calling to the public service had been in my mind for the first 25 years of my career, and I finally listened to that calling five years ago. The job I now have requires transformational leadership at a heretofore tremendously successful organization. I was more relieved than surprised to find a shared appetite and desire among my colleagues for a transformative risk environment.

The greatest risk for a regulator in fulfilling their mandate is to not act, or to act too slowly. The costs and consequences of not acting can erode our credibility, public confidence, as well as the financial stability we seek to achieve.

Prudential financial regulation has often been accomplished away from the public policy spotlight. Many issues like climate change, digitalization, and housing in Canada are in the media daily, and very much a part of the public discourse. These discussions can benefit from OSFI's views. We continue to seek better ways to communicate and engage the public on such issues, as well as others.

Our focus is always on serving our mandate. This necessarily requires tough decisions about individual financial institutions, and choices on broader public policy, that are not always easily understood by the public or popular. We, however, need to show leadership to maintain a strong and healthy financial system.

Peter Routledge *is Canada's Superintendent of Financial Institutions. He previously served as the President and Chief Executive Officer of Canada Deposit Insurance Corporation (CDIC).*

ENDNOTES

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2 Peter Routledge, Superintendent, "The Fierce Urgency of Now: The Canadian Financial Sector in a Post-Pandemic World, a Prudential Perspective," Remarks at the Global Risk Institute Annual Summit, Sept. 29, 2021. https://www.osfi-bsif.gc.ca/Eng/osfi-bsif/med/sp-ds/Pages/pr20210929.aspx

3 Office of the Superintendent of Financial Institutions, "A Blueprint for OSFI's Transformation 2022 - 2025." https://www.osfi-bsif.gc.ca/Eng/osfi-bsif/rep-rap/Pages/bl-pd.aspx

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5 Office of the Superintendent of Financial Institutions, "Culture Risk Management," Mar. 15, 2022. https://www.osfi-bsif.gc.ca/Eng/fi-if/in-ai/Pages/crmg_let.aspx?utm_source=osfi-bsif&utm_medium=email&utm_campaign=osfi-bsif-email

that the largest proportion of those open concerns relate to operational risk, for the third report in a row. The OCC also explained that operational risk is elevated due to the increasingly complex operating environment in which financial institutions currently find themselves.[308]

While the OCC has placed greater emphasis on conduct supervision, and punishing firms when misconduct takes place, it has not gone so far as to include *culture* supervision into its supervisory strategies or priorities. In fact, despite levying frequent fines for misconduct and holding executives personally accountable for the conduct of their firms, the OCCs "Fiscal Year 2022 Bank Supervision Operating Plan" does not include any mention of culture or employee conduct at all.[309]

In September 2021, President Biden nominated Saule Omarova, a professor at Cornell University, to serve as the Comptroller of the Currency. However, Biden withdrew the nomination at Omarova's request in December after a very contentious few months, with support for her nomination divided strictly by party lines.[310] Critics focused on her upbringing in the Soviet Union and academic works they deemed extreme, including a paper which proposed a state-run bank account system[311] and others in which she discussed problems with banks both owning and trading in commodities and the inherent advantages this dual role gives them.[312]

The current Acting Comptroller of the Currency, Michael Hsu, would be unlikely to win Senate confirmation were he to be nominated to the role by the Biden Administration. At present, political gridlock in Washington is such that it looks likely that Hsu will continue in his role as Acting Comptroller for the foreseeable future.

In a September 2021 speech entitled, "Safeguarding Trust in Banking," Hsu discussed the importance of safeguarding trust in the banking system and of guarding against complacency:

> *To me, the ultimate objective for us and the banking system is to foster and safeguard trust: Trust between financial providers and their consumers, trust between regulators and supervised institutions, trust that banks will not exploit working Americans and the vulnerable, and trust amongst financial regulators that we can work together to solve problems that we can't solve alone.*

Hsu argued that mere compliance with prudential standards established after the financial crisis is important, but observed that it does not ensure that trust in the banking system will be safeguarded. In short, compliance is necessary, but not sufficient. Hsu would have banks, and their regulators, go further and insisted that, to guard against complacency, they must go further.

In furtherance of this argument, Hsu cited the report prepared by law firm Paul Weiss, for the board of directors at Credit Suisse, following its investigation into the root causes of the firm's risk management failures in connection with Archegos. ▸PAGE 137 At Credit Suisse, the firm found:

> *...a lackadaisical attitude towards risk and risk discipline; a lack of accountability for risk failures; risk systems that identified acute risks, which were systematically ignored by business and risk personnel; and a cultural unwillingness to engage in challenging discussions or to escalate matters posing grave economic and reputational risk.*

To conclude his speech, Hsu argued that effective bank supervision and regulation requires "proactive identification of threats to trust in banking and the mapping out of strategies to address them." Such comments may suggest that, under his leadership, the OCC may place greater emphasis on firm culture as it pertains to risk management failures.

CONSUMER FINANCIAL PROTECTION BUREAU

Under the Trump administration, the Consumer Financial Protection Bureau (CFPB) was seen as comparatively business-friendly, issuing many fewer substantial fines than it had under the Obama administration.[313] However, this predisposition did not last long under the current Biden Administration.

In October 2021, the Senate confirmed Rohit Chopra, a fierce consumer advocate, to head the agency. Chopra worked in the Federal Trade Commission in the previous administration, where he championed large fines and criminal liability for executives in cases against BigTech.[314]

"Breaking the law has to be riskier than following it," Chopra wrote. "In my view, it is appropriate to charge officers and directors personally when there is reason to believe that they have meaningfully participated in unlawful conduct, or negligently turned a blind eye toward their subordinates doing the same." It appears likely that this mindset will characterize Chopra's priorities at the CFPB.

FEDERAL DEPOSIT INSURANCE CORPORATION

The Federal Deposit Insurance Corporation (FDIC) has made public its efforts to modernize its supervision of banks. In a December 2020 speech, then-FDIC Chairman Jelena McWilliams discussed the agency's efforts to modernize bank supervision. Digital bank examinations became essential during the covid pandemic, and are among the many innovations the remote work environment spurred that are likely to remain in place after the covid crisis is past.[315]

In April 2021, the FDIC announced a partnership with Duke University to advance technological innovation. The then-FDIC Chief Innovation Officer, Sultan Meghji, said, "We share a common interest to better understand the opportunities and the risks of new technologies and to build a first-of-its-kind strategic innovation program.[316]

However, the work of innovating at the regulator was more difficult than many expected, including Meghj, who left the regulatory agency in February this year. At the time, he issued an excoriating *Bloomberg* OpEd in which he stated that the organization was, "hesitant and hostile to technological change."[317]

This was not the first instance of a senior leader in the organization leaving on short notice at the FDIC recently. In late December 2021, FDIC Chair Jelena McWilliams announced she would be leaving the regulator in February 2022, more than a year before her term was due to end. McWilliams, who was appointed by the previous administration, resigned amid a battle over bank mergers with the democratic board members of the FDIC and CFPB.[318]

"This conflict isn't about bank mergers," McWilliams wrote. "If it were, board members would have been willing to work with me and the FDIC staff rather than attempt a hostile takeover of the FDIC internal processes, staff and board agenda. This episode is an attempt to wrest control from an independent agency's chairman with a change in the administration."

SECURITIES & EXCHANGE COMMISSION

ESG Disclosures

The Securities & Exchange Commission has led efforts in the past year to enhance ESG disclosure requirements in the US. SEC Chair Gary Gensler spoke at London City

Week, in June 2021, explaining that, along with climate risks, the SEC will look to require firms to report on human capital matters:

> *[I]nvestors have said that they want to better understand one of the most critical assets of a company: its people. To that end, I've asked staff to propose recommendations for the Commission's consideration on human capital disclosure.*
>
> *This builds on past agency work and could include a number of metrics, such as workforce turnover, skills and development training, compensation, benefits, workforce demographics including diversity, and health and safety.*[319]

SEC Commissioner Allison Herren Lee has offered the view that firms must enhance climate and ESG disclosures, not just to satisfy regulatory requirements, but so as to meet the demands of their many other stakeholders, including their investors.[320]

When it solicited comments on these initiatives, various advocacy groups and thousands of investors, private and institutional, requested that the SEC require firms to disclose more ESG related data and information.[321]

"Stronger human capital reporting, especially quantitative metrics rather than just qualitative narrative, is associated with higher returns on invested talent and higher operating margins and better risk-adjusted returns," said Eleanor Eagan, a research director at the Center for Economic and Policy Research's Revolving Door Project, a Washington-based non-profit organization that aims to educate investors

In an annual report on its oversight of credit-rating firms, the SEC listed ESG ratings as a key examination focus for the first time. While the report did not lay out any specific deficiencies it has found in ESG ratings, it did focus on compliance risks arising at rating agencies, stating that it would focus on these risks in its future examinations of these firms.[322]

Supervision and Enforcement

The SEC's Gurbir Grewal, who directs the agency's Division of Enforcement, explained in a October 2021 speech that he sees the decline of trust in institutions in the United States as partly caused by the perception that regulators take it easy on large financial institutions when they violate the law:

> *While there's no single cause for this decline when it comes to our financial institutions, part of it is due to repeated lapses by large businesses, gatekeepers, and other market participants, coupled with the perception that we — the regulators — are failing to hold them appropriately accountable, or worse still, the belief by some that there are two sets of rules: one for the big and powerful and another for everyone else.*[323]

Grewal made it clear that he and his division intended to dispel this sentiment by holding all bad actors equally accountable and enforcing a singular set of rules.

COMMODITY FUTURES TRADING COMMISSION

In 2019, the Commodity Futures Trading Commission (CFTC) announced the separation of its innovation lab, "LabCFTC," from its general counsel's office. In November 2020, as part of the CFTC's efforts to lead innovation in the financial regulatory sector more broadly, LabCFTC hosted Empower Innovation 2020. The event discussed innovation at the Federal Reserve Board and the Treasury Department, with emphasis on a law enforcement perspective regarding cryptocurrencies. The CFTC is just one of many regulators to establish an innovation office or lab in the last few years.[324]

In the keynote address at the ABA Business Law Section Derivatives & Futures Law Committee Virtual Winter Meeting, Acting CFTC Chairman Rostin Behnam explained that promoting innovation and "enhancing the regulatory experience" are key priorities for the regulator. In order to achieve this, Behnam laid out several strategic goals:

- increasing stakeholder engagement
- leveraging principles-based regulation towards ensuring that its regulatory approach is calibrated with the risks presented
- ensuring adherence to well-defined, transparent, and consistent processes
- harmonizing regulations for market participants subject to concurrent CFTC and SEC jurisdiction
- addressing risks and opportunities arising from significant emerging trends in derivatives markets, including DeFi, environmental, social, and governance (ESG) investing, digital assets, and event contracts.

Based on this, it is conceivable that, in calibrating their regulatory capabilities toward non-financial risks, such as those believed to be posed by firm culture and the conduct it may promote, the CFTC may elect to develop principles-based regulation in that direction.

THE DEPARTMENT OF JUSTICE

The Department of Justice (DOJ) has been clear on the importance of corporate culture as a driver of employee conduct. In its "Evaluation of Corporate Compliance Programs" guidance issued in 2019, the DOJ emphasized that firms should have a "culture of ethics and compliance." It also encouraged high-level executive ownership over the cultivation of this culture.[325]

In a speech at ABA's 36th National Institute on White Collar Crime last October, Deputy Attorney General Lisa O. Monaco doubled down on this theme. "Corporate culture matters," Monaco said. "A corporate culture that fails to hold individuals accountable, or fails to invest in compliance — or worse, that thumbs its nose at compliance — leads to bad results."[326]

Monaco also stated that the DOJ would seek to hold individuals accountable for misconduct and malfeasance that takes place on their watch. "Accountability starts with the individuals responsible for criminal conduct," Monaco said. "We will urge prosecutors to be bold in holding accountable those who commit criminal conduct."

The Deputy Attorney General's statements represent a shift in the DOJ's policy toward white collar crime as a whole. For example, it will no longer allow firms to determine for themselves who is to be viewed as having been *substantially* involved in misconduct. Instead, firms wishing to cooperate with the Department will be required to identify *all* actors involved in a case, regardless of the scale of their involvement.[327]

Kenneth Polite, assistant attorney general of the Justice Department's criminal division, echoed these convictions during a March 2022 meeting of the American Bar Association's White Collar Crime National Institute in San Francisco.[328] "When we talk about drug trafficking, or we talk about street violence, we all have no problem conjuring notions of accountability for those cruel actors," he said. "But the sheer mention of individual accountability in white-collar cases is and was considered a shock wave in our communities. That inconsistency, that hypocrisy, is yet another reason why some question the credibility of our criminal justice system."

The Attorney General himself, Merrick Garland, sent a similar message in a speech at the same gathering. Garland emphasized that it is people who commit crimes, not corporations. However, much regulation and prosecution efforts are focused on punishing corporations for acts that people committed. Holding individuals liable for misdeeds is, thus, the "first priority" for Garland's DOJ, "because penalties imposed on individual wrongdoers are felt by those wrongdoers, rather than by shareholders or inanimate organizations."[329]

NEW YORK STATE DEPARTMENT OF FINANCIAL SERVICES

The New York Department of Financial Services (NY DFS) is a state-level regulatory agency which oversees nearly 1,800 insurance companies and more than 1,400 financial institutions operating out of New York State.[330]

In July 2021, Linda Lacewell, Superintendent of the NY DFS, announced the launch an initiative to promote Diversity, Equity, and Inclusion. "Particularly in the wake of a changing society affected by the COVID-19 pandemic, racial injustice, and climate change," she said, "it is now more than ever paramount that the banking and financial industries have strong boards and executive teams comprised of people with diverse experiences, skills and perspectives in order to better confront evolving risks and find new opportunities. Let's make good on our words and move to action."[331]

In August, Lacewell announced that she would be leaving her position after she was referenced in a report by NY Attorney General Letitia James which found that those in former NY Governor Andrew Cuomo's inner circle contributed to a toxic work environment.[332]

Later that month, NY Governor Kathy Hochul chose Adrienne Harris, who previously worked as a senior adviser to the US Treasury Department under the Obama administration, to lead the DFS. Governor Hochul made clear that the largest priority of the NY DFS under her administration would be consumer protection and promoting equitable recovery in the wake of the covid pandemic.[333]

Canada

INDUSTRY AND REGULATORY BACKGROUND

While Canada has not suffered misconduct scandals to the same degree as many other financial markets, it has not entirely avoided such concerns. Among a global push to hold auditors to account for the quality of their audits and for their frequent failure to identify seemingly obvious fraud, for instance, in February 2022 PwC Canada was fined more than $900,000 by Canadian and US accounting regulators over exam cheating that involved some 1,100 of its auditors.[334]

THE OFFICE OF THE SUPERINTENDENT OF FINANCIAL INSTITUTIONS

In July 2021, Peter Routledge took the helm at the Office of the Superintendent of Financial Institutions (OSFI), when Superintendent Jeremy Rudin, who had held the position for the previous seven year term, retired.[335]

Routledge had served previously as chief executive officer of the Canada Deposit Insurance Corporation (CDIC). While at CDIC, Routledge led a successful transformation of its culture, strategy, and technology. Earlier, he held a variety of leadership roles in the financial services industry, both in Canada and abroad. "He has distinguished himself in both the public and private sectors and I know his leadership and eye for innovation will be of immense value," Finance Minister Chrystia Freeland said in a statement, "particularly as we navigate the end of the COVID crisis and Canada's economic recovery."[336]

Diversity and Inclusion

OSFI has sought to be more intentional in establishing an organizational culture, internally, that supports its work in regulating and supervising the financial sector. This explicitly includes priorities regarding its diversity. Superintendent Peter Routledge stated that OSFI would work "obsessively" on improving the regulator's diversity, in a September 2021 speech.[337]

"Having a diverse workforce is a valid policy end, in and of itself," Routledge wrote. "It reflects Canadian reality, the Canadian mosaic, and it is the right thing to do. And we pursue diversity for another very important reason," he added. "Diversity enables OSFI to leverage varied perspectives on the risks we face. We will be better prepared for whatever lands on our doorstep if we have an organization with diverse skills and mindsets drawn in full proportion from the Canadian mosaic."

Culture and Compliance Supervision

In a speech entitled, "Clear Expectations: OSFI's Priorities and Agenda," Routledge laid out the regulator's views on the importance of culture as a driver of sound decision-making and operational resilience:

> *Whether you are a regulated entity or the regulator, ensuring you have a responsible and forward-thinking organizational culture in place will not just help mitigate the impact of any future "black swan" events — and rest assured, COVID-19 will not be the last of these — it will also blunt any criticism that due consideration has not been given to acting responsibly and prudently.*[338]

In a December 2021 letter to Federally Regulated Financial Institutions, OSFI announced intent to issue a consultative document regarding culture and reputational risk in early 2022.[339] With this, OSFI proposes to issue draft guidance to consult on culture risk management by year end.

The letter, which was published in April 2022, laid out plans to issue a principles-based, outcomes-focused culture risk management guideline for consultation in late 2022, also seeking comments on proposed outcomes of effective culture risk management and on how culture risks can affect federally regulated pension plans.[340]

As part of its future guidance, OSFI will expect Federally Regulated Financial Institutions (FRFIs) to establish and maintain a robust approach to managing and overseeing culture risks. The approach includes attention to: Leadership; Compensation, People Management & Incentives; Accountability & Ownership; Risk Mindsets & Behaviors; Group Dynamics & Decision-Making; and, taken together, a firm's Resilience.

ONTARIO SECURITIES COMMISSION

OSC ONTARIO SECURITIES COMMISSION

In October 2020, the Ontario Securities Commission (OSC) published the Charter for its new Office of Economic Growth & Innovation, with the stated goal of "supporting economic growth and innovation in Ontario's capital markets."[341]

In a May 2021 Linkedin post, Office director Pat Chaukos wrote that, in addition to supporting fintech businesses through its launchpad program, the Office would aim to expand its reach.[342]

"What's changed is that we're striving to support the whole financial innovation ecosystem — not just individual businesses," she wrote. "We aim to build new ties with incubators, accelerators, and innovation centres, as well as VCs. We're also working on ways to help connect service providers with eligible businesses for advice that falls outside our specialty."

In Focus

Regulating a Cultural Shift in Audit

By SARAH RAPSON

Sarah Rapson

Financial Reporting Council

An individual audit is, in effect, a snapshot. Once taken, it is frozen in time. Yet the audit profession is in the early stages of significant and essential change, as it moves towards a culture-based approach. The Financial Reporting Council's regulatory approach is also adapting to take an assertive supervision and improvement approach to culture, using our 'four faces' framework, and this will continue to evolve as our knowledge and maturity increase.

Kingman and Brydon

Two recent reviews of the UK audit market (the 2018 Kingman Review and the 2019 Brydon Review), prompted by large corporate failures, triggered substantial reform, to improve the quality and effectiveness of audit, increase the chances of preventing unnecessary corporate failures and, in so doing, restore trust in the audit profession.

The Kingman Review was the catalyst for the Financial Reporting Council (FRC) to embark upon a transformational journey, including its evolution into the Audit, Reporting and Governance Authority (ARGA), with a specific aim to operate as an "Improvement Regulator", providing increased confidence in the UK market.

The Brydon review focused more closely on the role, scope and quality of the audit engagement itself, including the need for a redefinition of audit and its purpose, the need for improved audit techniques, such as in fraud detection and prevention, and the opportunity to extend auditing beyond just examining financial statements, embracing other information relevant to users of an audit such as operational resilience and cultural considerations.

The Brydon review also highlighted that good auditing is about an auditor having the right mindset and behaviours as well as following rules and processes. Increased standards, training and processes alone will not improve audit quality, as an auditor's mindset is as much a matter of behaviour and psychology as it is of knowledge and expertise. Audit firms need the right culture to drive the right behaviours which, in turn, are necessary for high-quality audits.

Restoring trust

At the heart of this change is a fundamental need to ensure that an audit firm has a purpose-led culture with the goal of assuring audit quality and maintaining trust in capital markets at its core. A purpose-led culture, aligned to strategic objectives, is not just a requirement for corporations, but also vital for those firms that provide professional audit and assurance services to the large organisations that affect the wider health of the UK markets.

An audit firm with a culture focused on the public interest role of audit and that promotes behaviours correlating to high quality audit, such as exercising professional scepticism and the courage to challenge an audited entity's management, will help to restore deserved trust in the audit opinion. ▶PAGE 153

The benefits of a focus on culture also stretch far beyond the delivery of high-quality audit. Culture also plays a strong factor in the retention of talent and is seen as a crucial element in improving the attractiveness of the profession.

The consequences of getting this wrong include financial penalties for individual audit firms, reputational damage and lack of trust for the profession as a whole. A number of successive high profile audit scandals has eroded trust in audit among UK investors, shareholders and the wider public. Trust is a function of competence, reliability, the public interest and, of course, culture. So prioritising culture change is essential if we want to restore trust.

A purpose-led culture, aligned to strategic objectives, is not just a requirement for corporations, but also vital for those firms that provide professional audit and assurance services.

FRC's 'four faces' model

Our regulatory approach is based on a 'four faces' model that represents the FRC's role as a multi-dimensional and integrated regulator. The roles we have articulated to influence firms' behaviours include: the System Partner, the Facilitator, the Supervisor and the Enforcer.

FRC as System Partner and Facilitator

These first two roles are broadly predictive and preventive in nature, geared towards encouraging good practice through structured engagement, and collaborating with and educating firms to support their continuous improvement. This includes setting expectations for firms around governance, values and culture.

Our approach to this model is therefore collaborative, working in partnership with the profession. In June 2021 we convened a series of virtual sessions to bring the best minds to the table over one week to discuss and debate 'the what, why and how' of the cultural conundrum. This was followed by the publication of a breadth of stakeholder views under the title: 'Audit Firm Culture: Challenge. Trust. Transformation — A Collection of Perspectives'.

The message from conference participants was clear — a strong audit firm culture requires a firm-wide environment that empowers and necessitates auditors to bring the full force of their professional skills to verify clients' financial reporting practices. Auditors need not only deep technical knowledge and skills but also an environment that prompts them to apply the right mindset and behaviours when performing an audit.

We will continue to share best practice among the industry, fostering a virtuous cycle of continuous improvement. There is much leverage we can gain as a leading UK regulator in this regard. Together with our network of international audit regulators, we are evolving our regulatory frameworks to supervise firms holistically, including through the lenses of governance, culture and behaviours.

FRC as Assertive Supervisor and Enforcer

These second two roles are more detective and corrective in nature, geared towards monitoring firms' adherence to regulatory requirements — including auditing standards and audit quality guidelines, supervising audit firm culture, investigating and, where necessary, applying proportionate sanctions and directions. If we get it right, our 'four faces' model will encourage, as standard practice, both the sceptical auditor's mindset and the ability to identify poor behaviours at the earliest opportunity — before they manifest as larger systemic problems down the line. And where we cannot transform behaviour through education and encouragement, we will enforce it through monitoring, inspections and financial sanctions.

In terms of our supervisory approach, we expect audit firms to understand the importance of culture and to have in place a culture programme that identifies the critical behaviours that correlate to high-quality audit with initiatives to embed these behaviours within the audit firm. Our role is not to prescribe how firms should construct and then roll out their culture frameworks — a firm's executive management needs sufficient autonomy to conceive and deliver this — but, where a firm does not have an adequate culture programme in place, it should expect increased FRC supervisory scrutiny.

> We expect audit firms to understand the importance of culture and to have in place a culture programme that identifies the critical behaviours that correlate to high-quality audit.

As firms' cultural frameworks become more embedded and reach maturity, we will expect them to undertake their own regular and complete culture assessments. The FRC will then look at the results of these assessments, combining them with its own independent assessments.

A firm's culture assessment strategy should take into account the various techniques and tools available. The most innovative firms are using a variety of techniques to measure the success of their culture frameworks. The FRC is monitoring their individual approaches with a view to identifying good practice.

In addition to surveys, which aim to provide some quantitative analyses, firms must obtain deeper qualitative research with employee narratives illustrating what employees *actually* experience versus the *desired culture* that the firm is communicating. To understand these employee narratives, the FRC has engaged a third party to perform focus groups, as a means of isolating the light and the shade; the exception from the routine; the calm state of mind from the stressed and pressured environment. Individual stories will yield greater insight into the conditions a firm must create to incentivise desirable employee behaviour and a culture that aligns to organisational shared values.

Looking ahead, our supervisory approach around audit firm culture will continue to focus on assessing those behaviours most directly correlated with high quality audit. Where necessary, we will perform deep dives into specific areas of concern; for example, we are presently close to finalising a thematic review looking at professional scepticism and challenge. This work looks at drivers of behaviour in an audit firm that either promote or inhibit the ability of the auditor to exercise professional scepticism, or to effectively challenge audit entity management; drivers such as: the firm's reward structure, performance management, leadership and governance.

Change is already underway

It is pleasing to see the Big Four audit firms voluntarily embarking upon structural changes to operationally separate their audit practices from the rest of their firm's businesses. A key objective of operational separation is to achieve a positive cultural shift in audit firms that is quite distinct from the mindset within a multi-disciplinary firm. Truly effective audit businesses require the attributes of independence, objectivity and a mindset of rigorous challenge to succeed.

Change won't happen overnight, but is essential to improve quality and restore trust

We are not naive enough to think that a full cultural shift will happen overnight. Lasting change needs to be habit-forming and requires a firm foundation and a genuine will to succeed. Companies and their leadership have a distinct role here too, of course. The evidence for audit firm cultural improvement, judged through measurable outcomes, may take several years to manifest but the FRC will be there for the journey.

Building an effective supervisory model for audit firm culture is an ambitious aim for the FRC as it embarks upon its own transformational journey towards becoming a new regulator. Like the audit firms, the FRC and its successor ARGA, will be judged and measured by its culture and its own behaviours. The rewards of success will be tangible and enduring: beyond the main regulatory objectives of improved audit quality and sustained resilience of the wider audit market, a fully functioning ARGA will enhance the attractiveness of the audit profession and equip investors with the confidence in audited financial information they require for effective decision-making. I am confident that all the stakeholders to these goals will work together to achieve this cultural step change.

***Sarah Rapson** joined the FRC as Executive Director Supervision in September 2021. She is responsible for leading the FRC's Supervision Division and its work to enhance audit quality both through standard setting and audit monitoring of firms; supervisory oversight of the Recognised Professional Bodies; and to promote improvement in corporate reporting through detailed technical reviews of companies' annual reports and accounts.*

INTRODUCING DEEPER DIVE SUPPLEMENTS

Renal Failure: a crisis in audit culture?

The audit industry is tasked with assuring that reliable financial information flows to investors and the public, to sustain effective markets and growing economies.

It is therefore troubling that recent past years have witnessed a rash of misconduct in the audit profession, evidenced among all the major accountancies, in many global markets.

If the financial sector sustains an economy's 'circulatory system', the audit industry serves as its kidneys. And where we see both 'blood toxicity' and 'renal failure,' the prognosis for the patient is not good. What next for culture risk governance and individual accountability in the audit profession?

Learn more in a Deeper Dive supplement to this report, available later this year on Starling Insights, a membership-based platform that will feature all of our *Compendium*, thought leadership, video, podcast, and event-driven content.

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United Kingdom 🇬🇧

INDUSTRY AND REGULATORY BACKGROUND

Conduct in Banking

Banks in the UK have faced much the same scrutiny for culture and conduct issues as has been experienced by their counterparts in other jurisdictions. The total of all fines issued last year by the UK Financial Conduct Authority (FCA), the country's conduct regulator, was £577 million — nearly four times the previous year's total. This principally involved a few very large fines, though the total number of fines also increased by 57 percent.[343]

In March 2021, the FCA filed criminal charges against NatWest, the UK's third largest bank by market value, for failing to prevent money laundering. This was the first prosecution under a 2007 money laundering rule. Previous infractions were largely resolved through settlement.[344] The case, which related to a £365 million money laundering scheme which the bank allegedly had failed to uncover, was thought likely to substantially damage the firm's reputation.[345]

It was revealed in the course of trial that Natwest had allowed trash bags full of cash to be stored in its branches. When the bank pleaded guilty to all three charges in the case, in October 2021, it was hit with a £265 million fine for its failures. This not only served to punish the bank, but also to send a message to all UK banks that prosecution was on the table if they failed to take their anti-money laundering obligations seriously.[346]

In July 2021, *Bloomberg* reported that senior leaders at HSBC, the country's largest bank, had received a 48-page report with the results of a survey on diversity and perceptions of racism among the firm's employees. The report, produced by an employee of the firm, detailed examples of racism, discrimination, and harassment that employees had faced at work and work-related functions. The report concluded that HSBC sufferers from "abnormal levels of systemic discrimination."[347] Bank officials opened an internal review into the findings of the report, investigating the incidents referenced within it. An HSBC spokesperson said, "We are committed to improving diversity and inclusion at HSBC." The employee behind this report resigned in August 2021, complaining of having experienced a lack of support from colleagues.[348]

HSBC also faced scrutiny over its anti-money laundering controls over the past year. In July 2021, the bank faced questions as to whether it had appropriately disclosed to the US Department of Justice information about a £3 billion money laundering scheme it had uncovered.[349] In December, the bank was fined £64 million by the FCA for weaknesses in its transaction monitoring systems over an eight year period.[350]

"HSBC's transaction monitoring systems were not effective for a prolonged period despite the issue being highlighted on numerous occasions," said Mark Steward, FCA executive director of enforcement and market oversight. "These failings are unacceptable and exposed the bank and community to avoidable risks, especially as the remediation took such a long time."

HSBC was in the news again in March 2022 for seemingly refusing to close its Russian business in accordance with its competitors. While the bank did begin to distance itself from current clients and refuse new clients from Russia[351], it was found to be censoring analyst reports to remove references to the "war" in Ukraine, instead referring to it as a "conflict." Some noted that HSBC still had 200 employees in Russia, where new laws banned the spread of what the Russian government deems "false" information relating to its invasion of Ukraine.[352]

In a review of anti-money laundering and counter-terrorist financing controls among its regulated entities, the FCA found several key weaknesses to be common among firms. As a result of these findings, the FCA issued an ultimatum to retail banks, stating that they must complete a gap analysis, comparing their own practices to the weaknesses found, before September 17th of this year — or face regulatory intervention.[353] "We expect the senior manager holding the financial crime function to have sufficient seniority to be able to carry it out effectively and to ensure that the gap analysis is promptly completed and its findings shared internally and acted upon as appropriate," the FCA said.

In December 2021, Standard Chartered was fined £46.6 million by the Bank of England's Prudential Regulation Authority (PRA) for misreporting its liquidity position and for failures in its internal controls.[354] "We expect firms to notify us promptly of any material issues with their regulatory reporting, which Standard Chartered failed to do in this case," PRA CEO Sam Woods said. "Standard Chartered's systems, controls and oversight fell significantly below the standards we expect of a systemically important bank, and this is reflected in the size of the fine in this case."

The FCA announced its plans to take a more 'holistic risk' approach to assessing financial crime after it levied a £147 million fine on Credit Suisse. The regulator pledged to "pursue serious financial crime control failings by regulated firms."[355]

There have also been further developments in the so-called "cum-ex" tax fraud scandal in the past year. As was discussed in last year's issue of this report, in 2020 the FCA began investigating 14 firms and six individuals for their role in this scheme. The firms, and certain individuals, are alleged to have run dividend stripping schemes in Denmark, Germany, France, and Italy — rapidly trading shares to duplicate dividend tax refunds.[356]

In mid-2021, the FCA fined Sapien Capital Ltd. £178,000 for "failings which led to the risk of facilitating fraudulent trading and money laundering" in the first FCA case relating to the "cum-ex" scheme.[357] "The FCA expects firms have systems and controls that test the purpose and legitimacy of transactions, reflecting scepticism and alertness to the risk of money laundering and financial crime, and failures here constitute serious misconduct," Mark Steward said in a statement. In November 2021, the FCA fined Sunrise Brokers LLP £642,000 for its relationship with hedge fund manager Sanjay Shah, who is said to have been instrumental to the tax fraud scheme.[358]

One theme that runs throughout this report is the distinction between misconduct and poor conduct. While misconduct refers to bad actors intentionally crossing the boundaries of ethical (or legal) behavior, poor conduct refers to honest mistakes. While many instances of poor conduct are innocuous, a confluence of mistakes can sometimes lead to terrible consequences. For example, Barclays faced a £450 million loss in March 2022 after it mistakenly issued $15 billion more structured notes and exchange traded notes than it had registered.[359]

As has been the case in many other jurisdictions which faced potential economic crisis as covid ran rampant, the UK prioritized speed and convenience over proper due diligence when issuing relief loans. While it was certainly essential to mobilize the relief monies quickly, banking systems seemed to have made it easy for fraudulent actors to procure large sums of the funds. In the UK, the various relief loan schemes paid out a total of £80 billion. However, PwC, hired by the government to analyze its relief programs, estimated that a total of £3.5 billion of the emergency funds were lost to fraud.[360]

In February 2022, Treasury and Cabinet Office Minister for Efficiency and Transformation, Theodore Agnew, resigned from his role citing rampant fraud in the government.[361] "The rapid roll out of the government's bounce-back loan scheme was an important and successful intervention to protect the productive capacity of our economy in the worst peacetime crisis since the second world war," he wrote in the *Financial Times*. "But the cack-handed implementation and catastrophic follow-through is costing us probably hundreds of millions of pounds a month."

In March, *JD Supra* reported that the FCA had received 90 reports detailing allegations of fraud at financial firms relating to the pandemic emergency loan scheme. "We can confirm that, as of February 21, 2022, the FCA has received 90 reports from Bounce Back Loan Scheme lenders (BBLS) of suspected fraud involving FCA-authorised firms," the FCA said in response. "These include referrals where a fraudulent application was suspected at source and the application was subsequently declined."[362]

These instances of actual and alleged misconduct, coupled with turmoil at the FCA (discussed in the "Financial Conduct Authority" subsection below), and with government officials seeming to ignore the rules they themselves set in order to halt the spread of covid, has led some to worry that irreparable harm has been done to the public trust in these essential institutions.[363]

"Once that trust is broken and observance of restrictions/rules is seen as a personal choice, a rules-based system cannot function and a community sets its own rules through social pressure, ever more of concern in a world of aggressive social media pressure," Douglas Flint, chair of fund manager Abrdn, said.

Individual Accountability

Financial institutions were not alone in facing repercussions for perceived culture and conduct risk management failures in 2021. UK regulators have also focused on holding the institution's senior leaders individually liable for such failings. For instance, in connection with a misconduct scandal surrounding his connection to Lex Greensill, the embattled financier who ran Greensill Capital up to its collapse, the FCA issued fines to Tim Haywood and his former employer, Swiss asset management group GAM, £230,000 and £9.1 million, respectively.[364]

Bank executives have also been held accountable for their behavior outside the office. Barclays CEO Jes Staley was revealed to have maintained a more questionably close relationship with sex-offender Jeffrey Epstein than he had earlier revealed during official inquiry. This led to Staley's ouster[365] and, amid subsequent investigation into these ties, Barclays froze millions in bonus awards to Staley.[366]

Moreover, individual accountability is not reserved exclusively for those who are found to have participated actively in alleged misconduct. UK regulators have made it clear that executives who fail to manage relevant risks effectively will be held accountable for misconduct that occurs under their purview.

Following the collapse of Archegos, the family office of billionaire Bill Hwang, the FCA and PRA warned that bankers may face cuts to their bonuses if they cannot demonstrate that they have made material progress in resolving the risk management failures illuminated in the course of the regulators' review of the incident.[367]

In previous releases of this *Compendium*, we have discussed the UK's Senior Managers and Certification Regime (SMCR), launched in 2016, and aiming to hold senior bankers personally accountable for risk management failures that take place on their watch. Administered by both the FCA and PRA, the SMCR, was intended to nudge senior managers into taking ownership of culture and conduct proclivities at the firms they lead.[368]

In May 2021, FCA Director of Retail Banking and Payments Supervision, David Geale, issued a "Dear CEO" letter laying out actions needed in order to rectify deficiencies found in banks' anti-money laundering programs. In this letter, Geale explained that senior executives are required by the SMCR to take appropriate account of these risks.[369] "The Senior Managers and Certification Regime (SMCR) places a responsibility on all senior management to counter the risk that their firm might be used to further financial crime," he wrote. "Particular responsibility lies with those SMCR roles holding responsibility for financial crime."

However, between the establishment of the SMCR in 2016 and mid-2021, only five London bankers have been fired for "disciplinary reasons." In the same time period, more than £1 billion in misconduct related fines have been levied, leading some to question whether the SMCR is being used to its full effect.[370]

Audit Woes

Financial institutions are not alone in being criticized for culture and conduct related issues. As in nearly every other major jurisdiction, UK auditors have faced increased scrutiny from regulators, legislators, and the public in the past year. The Financial Reporting Council (FRC), an industry regulator, found in its latest "Annual Audit Quality Inspection" report that nearly a third of all audits conducted by the seven largest UK audit firms were "high-risk" — a designation indicating that their audit work requires significant improvement.[371]

In mid-2021, a survey conducted by the Chartered Institute of Internal Auditors found that 45.5 percent of chief audit executives believed that the covid pandemic had deteriorated organizational culture. The institute issued a list of best practices to reverse this trend, including suggestions to engage with staff on culture issues and implement systems for internal auditors to hold managers accountable in maintaining organizational culture.[372]

In November 2021, the FRC's chief executive, Sir Jon Thompson, called for auditors to improve how they run their own businesses. "To be frank, one of the things that strikes you when you meet these people is they give people advice about how to run their businesses better but sometimes they don't run their own business very well," Thompson said.[373]

While the burden of improvement largely falls on the auditors themselves, the government is also working to put in place a more powerful successor to the FRC, with a view to raising practice standards across the industry. The FRC has issued a white paper outlining ambitions for the new Audit, Reporting and Governance Authority (ARGA), as the FRC's replacement is to be called.[374]

"Stakeholder and wider public trust in the credibility of directors' reporting and the statutory audit has been shaken by a succession of sudden and major corporate collapses which have caused serious economic and social damage," asserts a UK government Policy Paper entitled, "Restoring trust in audit and corporate governance," issued in March 2021. This paper includes recommendations from the UK's Competition and Markets Authority (CMA), including one which would require that two audit firms sign off on FTSE 350 companies' accounts, at least one being from a challenger firm. Consultation on this white paper ended in July 2021.[375]

Corporate Governance and London as a Financial Center

Mervyn King, chair emeritus of the International Integrated Reporting Council (IIRC) and former Governor of the Bank of England, argued in a May 2021 *Financial Times* piece that, if they are to succeed in the post-pandemic world, companies will have to transform their corporate governance from a mere box-ticking exercise to an outcomes-based approach. King outlined four critical outcomes which external stakeholders will push a company to achieve: an ethical culture with effective leadership; trust and confidence in the company from the community(-ies) in which it operates; adequate and effective risk controls; and an ability to create value in a sustainable manner.[376]

In September 2020, the FRC released a review of the implementation of the UK Stewardship Code 2020, which sets principles for investment professionals handling money on behalf of investors, and for those who support them. The Code came into effect at the beginning of 2020 and was discussed in some detail in that year's issue of this *Compendium*. While some reports evidenced good "stewardship activity," the FRC found that few showed the implementation of all principles or completed all reporting requirements.[377]

One year later, when the list of signatories to the Stewardship Code were released for the first time, many were surprised to see that a third of the asset managers which had applied to sign onto the principles subsequently failed to pass the FRC's relevant review process. While 189 asset managers applied to be signatories, the final list included only 125.[378] "We are proud of our robust approach to assessment and encourage those who have been unsuccessful to reflect on our feedback and apply again in future," FRC CEO Sir Jon Thompson.

In November 2021, the *Financial Times* reported that, while the UK was close to finalizing reforms to its corporate governance code and corporate reporting requirements, the reforms were being scaled back following backlash from those businesses that the new rules would impact. Some argued that the more stringent rules would make the UK a less attractive place in which to do business, and thus hurt London's status as a financial center.[379] This is especially important, as financial hubs in the US and Asia appear to have outpaced London in growth over the past decade.[380] Others view the weakened reforms as representing a missed opportunity to provide regulators with the 'teeth' necessary to advancing non-financial risk management and the reliable corporate governance necessary to sustaining London's enviable global posture.[381]

In 2021, Prime Minister Boris Johnson's government introduced a set of measures which aim to encourage regulators to "facilitate" London's competitiveness as a global financial center.[382] These deregulatory pressures — not unique to the United Kingdom — have recalled for some the pre-financial crisis regulatory environment, wherein efforts were focused on ensuring financial system "competitiveness" rather than focusing on its stability.[383] PRA Executive Director Vicky Saporta warned of a potential regulatory "race to the bottom," if regulators and legislators succumb to the pressure to lower standards to boost the competitiveness of the UK's financial system.[384]

As we go to print, the UK government announced that it would introduce a new wide-ranging financial services bill to Parliament. This bill would, in part, require that regulators consider international competitiveness, and give parliament scrutiny over the agencies.[385]

Operational Resilience

In March 2021, the FCA and PRA published a policy statement titled, "Building operational resilience."[386] Therein, the regulators set forth steps for firms to ensure operational resilience, as operational disruptions could "pose a risk to the soundness, stability or resilience of the UK financial system or the orderly operation of financial markets."[387] As a part of this policy, firms were instructed to identify their important business services and set impact tolerances for those services by March 31, 2022.[388] While the policy largely focuses on processes and systems, some believe a sound culture to be a key part of operational resilience.

When this policy came into effect one year later, firms were required to begin work on mapping and testing to ensure that they can remain within the impact tolerances set for their important business services by March 31, 2025. By then, they also must have made the necessary investments for them to operate within these tolerances consistently.

Collaborating on Diversity

Like many other global regulators and standard-setters, the FCA and PRA have made it a priority to determine and improve the statistical diversity of the firms they regulate. FCA CEO Nikhil Rathi has said, “We care because diversity reduces conduct risk and those firms that fail to reflect society run the risk of poorly serving diverse communities. And, at that point, diversity and inclusion become regulatory issues.”[389]

Several initiatives in this direction began in July 2021. For example, the FCA proposed new rules to require that 40 percent of board directors are women, that at least one senior board position is held by a woman, and that boards have at least one non-white member. These standards are not mandatory, but firms must “comply or explain” why the benchmarks have been missed.[390] ▸PAGE 371

The FCA also consulted the industry on new disclosure guidance for diversity and equity concerns. “Our proposals are intended to increase transparency by establishing better, comparable information on the diversity of companies’ boards and executive committees,” the FCA wrote. “This will provide better data for companies and investors to assess progress in these areas and make investment decisions, reduce investor search costs, and inform shareholder engagement, enhancing market integrity. “[391]

Lastly, in July, the Bank of England (BoE) and the UK Financial Conduct Authority (FCA) published a Discussion Paper entitled “Diversity and Inclusion in the Financial Sector — Working Together to Drive Change.” The central bank, which houses the UK’s Prudential Regulation Authority (PRA) and the conduct regulator argued that efforts to promote gender and ethnic diversity in the country’s financial sector have been insufficient, to date, and warn that firm leadership may face mandated pay cuts if they fail to report on the degree of diversity among their employees.[392]

In the Paper, the regulators also stated that they are considering an expansion of the FCA’s “fit and proper” assessment scheme so as to address diversity, and that they may adjust guidance regarding non-financial misconduct to include sexual harassment, bullying, and discrimination. Additionally, the regulators propose that senior management salaries be linked to meeting diversity goals.

FCA Chief Executive Nikhil Rathi said, “We are concerned that lack of diversity and inclusion within firms can weaken the quality of decision-making. We look forward to an open discussion on how we should use our powers to further diversity and inclusion within financial services, to the mutual benefit of firms and their customers.”

A diversity data collection pilot was planned for fall of 2021, as part of a partnership between the FCA and PRA. This program involved collecting sensitive employee data and, if successful, was intended to lead to future regulatory activities in this area.[393]

In a September 2021 article, London law firm CMS stated that the FCA’s new diversity targets would be “meaningless” should companies fail to improve their capability to gather relevant data reliably. While this is not as large of an issue for the diversity targets pertaining to personnel in more senior positions, it becomes much more important for targets farther down the org chart.[394]

“Most organisations only require provision of this data on a voluntary basis and, for some organisations, there is low take up,” CMS wrote. “While obtaining data on gender is simpler, experience has shown this is not necessarily the case for ethnicity data.”

The UK government has also planned an initiative to increase the number of women in boardrooms. “UK business has taken great strides when it comes to gender diversity at board level. Companies shouldn’t take their foot off the gas,” Business Minister Paul Scully said. “Evidence shows that more diverse businesses are more successful businesses."[395] However, even with proper data capture, some have raised concerns that reporting requirements focused on purely statistical diversity are not adequate to truly assess firms' cultures, regardless of the validity of the data.

In September 2021, the FCA's Executive Director of Consumers and Competition, Sheldon Mills, spoke on the importance of diversity *and* inclusion at the Investment Association Culture in Investment Management Forum. "Businesses have to adapt with the changing expectations of customers, employees, shareholders, and other stakeholders," Mills said. "Diversity and inclusion are critically important to the FCA. Firms that are diverse and inclusive deliver better outcomes for shareholders, consumers and markets."[396]

The industry seems to be more focused on cultivating an environment with diversity of thought than the more statistically-oriented diversity targets being discussed by most regulators. In a survey of FTSE-listed board directors, many pointed to personality and neurodiversity as being more integral to board effectiveness than ethnic and gender diversity.[397]

FINANCIAL CONDUCT AUTHORITY

By any measure, the FCA has had a difficult twelve months. It has faced scrutiny from the government which provides its mandate, as well as outcry from its employees that help to fulfill it.

In June 2021, the UK Parliament's Treasury Committee called for changes to the Financial Conduct Authority's (FCA) supervisory capabilities, following the collapse of investment firm London Capital and Finance (LCF). Committee Chair Mel Stride called the collapse of LCF, "one of the largest conduct regulatory failures in decades." The FCA must be better able to protect consumers and financial markets, the Committee concluded.[398]

In October, the FCA was lambasted for paying out more than £125 million to staff since 2016, despite the string of crises and criticisms the regulator has endured.[399] But when FCA leadership sought to reduce bonuses, it faced internal backlash, as three-quarters of its employees were confronted by a potential 10 percent cut in pay,[400]

A leaked internal memo showed FCA leadership grappling with morale issues, after a July 2021 survey revealed that 56 percent of the regulator's staff do not understand why the organization must be transformed.[401] As a result of the impending transformation and pay-cuts, staff at the FCA filed a formal petition for union recognition in October 2021, looking to the FCA to acknowledge Unite as the official labor union for its employees.[402]

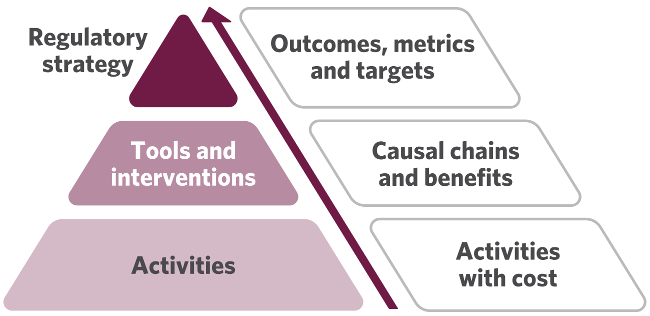
In January, there were reports that FCA staff were edging closer to a strike as a result of the regulator's cost-cutting measures.[403] In early February, 87% of Unite members voted to start a strike.[404] The months-long dispute culminated in the FCA's first ever staff strike this month.[405]

"The action will start with 48 hours of continuous strike action by workers across the financial regulator in London and Edinburgh," a Unite statement said on 4 May 2022. "This will be followed by a continuous 'work to rule' by the workforce, who will withdraw the regular overtime and additional work they currently do outside of their contractual duties."

New Regulatory Strategy

Despite dealing with this tumult, the FCA has made efforts to maintain its global leadership position in the regulation and supervision of culture and conduct. In April 2022, the FCA announced the launch of a three-year strategy that prioritizes resources to prevent serious harm, set higher standards, and promote competition. The regulator will, for the first time, hold itself accountable against published outcomes and performance metrics.[406]

Improving outcomes through our activities



Source: UK Financial Conduct Authority

"We intend to report on metrics regularly to monitor changes and over time, as we better understand the metrics we have proposed and how they are affected by wider economic shocks, we expect to include targets that we are aiming to reach," the FCA wrote. "Monitoring these metrics will be one of the sources of evidence that inform the actions we take."[407]

Another key initiative in the agency's strategy is shutting down firms which do not meet basic regulatory standards, aiming to protect consumers and improve the market. The FCA is recruiting 80 employees to work on the initiative.[408]

The strategy builds on activities launched last July, when Nikhil Rathi, Chief Executive of the Financial Conduct Authority, committed the regulator to become more innovative, assertive, and adaptive. "Our new strategy enables the FCA to respond more quickly to the rapidly changing financial services sector," Rathi said. "It will give us a foundation to continuously improve for the benefit of our stakeholders, and respond swiftly to economic and geopolitical developments."

Supervision and Remote Working

In the two years since the start of the covid pandemic, financial services firms, as many others, have been forced to operate in a largely remote context. While some organizations have returned to the office, many still operate remotely or with some sort of hybrid work model.

As discussed in our 2021 report, this presents quite a challenge — not only with regard to firm's ability to monitor their employees, but also for regulators tasked with assuring that these monitoring systems are sufficient. In July, the regulator announced that it would be investing £120 million over the next three years in order to improve its use of data to detect fraud and misconduct.[409]

The FCA announced in October last year that it would require firms to demonstrate that their remote working arrangements will not increase the chance of consumer harm or misconduct. Leaders must ensure appropriate oversight, and that the FCA is able to gather information it needs about the firm before adopting a hybrid model.[410]

In this memo, the FCA wrote that firms should ensure that employees are fully aware that the regulator can inspect any location where work is performed, including home offices.[411] However, after it was reported that financial executives had called upon lawyers to determine the legality of this policy, the FCA clarified that such intrusion into private homes would be very rare.[412]

In January 2022, the FCA warned that hybrid working arrangements could create "in" and "out" crowds in financial firms. At a City and Financial summit on diversity and inclusion, FCA senior adviser on public sector equality duty, Georgina Philippou, explained that more efforts are needed to ensure that hybrid working environments are made inclusive.[413]

Consumer Protection

The FCA has instituted several programs in the past year in an effort to improve the treatment of customers. In May 2021, the regulator proposed a Consumer Duty of Care, which requires that firms provide a "higher level of consumer protection consistently," with a view to assuring that consumers experience good outcomes.[414]

In a June 2021 webinar, the regulator explained that the new consumer duty will have three parts: a consumer principle reflecting the standards of behavior the FCA expects of firms, cross-cutting rules to avoid harm to customers, and an accompanying set of rules and guidelines for firm conduct in relation to communications, products and services, customer service, and price and value.[415]

In July 2021, the FCA's Nikhil Rathi announced that the regulator would establish a "Regulatory Nursery" to supervise firms conducting new types of business. "We want to support, as well as scrutinise, new businesses in the market as part of our supervisory role," Rathi said. "With this in mind, we will set up a Regulatory Nursery — a form of early-warning system where we monitor firms doing entirely new types of business and operating as fully regulated entities for the first time."[416]

Later in the year, the FCA announced a consultation period on a revised consumer duty, taking up some of the feedback from the proposal it had made in May. The new proposal also included further detail on rules targeted at stopping practices harmful to consumers. The consultation period was set to run through February 2022.[417] [Results are yet to be made publicly available as of the time of this writing.]

"The new duty will drive a change in culture at firms," the FCA's Sheldon Mills said. "We expect firms to step up and put consumers at the heart of what they do and we'll be holding senior managers accountable if they do not. The duty will also help create an environment for healthy competition between firms, encouraging them to be innovative in developing products and services that meet consumer's needs."

A study by audit and consulting firm EY found that financial firms seem unready for the additional responsibilities that the new consumer duty will impose. More than a quarter of firms, EY found, had not begun to prepare for the FCA's overhaul as of February 2022.[418]

The FCA has also undertaken other work to protect vulnerable customers from harm. It called for firms to improve governance and oversight of fund managers to protect their investors in the wake of the Woodford fund collapse, discussed in some detail in our 2021 report.[419]

"Some firms are not sufficiently meeting FCA standards and we want to see significant improvement," Mills said. "We expect firms to look at the key findings on governance structures, conflicts of interest, operational controls, and the other areas highlighted and take action."

Soon after, the FCA made clear that ensuring good outcomes for consumers was a core priority in its business plan for 2021-2022. This theme arises in several of the FCA's plans for the current 12-months, to include efforts to improve disclosures.[420] "We need to increase our use of behavioural science, economic analysis and available data capabilities to design targeted, effective disclosures," FCA CEO Nikhil Rathi wrote. "Where disclosures are ineffective, we will intervene so consumers have appropriate protection and competition works in their interests."[421]

The regulator is also consulting on changes which would allow its Regulatory Decisions Committee (RDC) to intervene "in real time" to prevent harm to consumers and to market integrity.[422]

In speech at the Credit Summit 2022 in March, Brian Corr, FCA Interim Director of Retail Lending, stated that the FCA has been working to improve consumer outcomes even before the Consumer Duty had come into effect. "For example, we have consulted on banning debt packagers from accepting referral fees for passing customers on to other providers of debt solutions, because of the conflict of interest between giving consumers advice in their best interests, and the financial incentive to make certain recommendations," he said. "We're also working more closely with other bodies like the Insolvency Service to deliver joined-up solutions to wider problems."[423]

The FCA is due to release the final policy statement laying out the consumer duty as it will come to effect in 2023. Leading up the publication of the official policy, there is still some uncertainty regarding the draft policies published in May and December 2021. For example, some have pointed to verbage in the draft documents, such as mandates for "fair" pricing and lack of clarity in the standard of care, as unclear and subjective.[424]

ESG

In November 2021, the FCA released a document entitled "A strategy for positive change: our ESG priorities." In the document, it outlines the goals of its ESG strategy. While many other regulators globally seem to focus largely on the Environmental aspects of ESG, the FCA seems almost equally focused on the Social and Governance facets.[425]

In the near future of its ESG and D&I work, the FCA aims to improve consumer trust around the marketing of ESG products, to establish governance arrangements surrounding ESG, to improve diversity and inclusion in the financial services industry, and more. Please eee the "Collaborating on Diversity" subsection above to learn more about the FCA's work on those goals.

In that same month, the FCA warned firms to avoid 'competence-washing' in their hiring spree of ESG talent. "We need to promote genuine capability-building across the financial sector, including through functional training and potentially certification," the FCA wrote.[426]

Regtech, Suptech, and Innovation

In November, the FCA proposed expanding the regulatory perimeter to mitigate potential consumer harm. The expansion would include extending the SMR to cover payment and e-money firms and increasing the threshold for retail investors to be considered high net worth individuals.[427]

As a part of its transformation program, the FCA announced new initiatives to make use of AI and machine learning to modernize its supervision of the financial sector. In a new partnership with data and AI specialist firm Aiimi, the regulator announced that it would look to make greater use of data science and AI in its supervisory work. The Aiimi Insight Engine would reportedly use a broad range of datasets to alert the regulator to risks, such as suspicious conduct.[428]

The FCA also made clear, in January 2022, that it would continue to utilize its criminal powers to prosecute in connection with money laundering cases. The regulator's successful prosecution of NatWest, discussed in the foregoing "Conduct in Banking" subsection, was the first time the FCA had used these powers since they were granted it in 2007.[429]

In a July 2021 speech, FCA chief Nikhil Rathi discussed aims to fashion the FCA into a more "forward-looking, proactive regulator," saying that the agency must be more innovative, assertive, and adaptive.[430]

"With our role more critical than ever, our remit bigger than ever, and scrutiny of our performance closer than ever, the FCA needs to get on the front foot," he said. "To become more proactive, we must become even more innovative to fully capitalise on data and technology; even more assertive to ensure consumer protection and market integrity; and even more adaptive to meet the challenges we know about and prepare for those that will come."

In February 2022, the FCA hosted a Regtech Forum entitled, "FCA Approach to Innovation & SupTech." At this event, several FCA officials, as well as outside regulators and academics, illuminated key areas of interest for the FCA.[431]

Jessica Rusu, the FCA's chief data, information and intelligence officer, explained the value of data and other technologies to the regulators' efficacy in supervising financial institutions.[432] "We're making the most of the data and intelligence we collect to anticipate and predict harm," Rusu said. "We regulate over 51 thousand firms — including thousands of small firms — and the data we collect from them helps us to understand, prioritise, and intervene more effectively than ever before. The sheer size of some of our data sets provides us with an extraordinarily rich resource." Rusu said more about the regulator's data and infrastructure strategy, in February 2022, explaining that the FCA is working to ensure it is able to regulate and supervise an increasingly digitalized financial services industry effectively.[433]

We're making the most of the data and intelligence we collect to anticipate and predict harm.

"Across the Data, Technology, and Innovation division, we are investing heavily in the skills and technology foundations that will make the FCA a regulator fit for a digital future," she said. "For many years the FCA has been increasing its use of data. This year we are seeking to achieve a step change on that journey. We are working incredibly closely with colleagues across the FCA building digital regulation bottom up and top down."

Later that month, Ian Phoenix, FCA Director of Digital and Intelligence, discussed how the regulator will leverage data to maximize its value, stating that data will be the "blood flow" of the organization, at the Association of British Insurers' annual conference.[434]

"There are two different lenses to look at. Data science — a comprehensive process that comes in many aspects of data processing according to regulatory compliance, [and] visualization," he said. "By contrast, AI is the implementation of a model to predict the future state of the world. It is increasingly used across financial markets. AI also helps in explaining how we use techniques for our own supervision, enforcement purposes, but also financial markets."

Phoenix explained that advanced forms of data analytics, including AI, can extract insights that may underpin regulatory decision-making and enable firms to be more efficient and targeted in their risk governance efforts. He encouraged listeners to be optimistic about how this may improve the classification and predictive accuracy of AI models, and allow for a better ability to automate sound decisions.

In April, Jessica Rusu announced that the FCA would be establishing "Innovations Pathways" for providing regulatory support to firms with innovative business models, helping them to understand how regulation relates to their activities. "Alongside our now 'always open' regulatory sandbox, innovation pathways will play a key role in informing and ensuring our regulatory environment is fit for future innovation," she said.[435]

BANK OF ENGLAND

The BoE collaborated with the Bank of International Settlements (BIS) to launch a new innovation hub in London in June 2021.[436] As is discussed in the BIS section of this report, the London Hub launched its first projects in March 2022: "Project Meridian" and "Project Rosalind."[437]

Also in March 2022, the BoE announced that it would be postponing its annual stress testing in order to allow banks to "focus on managing the ongoing financial markets disruption" caused by Russia's invasion of Ukraine. It cited increasingly volatile currencies and commodities prices, as well as generally heightened economic uncertainty, as the reasons behind this decision.[438]

Prudential Regulation Authority

In September 2021, the UK Prudential Regulation Authority (PRA) released a letter, from Executive Director David Bailey, expressing the agency's disappointment with banks' fulfillment of their regulatory reporting responsibilities. The regulator found "significant deficiencies" in the regulatory process, and reminded firms that they must be just as diligent in their regulatory reporting as they are with their financial reporting.[439] "We expect all firms to submit reliable and accurate regulatory returns and for the regulatory reporting process to receive no less rigour than financial reporting," wrote Bailey.

This comes amid a global push to improve the quality and validity of regulatory reporting, and to make that more comprehensive. "The findings of our work demonstrated there is an increased risk of material misstatements from firms who did not meet our expectations," Bailey added. "We therefore set out our most material findings in this letter covering governance and ownership, controls, and data and investment."

In January 2022, the PRA announced that it would be stepping up its scrutiny of cloud computing providers, as the increasingly digitized financial system relies increasingly heavily on their services. While cloud providers allow firms to spin up new offerings at a much faster pace, the concern is that the risk of disruption to operations as a result of an outage or hack is entirely out of a firm's control.[440]

As discussed in the "Collaborating on Diversity" subsection above, the PRA has made clear that diversity and inclusion are regulatory and supervisory priorities. But the regulator has also had to work to improve its own diversity in the past year. In 2021, CEO Sam Woods vowed to make "strenuous efforts to improve" diversity in the agency, as he believes its efforts were "not moving quick enough."[441]

FINANCIAL SERVICES CULTURE BOARD

In July 2012, as the world was still grappling with the effects of the Great Financial Crisis (GFC), the House of Commons and House of Lords established a Parliamentary Commission to examine banking standards in the UK. This Commission's final report recommended a professional association be established, as the Commission believed, "the onus should lie on the industry itself to maintain the impetus for its development."[442]

In response to the Commission's recommendation, the UK's largest banks tasked Sir Richard Lambert, former Director General of the Confederation of British Industry, with issuing a report on the new professional body, at that time referred to as the Banking Standards Review Council (BSRC). In his Final Report Lambert wrote:

> *There are big challenges to be overcome. The new organisation will be funded by the banks, but must remain independent of them. It must cover the whole banking industry if it is to be*

credible, but also recognise that there is very little in common between a small building society and a large investment bank. It must complement rather than confuse the work of the regulator, and it must rely on voluntary support rather than statutory backing for its ideas.[443]

The banks agreed to launch the BSRC and preparations began, to include establishing a panel led by past BoE Governor Mark Carney, to appoint a Chair for the body.[444] In April of 2015, the professional body recommended by the Parliamentary Commission was launched. No longer called the BSRC, with Dame Colette Bowe as chair and Alison Cottrell as CEO, the Banking Standards Board (BSB) began working to rebuild the trust and confidence that the public once had had in the financial industry.[445] The BSB, since renamed the Financial Services Culture Board (FSCB), has been issuing yearly reports, since 2016, which collate the results of various employee surveys run among the UK's largest banks.[446] In its 2021 survey, the FSCB found that many scores had regressed, as compared to 2020 levels. Scores on responsiveness, leadership and personal resilience suffered, for instance. And, on average, scores lost half the gains reported in the FSCB's 2020 report.[447]

"'As we all continue to adapt to a changing environment and new ways of working, firms can learn from each other's experience as well as their own to help identify and address the implications for organisational culture,'' Alison Cottrell said in a related statement.

"The FSCB's six years of data on culture in the banking sector highlights both areas of progress and ongoing challenges," Cottrell added. "Understanding the former and addressing the latter requires a focus on evidence and outcomes; an approach facilitated by a readiness to work collectively as well as individually on promoting trustworthy cultures, to the benefit of customers and clients across the financial services sector."

FINANCIAL REPORTING COUNCIL

In recent years, the FRC has been the subject of scrutiny relating to its ability to effectively regulate the audit sector. In 2018, the UK government launched an independent review of the agency, headed by Sir John Kingman, then Chair of UK Research and Innovation. The review found that the FRC has several serious constraints on its ability to set effective standards for governance and audit, including a lack of statutory base, government direction that it delegates to industry bodies wherever possible, and little practical regulatory power over the industry. [448]

As a result of these deficiencies, Kingman recommended the creation of a formal regulatory body to succeed the FRC, called the Audit, Reporting, and Governance Authority (ARGA). "The regulator should have an overarching duty to promote the interests of consumers of financial information, not producers," the report says. "It should also have a duty to promote competition; a duty to promote innovation; and a duty to apply proportionality to all its work."

Looking back, FRC CEO Sir Jon Thomspon agreed with Kingman's conclusions, calling the review "generous" in its findings. "It's probably arguable that as a regulator we weren't anywhere near as strong enough," Thompson said. "[W]e weren't big enough, and we weren't transparent enough to make a difference to the system."[449]

In 2019, the UK Government announced that it would be taking Kingman's recommendation and replacing the FRC. "This new body will build on our status as a great place to do business and will form an important part of strengthened public trust in businesses and the regulations that govern them," said Business Secretary Greg Clark.[450]

In this transitional period, some have criticized the government for seeming to abandon its current audit regulator, as it failed to promptly appoint successors when senior members of the FRC resigned. One such criticism came from Sir John Kingman himself. "It is indefensible that the body responsible for promoting good corporate governance in Britain not only lost its chair more than a year ago, but is about to lose its excellent interim chair as well, and the government has inexplicably still not begun the process to appoint a successor," he said.[451]

Others have expressed concerns at the delays in the timetable of the transition from FRC to ARGA. "The fact remains that until the government issues its response to the audit whitepaper it published over a year ago, and until it commits to passing the legislation required to put the audit regulator on a statutory footing with the legal powers it needs to do its job effectively, then the audit regulator will remain limited in what it can do," said Gavin Hayes, head of policy and external affairs at the Chartered Institute of Internal Auditors (CIIA).[452]

In April, the FRC announced a proposal which would expand its powers to include the ability to "impose conditions, suspensions and remove registration" of auditors where necessary. "The proposal will bolster the Financial Reporting Council's supervisory toolkit and enable it to become increasingly assertive in holding audit firms to account for the delivery of high-quality audit," it said in a statement.[453]

After the audit reform was removed from the Queen's speech this month, some have expressed fears that this means the government intends to abandon these reforms. More than 50 British businesses, unions and trade groups sent a letter to Prime Minister Boris Johnson warning him against dropping the legislation. "From Carillion to BHS and P&O Ferries, recent scandals have exposed gaps in our corporate governance framework and reduced trust in British business at the precise moment when we need to harness the skills, innovation and enterprise of the private sector to meet the challenges facing society and the environment," the letter said.[454]

The audit industry regulator has also faced criticism in relation to the manner in which it handles the proceeds of fines it issues as a result of misconduct. In what is known as the "Accountancy Scheme", the Institute of Chartered Accountants (ICA) helps the FRC to fund the initial inquiry phase of investigations, and then gets to keep any fines levied as a result of this work. While this seems reasonable, it does not include any provisions to give money to those who have been hurt by the misconduct.[455]

For instance, when KPMG was fined £13 million by the FRC for failures in its audit of insolvent pension fund Silentnight in 2021, the Accountancy Scheme allowed the ICA to keep the entire fine. A former Chair of the Silentnight trustees, Martin Jourdan, was troubled that an industry association would be allowed to profit on the failures of its own profession. "I find it bizarre if not unnatural justice that the fines are going to the trade association of those involved," he said. "It's not right."

In February 2022, four new directors were appointed to the FRC in a shakeup of its leadership after the new CEO, Sir Jan du Plessis, former Chair of Rio Tinto, said the regulator was in a "poor state."

"These appointments, drawing together directors with a wide range of experience, put the FRC in a strong position," said Business Secretary Kwasi Kwarteng, "and I look forward to working with Sir Jan and his team as we bolster the quality of audit and governance across UK plc."[456]

INTRODUCING DEEPER DIVE SUPPLEMENETS

Physician, Heal Thyself

Financial sector regulators are being held to the same culture and conduct standards that they seek to test for among the firms they oversee. Many have been found wanting.

The past year has seen the ire of an aggrieved public – and their representatives in government – aimed at the US Federal Reserve, the UK Financial Conduct Authority, and casino industry regulators in Australia, among others.

Are we entering a new era of personal accountability? And, if so, what does this mean for the public officers and industry overseers who are meant to assure that firm's under their purview sustain healthy cultures and effective conduct risk governance?

Learn more in a Deeper Dive supplement to this report, available later this year on Starling Insights, a membership-based platform that will feature all of our *Compendium*, thought leadership, video, podcast, and event-driven content.

Audit Culture

For years, the FRC has been clear on the importance of corporate culture, and the effect of good governance in the context of establishing positive firm cultures. To illustrate, the regulator has asked auditors to report on the number of senior staff involved in bullying and sexual harrassment complaints, as part of its efforts to improve "non-financial conduct" among the firms it oversees.[457]

In December 2021, the FRC released a report on "Creating Positive Culture," detailing its views with regard to establishing sound corporate culture and the benefits of so doing. The report points to psychological safety, diversity, and inclusion as key factors driving cultural change.[458]

Announcing the report's release, FRC CEO Sir Jonathan Thompson said, "As a regulator, we believe that by putting greater emphasis on creating and maintaining a positive culture, companies will boost their competitiveness, improving their ability to achieve sustainable success. More open and insightful reporting in this area will also lead to improved access to both capital and talent."[459]

ESG

In May 2021, the FRC published research by Royal Holloway, University of London, done with the Involvement and Participation Association, which found that many FTSE 350 firms had downplayed the importance of "workforce engagement" in their annual reports. This mirrors the work by many global regulators, most notably the US SEC, to consider closely firms' handling of human capital.[460]

Furthering its commitment to ESG matters, the FRC released a report entitled, "Reporting on Risks, Uncertainties, Opportunities and Scenarios: Closing the Gap," in which its Financial Reporting Lab spelled out the information that investors are seeking as regards risk, uncertainties, and opportunities. The report, released in September of last year, explains that there remains a widening gap between the information investors want and the data available to them in disclosures, as more investors seek to make use of ESG data in their investment decision-making.[461]

"[Investors] want to understand how the risk management framework and mitigation tool kit have adapted and changed in the face of the COVID-19 pandemic and how those changes more effectively equip the company for an uncertain future," the authors wrote. "They also need to understand how and where these uncertainties might impact the company and the opportunities and the risks relevant to the company's future."

The FRC also launched a consultation, in October of last year, to update the audit firm governance code. The changes aim to promote "high-quality audit and audit market resilience." The consultation covers three main areas: clarifying the role of partnership boards in holding firm leadership accountable; setting requirements for the makeup of boards to "strengthen oversight and governance"; and implementing new guidelines focusing on sustainability, people, culture, and employee engagement.[462]

The Institute of Chartered Accountants in England and Wales (ICAEW) criticized the changes stating that they were unclear and overly prescriptive. "Ultimately, it's investors and audit committees that are expected to use the Transparency Reports the Code requires firms to prepare," John Boulton, ICAEW's Director of Policy, said. "To be valuable, changes must be decision-useful to them. That's more likely where reforms form part of a visible and targeted package led by their needs."

In November, the FRC released its "Review of Corporate Governance Reporting," in which it stated that many firms were still failing to meet the expectations for disclosures set in the Corporate

Governance Code. The report specifically points to reporting on DEI[463] and climate-related decision making[464] as areas where many firms still fall short.

Europe

INDUSTRY AND REGULATORY BACKGROUND

Misconduct

Several European banks have become noted leaders in the management of behavioral and culture related risks, largely through implementing much of the ground-breaking work done on these matters by *De Nederlandsche Bank* in the the Netherlands (DNB), the UK's Financial Conduct Authority (FCA), and the Monetary Authority of Singapore (MAS).[465]

Yet, despite this leadership position, European banks suffered several notable non-financial risk management challenges and failures in the past year, many of which have centered on culture and conduct issues.

In May 2021, UBS, UniCredit and Nomura were fined €371 million for their involvement in a bond trading cartel. Traders across these firms, and several more which were not fined, were found to have used chat rooms on the Bloomberg terminal illicitly, so as to share information on trading decisions and strategies from 2007 to 2011.[466]

In December 2021, European antitrust regulators fined HSBC, Credit Suisse, Barclays and RBS for colluding to rig global currency markets. A €344 million fine marked the end of a years-long investigation which had involved traders across several banks using online chat rooms to share information, much like the previously mentioned cartel case settled earlier in the year.[467]

During the same month, the European Central Bank (ECB) announced that it would begin maintaining an "Amber List" in January 2022, which would "name and shame" banks with weaknesses in their AML regimes.[468]

ESG

In September 2021, the European Commission (EC) released a report focusing on the integration of ESG considerations into prudential regulation frameworks, business strategies, and investment priorities. This report highlighted that the EU lacked a common definition of ESG-related risks, and that few financial institutions had a well-defined and clearly articulated strategy by which to manage such risks. The Commission also found that banks had not integrated ESG risks into their internal risk reporting programs sufficiently well.[469]

In order to accelerate progress in these areas, the Commission has encouraged banks to work together, alongside their supervisors, to develop standard definitions of ESG risks and a framework for assessing them in a consistent fashion. The report also suggested that banks should develop and make public their strategies for reporting on and managing ESG risks.

In early 2022, the European Securities and Markets Authority (ESMA) directed rating agencies to improve their ESG ratings and related disclosures. credit rating agencies have sought to meet investor expectations for more reliable ESG data, as EU-based sustainable funds grew to €1.5 trillion in the first half of 2021.[470] "However, there is clearly room for further improvement: the level of ESG disclosures differs significantly across both CRAs [Credit Rating Agencies] and ESG factors, especially environmental topics," ESMA said.[471]

EUROPEAN COMMISSION

European Commission

The European Union faces difficulties in dealing with the hundreds of billions in suspicious transactions that occur each year as a result of the patchwork-like enforcement policies in operation across its member countries.

The EC tabled legislation in July 2021 to create an Anti-Money Laundering Authority (AMLA), which would launch operations in 2024 and eventually have power to supervise cross-border financial firms and to impose fines for breaching anti-money laundering laws and regulations.[472]

Later in the year, the Commission introduced legislation that would force banking regulators across the EU to act with greater independence, and to ban any sort of undue influence from any external bodies, to include regulated firms and governmental agencies. Some have pointed to German regulator BaFin's supervision of Wirecard as an example of these issues.[473]

"Recent developments such as the Wirecard scandal showed the need for clearer and more operational provisions on the principle of the independence of supervisors," an EC official said. "This is included in our proposal."

EUROPEAN CENTRAL BANK

In a blog post in December 2021, Andrea Enria, Chair of the ECB's Supervisory Board, and Mario Quagliariello, Director of Supervisory Strategy and Risk, laid out the ECB's current supervisory priorities. These emphasize greater focus on structural weaknesses which should be addressed through the promotion of innovation and improving risk governance.[474]

"Banks need to tackle the structural weaknesses that have kept profitability and market valuations at depressed levels for too long," Enria and Quagliariello wrote. "Greater, more focused supervisory pressure on the most important risk drivers could effectively combine with the strong market pressure on European banks to re-establish their business models on a more sustainable basis."

Germany

INDUSTRY AND REGULATORY BACKGROUND

Wirecard Fallout

In last year's *Compendium* we wrote extensively of the disaster at German payments processor Wirecard, leading to the collapse of a firm that at one point was valued at €24 billion. Wirecard was founded in 1999 as a payment processing company. The company had 323 employees in 2005.

By 2018, however, Wirecard was the largest financial technology company in Europe.[475] The company's runaway growth seemed, at first blush, to have resulted from acquisitions and the advanced technology it brought to market, as compared with competitors. With about 5,000 employees at the time, the company claimed to process payments for some 250,000 merchants worldwide. Then, on June 18, 2020, Wirecard reported that €1.9 billion in cash on its books was somehow "missing."

The fallout from Wirecard's implosion was not isolated to the firm. Its auditor of 10 years, EY, was forced to reorganize its Germany practice[476] and invest $2 billion to improve audit quality[477] amid questions of how it could possibly have missed massive fraud in areas so material to the company's financial results, also in light of press reporting of irregularities.[478]

The German Parliament's investigation of the Wirecard scandal ran from October 2020 through June 2021, unveiling repeated criticisms of failure of oversight at all levels, from government authorities to the supervisory board, auditors and in dealings with external counterparts and advisors. In May 2021, German newspaper *Handelsblatt* published a confidential parliamentary report into EY's audit work for Wirecard. The report found serious shortcomings in EY's work for the disgraced fintech firm, failing to implement professional guidelines and taking executive assurances at face value on key issues.[479]

Several German governmental agencies, including the Federal Financial Supervisory Authority (BaFin), were also implicated in the scandal, facing accusations of protectionism, regulatory capture and obstruction of justice. A probe by the European Securities and Markets Authority (ESMA) found many problems with BaFin's oversight and handling of Wirecard, calling it "deficient"[480]. Calls for the regulatory agency to be overhauled were sounded,[481] beyond the Wirecard-inspired reforms that increased BaFin's authority. A German court ruled in December 2021 that the agency could not be sued by Wirecard investors for its alleged failure to properly supervise Wirecard.[482] However, the regulator still faces substantial pressure to reform its regulatory and supervisory practices.

Other governmental agencies were not so lucky. In September 2021, German prosecutors raided the Finance Ministry as a part of an investigation into alleged obstruction of justice relating to the Wirecard case. The investigation sought to determine if the Ministry exercised undue influence over decisions at the Financial Intelligence Unit (FIU), Germany's anti-money laundering agency, into whether to share information about Wirecard with German prosecutors.[483]

Trouble at Deutsche Bank

Deutsche Bank has become known in recent years more for the scandals it has endured than for its legitimate business dealings and financial performance. The bank, Germany's largest and one of the biggest globally, has lurched from PR catastrophe to criminal charges and back again for the better part of a decade.

In the past year, the bank has made concerted efforts to rebuild its reputation. In May 2021, it set a 50% quota on hiring women for senior management positions, perhaps hoping to effect the corporate culture which led to the criminality for which the bank has become known.[484]

"Greater diversity among senior executives is a business necessity for us," Deutsche's Michael Ilgner, global head of human resources, told the *Financial Times*. "This will make us stronger as there is plenty of evidence that more diverse teams achieve better results and adjust faster to a changing environment."

Deutsche CEO Christian Sewing said in September 2021 that the bank must change its leadership and organizational culture in order to take the lead in sustainable finance, as it pivots from a history of heavily-leveraged trading and risk taking. "We will only be able to use the best conditions if we ourselves change — and I'm speaking first and foremost about our own company," Sewing said.[485] However, Deutsche was not able to avoid the repercussions of its apparently embedded culture, which focused first and foremost on maximizing short-term profits.

Attention continues to be drawn to the risks of conflict between short-term profits and longer-term stability and sustainability aspirations. "I'm a former regulator and central banker, and I can tell you that the German *Bundesbank* is an organization that is always focused on the long-term," said former *Bundesbank* head, Axel Weber, in an interview appearing herein. "I'm really very convinced that we need a permanent culture change in banking, and across corporations more generally. This has to be viewed as a critical element of governance, and integral to how business is done with the long-term in mind." ▸PAGE 71

The US's Commodities and Futures Trading Commission (CFTC) issued a $200 million whistleblower payout to a Deutsche Bank employee who helped US and UK regulators investigate the scheme that had allowed Deutsche Bank traders to manipulate the London Interbank Offered Rate (LIBOR) and rake in hugely inflated profits.[486] In December 2021, the US Department of Justice (DOJ) told Deutsche Bank that it may have violated its criminal settlement when it did not disclose an internal complaint relating to its asset-management arm's sustainable investing business. If the DOJ decides to formally charge the bank with this agreement breach, Deutsche Bank would be exposed to prosecution and further criminal sanctions.[487]

Deutsche Bank chair Paul Achleitner has argued that these legal issues may be due, in part, to the incongruencies between Germany's securities laws and the rules set by international regulators. Specifically, under German law, boards are only entitled to appoint, monitor and advise the executive teams, rather than issue specific orders.[488] International regulators, Achleitner said, are unwilling to take heed of these jurisdictional distinctions. It is unclear whether German laws will need to change or if international regulators will shift expectations.

Deutsche Bank faced further scrutiny in March 2022 when it deemed it "impractical" to cease its Russia operations in response to the Russian invasion of Ukraine. "We're there to support our clients," James von Moltke, Deutsche's CFO, said. "And so, for practical purposes, that isn't an option that's available to us. Nor would it be the right thing to do in terms of managing those client relationships and helping them to manage their situation."[489]

Deutsche quickly reversed course after facing severe backlash, announcing that it would be winding down its business in Russia. "We are in the process of winding down our remaining business in Russia while we help our non-Russian multinational clients in reducing their operations," the bank said. It also stated that it would not take on any new business in the country.[490]

Deutsche has gotten in trouble in the past regarding its Russian ties. In 2017, for example, Deutsche was fined more than $600 million by several regulators, including the New York Department of Financial Services and the UK's Financial Conduct Authority, regarding a "mirror trading" scheme which helped to move more than $10 billion out of Russia between 2011 and 2015.[491]

Other Misconduct

There were also several instances of misconduct in the past year which did not involve Deutsche Bank or Wirecard. In May 2021, a German court ruled that basic components of the "Cum-Ex" tax fraud scheme were illegal. In this scheme, bankers sought tax rebates on taxes which had never actually been paid. The court also threw out appeals from two British bankers and a bank that had been convicted for involvement in this scheme.[492]

Later in the year, it was revealed that a German fund management firm, Aquila Capital, had failed to pay into a pension fund for its UK employees. The firm was audited by KPMG, which has been under fire in the UK in the past year for serious audit failures ▸PAGE 231.[493]

FEDERAL FINANCIAL SUPERVISORY AUTHORITY *(BUNDESANSTALT FÜR FINANZDIENSTLEISTUNGSAUFSICHT)*

BaFin
Bundesanstalt für Finanzdienstleistungsaufsicht

In the wake of the Wirecard scandal, BaFin CEO Felix Hufeld, who earned a reputation for protecting German firms from the consequences of their actions, was forced out. Elisabeth Roegele, BaFin's Executive Director of Securities Supervision, was also forced to resign, with the twin scandals of Wirecard and the Cum-Ex tax fraud scheme hanging over her.[494] BaFin's new leadership must prove that the regulator has reformed its culture and supervisory practices.

Mark Branson, past head of Switzerland's FINMA, was selected to succeed Hufeld. Branson gave an initial progress report on BaFin's reform in October 2021.[495] "I'm impressed by the speed of implementation and the breadth of BaFin's reform," Branson said. "But for me this is only the beginning of BaFin's long-term development. The expectations placed on BaFin are clear: decisions of the highest quality, clear, ambitious targets and modern, digital working methods. It will take time before we reach our objectives in all areas. But we are heading in the right direction and motivation is high."

Netherlands

INDUSTRY AND REGULATORY BACKGROUND

Misconduct and Individual Accountability

Much like every major financial market, the Netherlands has had its fair share of misconduct scandals in recent years.

In April 2021, for example, ABN Amro reached a €480 million settlement with Dutch Prosecutors over anti-money laundering failings.[496] Chris Vogelzang, former board member of ABN Amro, was forced to resign from his role as chief executive of the Swedish Danske Bank when he was named as a suspect in an investigation relating to this scandal.[497]

Corporate Governance

In February 2022, the Corporate Governance Code Monitoring Committee, an independent committee tasked with ensuring the efficacy of the Dutch Corporate governance code and monitoring its implementation at firms, proposed an update to the Code. The changes include provisions which encourage communication between shareholders and firms, define new rules surrounding proxy voting, and promote cognitive diversity among management and board members.[498]

The proposal also included several recommendations for internal audit functions, including that they focus more on culture and behavior, that they report directly to the CEO, and that they are reviewed by a third-part every five years.

DE NEDERLANDSCHE BANK

The De Nederlandsche Bank (DNB) has long been acknowledged as a leader in the regulation and supervision of culture and conduct risks in the financial sector.

Culture Work

In 2015, the Dutch Banking Code was revised to require about 90,000 Dutch bank employees to swear an Oath, called the Bankers' Oath, and adhere to an accompanying code of conduct or face disciplinary measures. This Oath was largely modeled and inspired after the Dutch Oath for Civil Servants, and, in part, requires that bankers make every effort to "retain and improve trust in the financial sector."[499]

In November 2021, the DNB published research into the implementation of the Bankers' Oath across the industry. that firms take the "taking of the oath" seriously, and frequently include employees who are not required by law to take the Oath. It also found that the Oath is sufficiently embedded in the culture initiatives of firms. Despite this, the DNB also observed that it had been years since many employees had taken the Oath, and that it was not often utilized beyond the initial ceremony.[500]

The DNB hosted a roundtable with industry leaders to discuss these findings in the beginning of 2022 to facilitate the exchange of best practices and promote the use of the Oath as a means to drive desired behavior.

The Future of Supervision

In June 2021, the DNB published a document entitled "Virtual Working and Virtual Decision-Making: Opportunities, Experiences and Risks." Therein, the DNB examined the pros and cons of remote and hybrid working environments, including their effects on employee well-being, on their mutual collaboration and on team decision-making.[501]

In a speech at Financial Study Association of Groningen Conference in March 2022, Steven Maijoor, Executive Director of the DNB, spoke about the how the increasingly digitalized financial system impacts the role and responsibilities of financial regulators:

> *The banking landscape is changing fast, and the stakes for organizations like us, De Nederlandsche Bank, are high. As central banks and supervisors, we have a responsibility to make sure that we can continue to keep the financial system stable and safe. We want no holes in the global financial safety net, however much it gets stretched and reshaped. To do this, we need the best and the brightest from all kinds of disciplines. We need people that see the bigger picture.*[502]

Sweden 🇸🇪

Danske, Denmark's largest lender, went from being one of Europe's most respected financial institutions to cautionary tale, after a US Department of Justice investigation found that €200bn in non-resident monies had flowed through its Estonian branch, from 2007 until 2015.

In 2018, Estonian prosecutors detained ten former employees on suspicion of knowingly enabling money laundering. The firm's troubles were compounded when a new CEO, Chris Vogelzang, was forced to resign in April of last year, after being implicated in a separate money scandal at his former employer, Dutch bank ABN AMRO.[503]

Following an investigation, Sweden's Financial Supervisory Authority (*Finansinspektionen*) found that Danske Bank had failed to correct adequately for past controls failures, after one of the world's largest money-laundering scandals. The regulator has given the institution a deadline to take corrective action after reprimanding Danske for risk management "shortcomings."

"The Financial Supervisory Authority finds it remarkable that the shortcomings have existed for such a long time and considers the bank's timeframe for fixing them cannot be considered acceptable," the regulator wrote in a letter to Danske in October 2021. It told the bank to remedy the situation by June of 2022.

In a January 2022 interview with the *Wall Street Journal*, Danske's Chief Compliance Officer, Satnam Lehal, explained that innovative technology solutions are an important part of the work it is doing to improve its compliance regime.[504] "As banks have more data, and as regtech has developed and proven itself more and more, we are harnessing increasingly more of these technologies ourselves," Lehal said.

Danske is not the only Swedish bank to come under fire for handling illicit funds in the past year. Former Swedbank chief executive Birgitte Bonnesen was charged with fraud in January 2022, stemming from statements she made in 2018 and 2019 about the bank's anti-money-laundering controls.[505] When news outlets reported that money had been flowing through Swedbank's Estonian operations, Bonnesen attempted to play down the concerns, saying that the bank had the situation under control.[506]

In reality, subsequent investigations showed that the bank had allowed money to flow from countries including Russia into Europe via Estonia without adequate checks.[507] "The former CEO of the bank intentionally or through gross negligence … disseminated misleading information about the bank's measures to prevent, detect, and report suspicions of money laundering in Swedbank's operations in Estonia," lead prosecutor Thomas Langrot said.

Ireland

CENTRAL BANK OF IRELAND

In the foreword to its new Strategic Plan, published in September 2021, Governor Gabriel Makhlouf of the Central Bank of Ireland (CBI) explained that its strategy was built around four central themes: future-focused, open and engaged, transforming, and safeguarding.[508]

"The Strategy's four connected themes … represent a renewal and repositioning to ensure that our direction and ambitions over the next five years are responsive and forward looking," Makhlouf wrote. As a part of this strategy, the CBI has made it clear that it intends to expand upon its work in technological innovation, climate-related risks, and culture and conduct concerns in the financial services industry.[509]

In February 2022, the CBI announced that Ed Sibley, the CBI's Deputy Governor Prudential Regulation, would be leaving when his term ends in August of this year. "The bank has strong foundations to continue to deliver for the people of Ireland," Sibley said. "I wish the bank every success in delivering on the important work the bank is mandated to deliver, as well as the important transformational change that is required."[510]

Supervision in 2022

The CBI's Director General, Financial Conduct, Derville Rowland, spoke about the CBI's approach to supervision and enforcement in an increasingly digitalized financial services industry:

> *As the Central Bank looks ahead, we seek to be proactive in preparing for future innovation in financial services; we aim to mature our regulatory, supervisory and oversight frameworks to promote the resilience of the financial sector; we want to support financial system resilience to climate risks; and we intend to further develop and implement our consumer and investor protection framework and ensure that the highest standards of accountability and conduct are maintained.*[511]

The CBI also issues "Dear CEO" letters to provide guidance to the industry on important, widespread issues. In July 2021, for example, the CBI sent such a letter to dozens of companies, noting deficiencies in the identification and reporting of insider trading risks. "We expect individual entities to address these requirements comprehensively and without delay, " the CBI wrote.[512]

Individual accountability

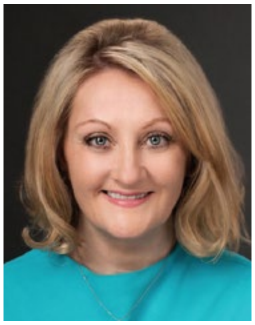
The CBI has placed substantial emphasis on corporate culture in recent years, recognizing it as a driver of conduct, both good and bad. As a part of this work, the CBI has sought to establish a formal executive liability regime, attempting to spur executives to take ownership of the culture and conduct that prevails within their organizations.

In its July 2018 Report into the behaviour and culture in the Irish retail banks, the CBI set out in some detail its recommendation for a new Individual Accountability Framework, including a Senior Executive Accountability Regime (SEAR), which is modeled on the UK's Senior Managers and Certification Regime, and includes an enhanced 'Fitness and Probity Regime'.[513]

Work subsequently commenced on preparing the relevant primary legislation to implement the CBI recommendations. In July 2021, the Irish Department of Finance published the General Scheme for the Central Bank (Individual Accountability Framework ("IAF")) Bill.[514] As noted by Finance Minister Paschal Donohoe on publication of this General Scheme, "This new regime will place obligations and firms and senior individuals within them to set out very clearly for responsibility and decision making lies to enhance individual accountability". [515]

Later in the year, the Joint Committee on Finance, Public Expenditure and Reform, and Taoiseach conducted pre-legislative scrutiny of the General Scheme.[516] In this hearing, a CBI representative made clear that the CBI would not be guiding firms through every step of this process and "checking their work." Rather, the CBI, as regulator and supervisor, would instead ensure through supervision that firms take ownership of implementing the regime's requirements. Also, in April 2022 this Joint Committee published a report on pre-legislative scrutiny of the General Scheme and set out a number of minor recommendations.[517]

"The Central Bank is increasingly focusing its attention on going after individuals who engage in, or tolerate, misconduct," said Ciaran Walker, a consultant in financial services regulation and governance with law firm Eversheds Sutherland. "It will focus the minds of individuals at all levels of a regulated firm, from board members and senior management to those in less senior positions, on the risks to them individually, in terms of professional reputation, employment prospects and Central Bank sanctions, of engaging in, facilitating or turning a blind eye to misconduct."[518] ▸PAGE 179



Marion Kelly

The activities of the Irish Banking Culture Board (IBCB) over the past year focussed on our core purpose of working with our member banks to build trustworthiness in order to assist the industry in regaining trust, through changes in culture and behaviour. Our work is focussed on bank staff and internal organisational culture and external customer facing measures aimed at restoring trust. To do this we measure and assess core aspects of bank culture with staff and external stakeholders and use the findings to inform our work.

In May 2021 we published our most recent research with bank staff, customers and wider stakeholders focussed on trust and cultural change under the banner of 'éist', which is an Irish language word meaning listen.

We are very pleased that the survey results of Bank Staff show strong progress has been made internally across all IBCB member banks since our last assessment in 2018, particularly in the area of speaking up and ethics. It is clear, however, from the results of our customer focussed survey, that internal changes in culture *have yet to resonate externally with a significant majority of bank customers and the public in general. Achieving this is crucial for the future of the industry and for overall pride levels of staff. Trust is the key currency of change in the banking sector, and it must be earned by the banks to be recognised by the public.*

Over the course of the last year we have continued to focus on aspects of ethics — specifically ethical decision making via our DECIDE framework and also the ethical challenges associated with the ever-increasing use of Artificial Intelligence (AI) in banking.

During the course of 2021, material announcements were made in relation to the composition of the Irish retail banking market with Ulster Bank and KBC Bank Ireland announcing their intention to leave the market. The IBCB recognises that from time to time there will be commercial decisions taken by our member banks which may result in both negative (and positive) impacts on specific customer and/or staff cohorts. While it is not the role of the IBCB to focus on the commercial aspects of these decisions, we are of course concerned with whether the decisions are fair and how they will be implemented in the context of the behaviours the IBCB promotes. In response to these ongoing changes, the IBCB developed a series of Guiding Principles ('the Principles') for our member banks to adhere to, as relevant, where there are significant changes in operating models and/or activities resulting in material impacts on bank customers, and/or staff, and/or the wider market. The Principles are composed of five broad categories: 1. Behaviour & Culture; 2. Corporate Citizenship; 3. Communications; 4. Structured Listening and Consultation and 5. Supports. These principles will form a core part of our activity in the year ahead and will enable the IBCB to play a strong role in ensuring that positive behaviour and culture lies at the heart of strategic decision-making in our member banks resulting in fair customer and staff outcomes.

Marion Kelly, CEO,
Irish Banking Culture Board

For further information please visit www.ibcb.ie

Spain

In a speech at the Banking Law Conference hosted by the Málaga Lawyers' Association, Banco de España (BOS) Deputy Governor Margarita Delgado explained that the central bank's supervisory activities have shifted from a focus on compliance to ensuring that banks have adequate conduct risk management.[519]

"Our supervisory framework has also evolved," she said. "Now, in addition to focusing on formal compliance with conduct obligations, it also envisages the management and mitigation of these risks by banks and their incorporation into the business model."

Spain's Council of Ministers approved a draft bill, in March 2020, for the creation of a regulatory sandbox that would allow financial institutions and fintech companies to trial new solutions without risk of sanction where they may inadvertently violate regulations.[520] The bill was approved in November 2020, creating a space for the implementation of innovative technology projects in the financial services sector.[521] In May 2021, the sandbox officially welcomed its first 18 projects, chosen from 67 applications. The projects had a wide range of focus, including preventing money laundering and fraud.[522]

In Focus

Counting What Counts

By MARCUS LIM

Marcus Lim

In 1942, author Isaac Asimov laid out a set of rules intended to govern the choices of robots and avoid potentially catastrophic consequences of artificial intelligence proliferation.[1] Numerous arguments have since been put forth as to why the Three Laws of Robotics are inadequate and Asimov's subsequent short stories intentionally depicted robots in various situations where their application led to counterintuitive outcomes.

While artificial intelligence has become more embedded in our daily life since then, we are still some distance away from the robot apocalypse. Nonetheless, its increasing adoption has added impetus for us to explicitly codify what is acceptable behaviour so that we do not end up with unintended outcomes. Values and norms that are implicit in our decision-making cannot be assumed when handing the reins to a machine. The need to find ways to connect values to tangible metrics presents an opportunity for us to reflect on what metrics we might leverage to identify good "culture".

Culture is generally understood as the shared values, attitudes, behaviours and norms in an organisation.[2] At the Monetary Authority of Singapore (MAS), our focus on culture and conduct in financial institutions (FIs) seeks to achieve two key objectives:

- Ethical business practices; and
- Prudent risk-taking and robust risk management.

While one could measure the safety and soundness of a FI through indicators like capital, VaR and other financial metrics, measuring the fair treatment of customers requires more judgement.

Recent work by the MAS and industry partners have helped to advance the conversation on what fair and ethical treatment looks like in the context of artificial intelligence and data analytics (AIDA). This work provides us with some useful perspectives as we consider the potential applications to culture and conduct supervision more broadly.

FEAT Principles

MAS supports the exploration of new technology and data solutions to achieve better risk management and customer outcomes, but also recognises the potential risks associated with them. Depending on how it is deployed, AIDA has the potential to amplify the impact of poor human decision-making that is embedded, often unconsciously, within its code.

In 2018, MAS released a set of principles to foster greater confidence and encourage the use of AIDA.[3] The principles promote fairness, ethics, accountability and transparency, and are known as the FEAT Principles. They were co-created with the financial industry and other stakeholders. MAS also worked closely with government agencies, including the Personal Data Protection Commission and the Infocomm Media Development Authority, to align the Principles with existing AI governance initiatives.[4]

To translate the FEAT Principles into tangible measures, MAS established a consortium to develop an assessment methodology and open-source toolkit to evaluate AIDA systems against FEAT.[5] The current Veritas consortium consists of 27 members from FIs, top AI firms, industry associations, and consulting firms who lead and support the development work.

The first phase of the Veritas initiative commenced in 2020 with the development of fairness metrics in credit risk scoring and customer marketing.[6] These metrics help FIs validate the fairness of their AIDA solutions in these two use cases. In January 2021, the Veritas consortium published two white papers on the fairness assessment methodology and the open-source code of these two use cases.[7]

The second phase of the Veritas initiative commenced in 2021 to enhance the fairness assessment and to develop the Ethics, Accountability, and Transparency assessment methodology for the two use cases in the first phase. The second phase included use cases for the insurance industry, focused on the fairness assessment methodology for predictive underwriting, and applied the ethics and accountability assessment methodology to a fraud detection use case.

In February 2022, the Veritas consortium published five white papers detailing assessment methodologies for the FEAT principles.[8] One of the papers is an enhanced Fairness Assessment Methodology to enable FIs to define their AIDA systems' fairness objectives, and identify personal attributes of individuals and any unintended bias.

Fairness

Given the potential for bias to be replicated at scale, AIDA solutions should be assessed for their ability to achieve a "Fairness" objective. Undetected bias in the data sets or model algorithms could lead to systemic discriminatory behaviour. Such bias can arise due to deployment decisions made by humans that reflect, for example, implicit biases against particular groups, confirmation biases and decision fatigue.

FIs would first articulate a "Fairness" objective. One way "Fairness" objectives can be defined is using a fairness decision tree, focused on specific at-risk groups, where each decision point question answered helps to narrow down to the relevant "Fairness" objective. This means that the "Fairness" objective is likely to differ from one AIDA application to another.

AIDA Model	Fairness Objective	Fairness Metric
1. Credit scoring for car loan	Males and females have same opportunity to get a loan	**Equal Opportunity** $\frac{\text{\#males model correctly says should get a loan}}{\text{All males that should get a loan}} = \frac{\text{\#females model correctly says should get a loan}}{\text{All females that should get a loan}}$ True positive rate for males = True positive rate for females
2. Fraud indicator for insurance claim	Males and females have same likelihood to be mistaken for a fraud	**Predictive Equality** $\frac{\text{\#males model incorrectly says are fraudulent}}{\text{All males that are not fraudulent}} = \frac{\text{\#females model incorrectly says are fraudulent}}{\text{All females that are not fraudulent}}$ False positive rate for males = False positive rate for females

Once the objective is defined, a suitable "Fairness" metric can be identified to test if the objective is being met. Two examples are illustrated above.

To accelerate FIs' adoption of the FEAT methodologies and principles, the Veritas consortium developed an open-source software toolkit. The toolkit enables the automation of the "Fairness" metrics assessment, allows for visualisation of the interface for fairness assessment, and has plug-ins that integrate with FI's IT systems.

In the next phase of work, the Veritas consortium will develop additional use cases and run pilots with selected FIs to integrate the methodologies with members' existing governance framework.

MAS is also enhancing our ability to supervise FIs' use of AIDA, by piloting the use of Veritas in our inspections of FIs. MAS will build supervisory capabilities on this front in tandem with the pace and pervasiveness of AIDA use by the financial sector.

Culture Assessment Framework

The work of the Veritas consortium and others demonstrates that it is possible to apply quantifiable metrics to a principle such as "Fairness". By extension, it suggests that "culture" could be similarly defined and measured.

Over the years, substantial research has been invested into drawing the link between culture and corporate performance. Approaches to measuring culture have ranged from the use of surveys to more unobtrusive approaches like looking at complaints, online forums and employee emails.[9] CultureX's collaboration with Glassdoor on the Culture 500 is one example of how AIDA is also being leveraged to measure a company's culture.[10]

MAS has been working on a Culture Assessment Framework to facilitate a supervisory strategy where intensity and focus is informed by the level of assessed risk of a given FI. The Framework will leverage behavioural science and organisational psychology concepts and techniques.

MAS has been working on a Culture Assessment Framework to facilitate a supervisory strategy where intensity and focus is informed by the level of assessed risk of a given FI.

The Framework is still in development and will broadly look to determine the likelihood that behavioural pressures in the internal and external environment of an FI would interact with behavioural patterns within the FI to result in negative control and conduct outcomes. Given the need for benchmarking across FIs, a survey approach will be adopted, with the model calibrated over time against information and insights derived from other aspects of our supervision.

Conclusion

"Not everything that counts can be counted, and not everything that can be counted counts."[11] The empirical impact of a healthy culture can be observed, and its presence within thriving organisations can be felt. Yet giving it a score and benchmarking one firm against another has proven to be practically difficult.

As a financial supervisor, we recognise the key role that culture plays in ensuring a strong control environment from a risk-taking perspective, as well as in promoting good market conduct outcomes. The challenge is being able to assess culture in objective terms and to be able to identify problems early on. In this regard, the progress on the AIDA front perhaps

The challenge is being able to assess culture in objective terms and to be able to identify problems early on.

provides us with some digital breadcrumbs on our journey towards a deeper understanding of this important field.

Mr Marcus Lim *is the Assistant Managing Director of the Banking and Insurance Group at the Monetary Authority of Singapore, where he oversees the licensing and supervision of all banks, merchant banks, insurers and finance companies in Singapore.*

ENDNOTES

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France

INDUSTRY AND REGULATORY BACKGROUND

Conduct and Culture

In 2018, Société Générale, one of France's biggest banks, agreed to pay $2.7 billion to settle a series of legal disputes in the US under a three-year deferred prosecution agreement (DPA). When the DPA expired in December 2021, SocGen CEO Frederic Oudea decided to take control of the bank's risk and compliance functions, giving him closer control over the bank's work in these areas and elevating them to a foremost concern as the bank moves forward.[523]

In March 2022, BNP Paribas and Crédit Agricole, France's two biggest banks, announced that they would be ceasing all operations in Russia after its invasion of Ukraine.[524] SocGen followed suit in April when it sold Rosbank, its Russian subsidiary, to Interros Capital, a firm linked to Russian oligarch Vladimir Potanin. The bank took a $3.1 billion income hit from the sale.[525]

BANK OF FRANCE

In a speech in September 2021, Denis Beau, First Deputy Governor of the Bank of France, discussed the risks and opportunities associated with the digitalization of the financial sector. In order to best mitigate these risks, while taking advantage of the desired benefits, Beau advocated for increased collaboration between regulators and regulated entities.[526]

"[T]o meet the challenge of transforming the financial sector digitally towards greater efficiency and stability, we feel it is vital to ensure that public and private initiatives complement each other and are properly coordinated, in order to support the innovation ecosystem and safeguard the stability of the financial system," Beau said. "It is in this spirit that we intend to continue developing our own initiatives."

AUTORITÉ DES MARCHÉS FINANCIERS

Echoing discussion among regulators worldwide, in an April 2021 Speech, AMF Chairman Robert Ophèle stated that the AMF plans to continue to innovate so as to remain a "leading supervisory authority" by continuing to make "progress on data monitoring and use — with the implementation of a new internal organization."[527] It is unclear if the AFM intends that this digitalization should allow greater supervisory capabilities around culture and conduct risk issues but, if so, that would also be consistent with broad global trends among its peers.

Singapore

INDUSTRY AND REGULATORY BACKGROUND

In a speech to the IMAS-Bloomberg Investment Conference, in March 2022, MAS chairman Tharman Shanmugaratnam discussed five forces that are currently affecting all countries: the war in Ukraine, the risk of stagflation, the climate crisis, the pandemic, and the increased fragility of our institutions.[528]

"These are each major risks and sources of fragility," Shanmugaratnam said. "Together they define a perfect long storm. I say long storm, because this is not just a perfect storm in the traditional sense where you have a confluence of one-off, conjunctural factors. These are structural shifts. They're not cyclical or random shocks. They're structural shifts, interacting with each other, that are going to be with us for some time."

In response to the war in Ukraine, MAS put in place targeted sanctions against Russia in March 2022. All financial institutions, including payment service

Ravi Menon **REUTERS / Edgar Su — stock.adobe.com**

As the COVID-19 situation improves globally, organisations are looking to return to "normal" and rebuild social capital and address the phenomenon of the "Great Resignation."

The past two years have demonstrated how flexible people can be in adjusting the way they work when circumstances require it. Notwithstanding its downsides, hybrid work has opened up new possibilities in employee engagement and created safe spaces for alternative voices to be heard.

As we emerge from the pandemic, it is important that financial institutions appreciate this fundamental shift in the workplace so that we emerge better than "normal" from a culture and conduct perspective. MAS will continue to partner financial institutions and industry associations such as the Association of Banks in Singapore (ABS) to promote trust and strengthen culture and conduct standards across the industry.

Ravi Menon, Managing Director,
Monetary Authority of Singapore

providers, operating in the city-state were required to comply with the financial measures and are prohibited from facilitating transactions that would contravene the sanctions measures. Financial institutions who do not comply with MAS' direction will be guilty of an offence and subject to a financial penalty and regulatory action.[529]

MAS also tightened its monetary policy three times over the six months from October 2021 to April 2022 as means of managing inflation risks. The city-state, with its largely trade-based economy, is especially susceptible to global inflation trends. Current global supply-chain and production constraints have driven prices up nearly everywhere. "With the labour market remaining tight and higher global inflation passing through to domestic costs, core inflation will see a broad-based step up in 2022 and risks remaining elevated over the medium term." MAS said.[530]

In December 2021, MAS found that up to a third of the country's financial assets are vulnerable to climate-related transition risks as a part of its study of the exposure of the city-state's financial sector to these risks. The study was part of MAS's efforts to build up capabilities to better assess the impact of climate risks. "While these risks may be less pronounced at this juncture, they warrant close monitoring and an active assessment of options due to their potential to rapidly develop and materialise into significant financial stability risks," MAS said.[531]

The Singapore Exchange (SGX) has also worked to address these risks, unveiling plans in December 2021 to mandate ESG disclosures related to climate and board diversity. Among these requirements are mandates that issuers set policies on board diversity that address gender, skill, and experience and publish sustainability reports alongside their annual reports.[532]

"Recent uncertainties have posed financial and governance challenges for boards. Having a broad set of perspectives will better enable companies to anticipate and face these challenges. It is therefore crucial that boards are diverse and have the necessary skill and experience to deal with the complexities of today's operating environment," Singapore Exchange Regulation (SGX RegCo) CEO Tan Boon Gin said.

The SGX also consulted on, and implemented, 27 core ESG metrics and a portal for issuers to report ESG data. While these would not be mandated, they would serve as guidelines for what sort of data listed companies could disclose in their reports.

In order to manage the economic risks presented by the covid pandemic, Singapore has begun to treat covid as endemic, abandoning the Zero-Covid policy which mandated long quarantines and made business travel difficult.[533] As Singapore has loosened its policies surrounding the pandemic, it has benefited from Hong Kong's continued attachment to strict restrictions. Bloomberg economics project 4.7% GDP growth in 2022, as opposed to 1.4% for Hong Kong, as the SAR maintains its own Zero-Covid policy.[534] Some have noted that, while its unlikely for Singapore to wholly supplant Hong Kong as the region's premier financial center, these gains hint at a future where Hong Kong and Singapore act as complements instead of competitors in the global economy.[535]

As a means of addressing the general fragility that these key risks have introduced, MAS and other stakeholders in Singapore have undertaken efforts to improve corporate governance, ultimately looking to ensure operational resilience.

CORPORATE GOVERNANCE

Singapore's corporate governance ranking among its APAC peers has improved in the past year, according to the Asian Corporate Governance Association's (ACGA) "CG Watch 2020." The city-state ties for second-best with Hong Kong, outscored only by Australia.[536]

There has been a prominent push to expand corporate governance guidelines in the last year, witnessed globally. Singapore has been one of the drivers of this change, with a coordinated effort involving MAS, Singapore Exchange Regulation (SGX RegCo), and other government and industry stakeholders.

MAS issued a revised set of Guidelines on Corporate Governance (CG Guidelines) for all locally incorporated designated financial holding companies, banks, direct insurers, reinsurers and captive insurers, on 9 Nov 2021. The CG Guidelines were revised to incorporate the 2018 Code of Corporate Governance, which reinforces board competencies, places greater emphasis on disclosures of the relationship between remuneration and value creation, as well as the interests of stakeholder groups other than shareholders. Other key revisions include aligning the CG Guidelines with international standards and industry good practices as well as refining the compliance approach for different categories of financial institutions (FIs).[537]

Under the CG Guidelines[538] , MAS implemented a tiered compliance regime for different categories of FIs, depending on the size and complexity of their business. For example, larger FIs such as locally incorporated banks and Tier 1 insurers[539] are to fully observe the Principles of the CG Guidelines, while Tier 2 insurers were allowed to explain their variances from the Principles. MAS continues to allow FIs subject to the CG Guidelines to state and explain variances from the Provisions and Additional Guidelines in their annual reports or on their company websites, as long as they are consistent with the policy intent of the Principles.

In January, Singapore's parliament passed the Corporate Registers (Miscellaneous Amendments) Act. This put in place numerous new requirements and guidelines for corporate governance. One such change requires that firms keep current their registers of nominee stakeholders and their nominators. Previously, a nominated shareholder could hold shares on behalf of an anonymous nominee. Other reforms require transparency on beneficial ownership and clarify timelines for the maintenance of registers.[540]

In March 2022, Stewardship Asia Centre (SAC) released the second edition of the Singapore Stewardship Principles (SSP) for Responsible Investors. The revised principles were drawn up by a 10-member steering committee supported by MAS and the SGX. "We received feedback from more than 20 stakeholders," Rajeev Peshawaria, CEO of SAC, said. "These recommendations were taken into consideration to enhance the principles in the areas of internal structures and governance, stewardship beyond listed companies, and ESG considerations.

We urge the financial services and investment industry to adopt the updated SSP and make a greater commitment towards responsible investment."[541]

MONETARY AUTHORITY OF SINGAPORE

Supervision

In recent years, Singapore has emerged as a global thought leader in the supervision of culture and conduct related risks in the financial industry. The Monetary Authority of Singapore (MAS), both the nation's prudential and conduct regulator, has been at the fore in this regard.

As noted in our 2021 *Compendium*, in September 2020 MAS released a paper entitled "Information Paper on Culture and Conduct Practices of Financial Institutions." The paper sets out its approach to culture and conduct, the outcomes towards which financial institutions should work towards, and provides examples of good practices for the institutions to consider adopting. More specifically, MAS set out nine outcomes towards which financial institutions should strive. These include expectations for financial institutions to identify and empower staff who are responsible for driving culture and conduct, as well as to incorporate culture drivers and conduct risk as part of their risk management framework.[542]

In July 2021, MAS sought feedback on a proposal which would expand its powers to investigate and punish misconduct in the financial sector. One of the proposed changes would allow its officers to enter premises, without warning or a court order, in order to gather evidence in its investigations. Another would give the regulator power to punish those who commit misconduct even if they have already left the institution or even sector in which the misconduct took place.[543]

One theme throughout this report is the expansion of the regulatory perimeter, and this has been evident in Singapore as well. In November 2021, MAS said that financial influencers, social media creators sharing financial information and advice, must comply with disclosure requirements."[S]uch third parties must comply with the same disclosure requirements as regulated entities, including issuing warnings to consumers to alert them to the risks of trading DPTs, such as possibly losing all their money or tokens," a MAS spokesperson told *Capital.com*.[544]

Another bill was proposed, in February 2022, which would prohibit individuals who are not "fit and proper" from engaging in activities and functions that are critical to the integrity and functioning of financial institutions. It also establishes a fit and proper test, to be administered by MAS. Additionally, it brings cryptocurrency into MAS's regulatory perimeter for supervising anti-money laundering risks.[545]

The industry-led Insurance Culture and Conduct Steering Committee[546] (ICCSC) published two papers on culture and conduct best practices in the areas of human resources and corporate governance for stakeholders within the insurance ecosystem in March; and a third paper on the best practices in the area of conduct of financial advisory representatives and financial advisory firms in April. The papers aim to elevate the culture and conduct standards of the insurance sector and will be reviewed in 12 months to assess the effectiveness of the recommendations for the industry. Marcus Lim, MAS Assistant Managing Director, said, "MAS encourages all firms to take reference from this set of papers and consider how best to apply them to their business so as to better serve their customers."[547]

The Association of Banks in Singapore Culture and Conduct Steering Group (ABS CCSG) is an industry group that seeks to elevate standards of culture and conduct in the banking industry, and maintain public trust and confidence in banks in Singapore. In 2021, the CCSG published an industry practice note on Culture and Conduct Dashboards (CCDs), which shared existing and potentially useful practices to encourage and facilitate wider adoption of CCDs among banks.[548]

In April 2022, CCSG released the results of its second annual Banking Trust Index for Singapore (BTIS). The BTIS is the first standardized means of measuring public trust of banks in Singapore, and was commissioned by the ABS to understand consumers' level of trust in banks as well as areas to improve on. The results show that trust in the Singapore banking industry continues to be resilient and Trust Capital has increased. There is also an increased expectation for banks in Singapore to do more to keep the banking system and customer data secure; create accessible, reliable and innovative banking solutions; and improve customer service standards and consistency.[549]

"With the increasing digitalisation of financial services, banks must continually invest in maintaining and building trust with their customers," MAS's Marcus Lim said. "There may be service issues along the way, but a consistent demonstration of accountability and commitment to protecting their customers' interests will bolster the public's confidence in the industry. In this regard, the BTIS serves as an important reference for banks to understand the effectiveness of their collective efforts."

International Collaboration

MAS initiated several international collaborative efforts in the past year. In June 2021, MAS and the United Kingdom announced Financial Partnership to improve their relationship in financial services and expand regulatory cooperation.. "Under the Partnership, the UK and Singapore will explore opportunities for greater financial cooperation, including enhanced information sharing, closer cooperation in international fora, as well as regulatory deference, to drive new and broader opportunities for financial services trade and cooperation," MAS wrote in the announcement.[550]

MAS also initiated several initiatives in collaboration with China. In late December last year, it announced plans to deepen collaboration in green finance and initiatives on bond platform linkage, commodity derivatives collaboration and ETF product link.[551]

MAS signed a Memorandum of Understanding (MOU) with the Bank Indonesia to strengthen bilateral cooperation and improve collaboration on innovation and financial regulation. Specifically, the organizations are looking to promote innovation in payments and to formalize a framework for cooperation on several functions, to include their regulatory and supervisory frameworks and anti-money laundering priorities.[552]

MAS collaborated with the BIS Innovation Hub Singapore Centre on Project Ellipse, an effort to establish a data and analytics platform to improve bank supervision, with support from the Bank of England, the International Swaps and Derivatives Association (ISDA), Financial Network Analysis (FNA) and Accenture. In March 2022, MAS and the BIS launched the prototype of this platform. "Regulators need accurate and timely information to assess emerging risks and to make informed supervisory decisions," Ross Leckow, Acting Head of the BIS Innovation Hub, said. "Project Ellipse has now developed a potential tool for the global regulatory community to further explore and collaborate on common solutions that can improve the data and analytical capabilities of regulatory authorities."[553]

In April 2022, MAS and the Australian Treasury signed the Australia-Singapore FinTech Bridge Agreement, which laid out plans to strengthen fintech collaboration between the countries. The Agreement established a framework to:

- deepen bilateral and multilateral cooperation on FinTech;
- support the mutual establishment of FinTechs looking to expand in each other's markets;
- build on current engagements to strengthen linkages between Australia and Singapore; and
- explore joint innovation projects on emerging issues in FinTech [554]

AI and Regtech Adoption

In July 2021, MAS launched the Global Veritas Challenge to accelerate adoption of artificial intelligence (AI) solutions which promote the principles of fairness, ethics, accountability and transparency (FEAT).[555] The Veritas Consortium, a partnership between MAS and 26 industry participants, published five papers laying out assessment methodologies for FEAT principles to promote responsible adoption of AI technologies.[556] Alongside these white papers, the consortium released a software toolkit which help with the automation of fairness metrics.[557]

In August, MAS announced that the Singapore Fintech Festival, an event it organizes with the ABS, would take place in November, and would be spun off into its own entity. "For the last five years, MAS has grown the SFF into a leading global platform for FinTech," Sopnendu Mohanty, MAS' Chief FinTech Officer and a director of the SFF, said. "It is now time for the SFF to further a global mission. Singapore has an important role to play as a knowledge centre and as a platform to enable greater collaboration and exchange between the public and private sectors around the world."[558]

Later in the year, MAS announced the creation of a new digital platform and regulatory framework to allow banks in Singapore to securely share information on customers or transactions where they cross material risk thresholds. The new digital platform, called Collaborative Sharing of ML/TF Information & Cases (COSMIC), will help MAS and the banks it regulates to prevent money laundering, terrorism financing, and the financing associated with the proliferation of weapons of mass destruction.[559] MAS writes that, while defenses against these crimes have strengthened in Singapore in recent years, FIs are still limited in their ability to identify financial crime by the information to which they have access.[560]

"[A] remaining weakness is that FIs are not permitted to warn each other about potentially suspicious activity involving their customers," MAS wrote. "As such, each FI's understanding of their customers' risk profile is limited by the information the FI collects."

There has also been collaboration among governmental and industry stakeholders in this regard. In November 2021, the Smart Nation and Digital Government Office (SNDGO) announced that it was launching two national AI programmes focused on the government and financial sectors. This program, along with MAS's COSMIC platform, contribute to the Singapore government's National AI Strategy.[561]

ASSOCIATION OF BANKS IN SINGAPORE

abs
The Association of Banks in Singapore

The Association of Banks in Singapore (ABS) is an organization which represents the 154 local and foreign banks and financial institutions which operate in Singapore.[562] Much like MAS, ABS has been a driving force in the adoption of new technologies to manage conduct and operational risks in Singapore. In August 2021, for instance, ABS released a handbook laying out a standardized approach to data-sharing among banks and non-bank firms in Singapore. The framework seeks to ensure that data-sharing meets regulatory requirements and is built on principles of trust and security.[563]

Together with nine banks in Singapore, ABS is also part of the steering group of the AML/CFT Industry Partnership (ACIP) which is co-chaired by MAS and the Commercial Affairs Department of the Singapore Police Force. ACIP was established in April 2017 as a public-private partnership to uplift the banking sector and industry's knowledge and understanding of Anti-Money Laundering, Countering the Financing of Terrorism and Countering Proliferation Financing issues, as well as enhance operational cooperation between the banks and the authorities. Over the years, ACIP has sought to increase industry-wide understanding of money laundering, terrorism financing and proliferation financing risks and strengthened Singapore's collective ability to detect and deter financial crime. To augment the effectiveness of ACIP's work, expert working groups are created to monitor and study key risk areas and other emerging areas of interest.[564]

SINGAPORE EXCHANGE REGULATION

Singapore Exchange Regulation (SGX RegCo) is a subsidiary of the Singapore Exchange which handles all frontline regulatory functions of the exchange. SGX RegCo is responsible for ensuring that its regulatory and enforcement framework for listed companies continues to be relevant and effective in supporting regulatory goals. This includes being able to deliver efficient and timely regulatory outcomes.[565]

In mid-2021, SGX RegCo announced that it was expanding its enforcement powers and amending listing rules, effective as of August that year. Among these rule changes are provisions to allow SGX RegCo to publicly reprimand issuers, require issuers to comply with specified conditions, and a new requirement that all issuers have a whistleblowing policy.[566]

"The market has spoken and is demanding more public accountability more quickly," SGX RegCo CEO Tan Boon Gin said. "Particularly in uncertain times, we need to give investors faster answers and greater assurance. Speedy enforcement is also a stronger deterrent that will complement our other pre-emptive efforts such as our new whistleblowing framework."

SGX has for years faced more delistings than new listings. In September 2021, SGX announced new rules that enable the listing of Special Purpose Acquisition Companies (SPACs) to give companies an alternative capital fund raising route with greater certainty on price and execution. To result in good target companies, SGX RegCo introduced a framework that focuses on the sponsors' quality and track record as well as increases sponsors' skin in the game and their alignment with shareholders' interest. SGX listed the first three SPACs in January 2022.[567]

In December 2021, SGX RegCo announced that it would be focusing its work on three broad areas in the following year: digitalisation of general meetings, board diversity and climate reporting, and improved disclosure around letters of demand.[568]

Hong Kong

INDUSTRY AND REGULATORY BACKGROUND

Fintech and Regtech Adoption

Many have said that Hong Kong must take advantage of the strengths of China's Greater Bay Area, in order to make fullest use of its potential as a hub for global fintech and regtech innovation.[569] The Hong Kong Monetary Authority (HKMA) has focused much of its effort on this undertaking in the past few years.

The HKMA unveiled "Fintech 2025," its new strategy for promoting fintech innovation in Hong Kong, in June of last year. The plan focuses on five key areas: banks going fully digital; strengthening research into digital currency; enhancing existing data pipelines and establishing new ones; expanding the fintech workforce; and cultivating an ecosystem supportive of fintech innovation.[570]

Accompanying its "Fintech 2025" strategy are specific goals for realizing Hong Kong's regtech potential. "Regtech constitutes an integral and important driver of the HKMA's 'Fintech 2025' strategy," HKMA CEO Eddie Yue said. "On that, we have developed a vision that by 2025, Hong Kong will become a leading hub for developing regtech solutions and cultivating regtech talents."[571]

In order to enact this vision, the HKMA has sought to raise awareness among banks of the potential benefits and use cases of regtech, to encourage the development and adoption of new solutions, and to expand the regtech ecosystem by nurturing talent in the Hong Kong workforce.

In June 2021, the HKMA released the seventh and final issue of its "Regtech Watch," which intends to lay out "actual or potential Regtech use cases rolled out or being explored in Hong Kong or elsewhere." In this issue, the regulator explained its three-year roadmap to integrate Supervisory Technology (Suptech) into its regulatory framework. "One key constant in this journey will be the need to enact an internal cultural shift towards embracing technology and more agile and flexible ways of working," it wrote. "For a Regtech or Suptech journey to be successful, hardware and software upgrades alone will not be adequate. The journey needs to be complemented by a culture change and the development of relevant soft skills by staff."

In August, the HKMA announced the launch of an Anti-Money Laundering and Financial Crime Regtech Lab in November this year. The labs will allow regulated financial institutions to experiment with new technologies and data analytics tools as a part of the larger "Fintech 2025" strategy.[572] Alongside the labs, the HKMA intends to engage directly with the participants in Hong Kong's AML/CFT ecosystem, to gather suggestions and facilitate the adoption of new solutions.

The HKMA also undertook initiatives to promote the adoption of regtech to better manage a range of non-financial risks. For example, the regulator published a Practice Guide for utilizing regtech to manage cyber risks. "As banks become increasingly digital, it is crucial for banks to enhance their controls and technical capabilities to protect their data, systems and broader business activities from cyber attacks," the HKMA said. In this Guide, the HKMA outlines the following potential opportunities for the deployment of regtech:

- Identifying potential cyber attacks
- Prioritizing vulnerability remediation
- Responding to cyber attacks
- Assessing cyber risk
- Protecting data[573]

Later in the year, the HKMA Deputy Chief Executive Arthur Yuen sent a letter to institutions stating that the HKMA would include regtech on an Enhanced Competency Framework on Fintech (ECF-Fintech) for banking practitioners. According to Yuen, the biggest barrier to regtech adoption in the HK Special Administrative Region (SAR) is a lack of sufficiently experienced talent. The HKMA commissioned consultants to develop a skills matrix involving 38 basic skills falling into four categories: soft skills, compliance skills, business skills, and technology/data skills.[574]

The HKMA has since taken further steps to address this issue. The ECF-Fintech was published in December 2021, in collaboration with the Hong Kong Institute of Bankers (HKIB) and participating firms in the Hong Kong banking sector. The HKIB was announced as the Administrator of the Framework, handling examinations and certifications, among other responsibilities.[575]

The HKMA has also continued its work to create a platform for data-sharing between banks. As discussed in last year's issue of this report, in a

November 2020 speech, Eddie Yue announced the creation of a Commercial Data Interchange (CDI). The CDI is an interoperable platform allowing data providers to — with the consent of data owners– share data with all banks, rather than relying on individual connections between banks and data providers. Yue said he expected the CDI will lead to reduced fraud and lowered compliance costs, while enabling financial institutions to offer innovative new products.[576] Some have also pointed to the CDI as permitting smaller businesses to connect with banks and to secure financing.[577]

Geopolitical Jockeying

In recent years, Hong Kong has had to contend with geopolitical tensions between the United States and China, creating a very difficult operating environment for firms that need to remain in the good graces of both governments. For example, when the US imposed sanctions on Hong Kong and Chinese officials for what it perceived as violation of civil liberters in relation to the Chinese National Security Law, new Chinese legislation threatened to punish any bank operating in Hong Kong that implemented the sanctions, imposing "discriminatory measures against Chinese citizens or entities." However, firms that refused to implement the sanctions would find themselves in violation of US law.[578]

In July 2021, the Biden Administration warned US companies of risks it perceives as a consequence of operating in Hong Kong, as China asserts greater direction over the SAR's financial markets.[579]
For instance, in a statement entitled "Statement Holding Foreign Companies Accountable Act: Final Amendments," the SEC's Gary Gensler claimed that Hong Kong and China have not historically cooperated with the Public Company Accounting Oversight Board (PCAOB) to allow inspections in their jurisdictions.[580]

Christopher Hui Ching-yu, Hong Kong's Secretary for Financial Services and the Treasury, rejected these claims as did its accounting regulator, the Financial Reporting Council (FRC).[581] "We regret to see the US SEC in its statement on December 2 [describing] Hong Kong as a jurisdiction not having worked with the US PCAOB, which is unfair and ungrounded," Hui said. "We urge the US SEC to correct its misleading statement."

Many global financial institutions operating in both Hong Kong and the US have struggled to comply with the demands and expectations of both governments — a tension most expect to escalate going forward.[582] As an example, HSBC came under fire from US lawmakers for freezing the accounts of activists in Hong Kong, despite these actions being legally required of it in the SAR.[583]

The operation environment became even more complex in March 2022 as the West levied sanctions on Russian citizens and firms. Former HKMA CEO Joseph Yam Chi-kwong criticized the US' sanctions regime for weaponizing financial markets. "Some countries, like Russia, are not allowed to use the international financial infrastructure due to some of the crazy US tactics in the short run," Yam said. "The affected countries will come across troubles and inconvenience. However, if you look at the long term, I think there will be some major negative risk for the US dollar as an international reserve currency."[584]

Earlier this month, *Asia News* reported that the HKMA had prepared emergency plans in case Hong Kong or China were sanctioned by the US for supporting Russia, including minimizing the risks to the SAR's financial system if it were removed from SWIFT, the payment system which connects banks globally.[585]

Covid Complications

The covid pandemic has presented additional challenges for Hong Kong. Some complain that its Zero-Covid policy, which originally required a three week quarantine upon entering the SAR, has made it difficult and costly for people to travel to Hong Kong.[586] Even after Hong Kong reduced quarantine periods from three weeks to two, the pursuit of "zero-covid" made it clear that the restrictions would not soon end.[587] This came after many banks had actually stepped up their hiring in mid-2021.[588]

The Asia Securities Industry and Financial Markets Association (ASIFMA) conducted a survey of the world's largest banks and asset managers and found that 48 percent were considering moving staff and business functions out of Hong Kong as a result of these policies. ASIFMA CEO Mark Austen argued that these policies could be disastrous to Hong Kong's long-term prospects. "Hong Kong's status as an (international financial center) is increasingly at risk along with its long-term economic recovery and competitiveness as a premier place to do business," he said.

There is some evidence for this, as banks have complained of facing substantial difficulties in seeking to bring new talent into the market. Jason Kennedy, founder of London-based executive recruitment firm Kennedy Group, claims that, for many people, there is no amount of money that makes Hong Kong an enticing place to work in the current environment.[589]

Posing yet further challenge, other surveys warn of a potential mass exodus from Hong Kong in the coming year. The American Chamber of Commerce in Hong Kong found that more than 40% of its members had said they were more likely to leave Hong Kong, with most citing quarantine requirements as the largest reason.[590] "For the fastest growing sector of wealth and asset management there is a lack of trained supply of talent," said Tara Joseph, president of the Chamber. "If draconian travel restrictions continue for an undefined and lengthy period, the talent issue will become all the more serious." The Chamber also found that 70% of firms wishing to bring new talent into Hong Kong were struggling to do so, as a consequence of the quarantine restrictions.[591]

In February 2022, the EU warned that more than 10% of European expatriates working in Hong Kong had left the city due to the strict quarantine guidelines. EU and US diplomats have sought to convince Hong Kong authorities to loosen restrictions.[592] "We estimate over 10 per cent of EU residents in Hong Kong have left in the past year and a half," Thomas Gnocchi, head of the EU Office to Hong Kong and Macau, told the *Financial Times*. "We made it clear this is a conservative estimate, since what we are hearing over the past few weeks points to many more leaving Hong Kong."

The strict measures are not only driving talent out of the SAR, but have also halted important business travel in and out of Hong Kong. Many executives in business with Hong Kong operations have been reluctant to travel to the SAR, as they cannot afford to quarantine for three weeks upon entering.[593]

Firms with operations in Hong Kong have had to institute new systems, and relocate some staff to other locations both within and outside Hong Kong, in order to mitigate strains posed by the strict quarantine policies. HSBC, for instance, split its Hong Kong practice among three different locations in Hong Kong, to avoid the possibility of forced mass quarantines of its employees.[594] As was discussed in detail in the 2021 version of this *Compendium*, the hybrid and remote models of working that these policies necessitate have the potential to elevate culture and conduct risks, as they make it more difficult for firms to maintain their desired culture and monitor employee conduct.

The talent crisis is not only hitting the financial industry, but also the regulators charged with supervising it. In 2021, the Hong Kong Financial Reporting Council (FRC) lost 12% of its workforce, including 25% of its junior staff, while its remaining employees faced a pay freeze. In a budget submitted in February 2022, the FRC requested approval for pay raises, as it feared that, without the necessary staffing, it would "not be able to deliver on the various initiatives underpinning Hong Kong's development" as an international financial center.[595]

In late March, Hong Kong announced that it would be easing its travel rules, reducing mandated hotel quarantine to seven days from 14 and allowing flights from the UK, Australia, Canada, France, India, Nepal, Pakistan, the Philippines and the US.[596]

In April, Hong Kong Financial Services Secretary Christopher Hui stated that any losses from Hong Kong, whether in talent or capital, were unlikely to be permanent. "Hong Kong has always been a highly open economy," Hui said. "Any outflow of talents is likely to be a temporary phenomenon as long as we are able to maintain our competitive edges."[597]

Money Laundering and Misconduct

In our 2021 *Compendium*, we reported on seven Hong Kong bankers accused of laundering HK$6.3 billion — a case which the *South China Morning Post* calls the largest in a decade.[598] Since then, additional money-laundering schemes have been uncovered. In April 2021, Hong Kong authorities arrested six people suspected of laundering HK$2.5 billion.[599] In June, 24 people were arrested for laundering HK$27 million in proceeds from a scamming operation.[600] Regulators in Hong Kong, most particularly the HKMA, seem to be taking this problem seriously.

In November, the HKMA announced that it was taking action against four banks for failing to meet their anti-money laundering (AML) obligations and to monitor business relationships through ongoing Know Your Customer diligence.[601]

"Banks should make reference to these case examples to review data quality and respective transaction monitoring system effectiveness, and take appropriate risk mitigating measures on an ongoing basis," warned Carmen Chu, Executive Director (Enforcement and AML) of the HKMA. Looking forward, Chu indicated, the HKMA would expect that a risk-based approach in AML/CFT efforts should reflect an "up-to-date understanding of evolving risks, use of better quality data, responsible innovation including Regtech adoption, and close collaboration in the ecosystem."

There have also been instances of other sorts of misconduct in the SAR in the past year. In October 2021, Hong Kong's Financial Reporting Council (FRC) initiated an investigation into the Financial Statements of China Evergrande and its auditor, PricewaterhouseCoopers (PwC). Evergrande, China's second-largest real estate developer, faced a liquidity crisis in late 2021 which led to continued uncertainty regarding its ongoing solvency. The regulator contends that PwC signed off on Evergrande's financial statements with no reference to "going concern material uncertainties."[602]

In January 2022, the Hong Kong Securities and Futures Commission fined Citigroup Global Markets Asia Ltd (CGMAL) HK$348.25 million for alleged misconduct among employees working on the firm's equities-trading desk over a ten year period. The bank stands accused of misleading institutional clients when executing facilitation trades.[603] "The severity of CGMAL's failures exposed a culture that encouraged chasing revenue at the expense of basic standards of honesty," SFC CEO Ashley Alder said. "As a result, in the face of unrelenting commercial pressure to solicit more business and increase CGMAL's market share, deceptive practices were deployed at the expense of clients' best interest and to the detriment of market integrity."

Continuing to Serve as a Global Financial Center

Notwithstanding the geopolitical challenges and those tied to the covid pandemic, officials in Hong Kong remain optimistic for its future as a global financial center.

In a speech at the Hong Kong Association of Banks Distinguished Speaker Luncheon in October 2021, Hong Kong Chief Executive Carrie Lam explained that Hong Kong's economic recovery, coupled with the work by the HKMA and other stakeholders, leaves her confident that the SAR will see continued growth.[604]

"[M]y Government is fully committed to our financial services sector, and the banks and banking professionals so critical to its continuing success at home, with our nation and around the world," she said. "I know that we can continue to count on the Hong Kong Association of Banks for its support in our efforts to enhance Hong Kong's position as an international financial centre."

Powerful figures on the Chinese mainland have expressed their own support for Hong Kong's role in the global economy. Yi Gang, governor of the People's Bank of China (PBOC), pledged to work with the HKMA to develop a stronger regtech, fintech, and green finance ecosystem in the SAR.[605] "The PBOC will continue to support the further development of Hong Kong as an international financial centre and enhance the various Connect schemes in financial markets, with a view to consolidating Hong Kong's leading position in global financial markets," Yi said.

HONG KONG MONETARY AUTHORITY

Culture Efforts

The HKMA has long been at the fore among global banking regulators in regards to its culture and conduct work, and continued to display such leadership despite the challenges discussed above. At the ASIFMA Compliance Week 2021, HKMA Deputy Chief Executive Arthur Yuen cautioned that, among heightened concerns around operational resilience imposed by the pandemic and the difficulties in maintaining culture in a remote working environment, banks seem to have lost some focus on the topic.[606]

"We at the HKMA are still pushing hard on the various bank culture initiatives despite the pressure brought about by the pandemic," Yuen said. "We believe that similarly, whilst banks have all been very busy adapting to the unprecedented Covid impacted environment, they must not lose sight of the need (and indeed the importance) of maintaining momentum in their bank culture efforts."[607]

In June 2021, the HKMA announced that it would be launching a focused review of the incentive systems in retail banks' front offices as a part of its work to promote sound bank culture. "The Focused Review aims to dive deeply into a number of specific areas of incentive systems of 20 retail banks," HKMA Deputy Chief Executive Arthur Yuen wrote in the announcement. "These areas include how the incentive systems of the front offices are designed and implemented, and how they drive behaviours of frontline staff and affect customer outcomes, in particular their role in minimising potential misconduct behaviour and mis-selling practices in the sale and distribution of banking, investment and insurance products."[608]

The HKMA published the interim report on this work in November 2021. A survey of frontline staff found that they felt their incentives were largely focused on business outcomes rather than customer and conduct outcomes, and as such did not believe customer and conduct outcomes to be valued as much as other factors. The HKMA's review of firms' policies echoed these sentiments, finding financial performance to be weighted more heavily than non-financial performance in many cases. It also found that there were fewer opportunities to earn rewards for non-financial performance, and more opportunities to be punished for it.[609]

HONG KONG EXCHANGES AND CLEARING LIMITED

HKEX 香港交易所

In December last year, the *Financial Times* reported that new listings in Hong Kong raised 10% less in funds over the year, which the *FT* associated with a crackdown on tech groups by Beijing.

The slide in listings made Hong Kong an exception across global markets: global IPO fundraising has jumped 75 per cent from last year's total, with deals in New York alone rising to about $300 billion, the *FT* reported,[610] while Shanghai and Shenzhen reported an 8 percent increase in fundraising, to total $61.5 billion. Moreover, Dealogic data cited by the *FT* showed that 80 per cent of Hong Kong's 73 IPOs last year were trading well below their issuance price — a 15 percent drop on average.

The Asian Corporate Governance Association complains that Hong Kong's corporate governance regime lags international standards as regards transparency.[611] In particular, some were unsettled by proposals that corporate directors of Hong Kong listed companies would be permitted to obscure their identities.[612] "The proposed law will facilitate corruption, fraud and other crimes, and make it easier for directors to hide from creditors," argued David Webb, a Hong Kong activist investor.

Hong Kong's Carrie Lam pushed back on this, arguing that the proposal aimed to prevent "doxing", whereby the personal details of individuals are exposed online. Some accuse anti-government activists of using such tactics to attack authorities. And Christopher Hui, Hong Kong's Secretary for Financial Services and the Treasury, indicated that "agencies and officers who work against money laundering will still be able to get the information."[613] Further indication that Hong Kong would continue to promote good corporate governance was seen in mid-2021 when, echoing global trends, Hong Kong Exchanges and Clearing Limited (HKEX) expanded its enforcement powers and established a disciplinary regime which allowed it to hold individuals accountable for misconduct and rule violations.[614]

"We want to make sure that we're focusing more on individuals, and not just on the listed issuer companies," Jon Witts, HKEX's head of listing enforcement, said in an interview with *Regulation Asia*. "It is individuals who can help to drive meaningful change, so it is important that the sanctions impact those who are best placed to make a difference to a company's compliance approach and culture."

Later in the year, the Stock Exchange of Hong Kong (SEHK) finalized changes to its corporate governance code which sought to enhance focus on corporate culture, director independence, diversity, and ESG disclosures. The code includes the following requirements:

- Firms must ensure that their culture aligns with their purpose, values, and strategy
- Boards of listed entities cannot be comprised of solely one gender
- Lastly, firms must appoint a new independent non-executive director (INED) if all current INEDs have served for more than nine years, and disclose tenure for all long-serving INEDs[615]

THE FINANCIAL SERVICES AND THE TREASURY BUREAU

The Financial Services and the Treasury Bureau (FSTB) in Hong Kong announced in January 2021 that it would open applications for a Fintech Proof-of-Concept Subsidy Scheme, which was subsequently launched in February and administered by Cyperport. Financial services firms are being encouraged to use the scheme to test innovative solutions in such fields as regtech, trade financing, and cross-border payments. FSTB Secretary Christopher Hui said, "The pandemic has also spurred wide adoption of fintech. As an international financial center, Hong Kong is an excellent place to groom one's fintech business."[616]

In November 2021, Hui spoke about the results of the Fintech Proof-of-Concept Subsidy Scheme at the Cyberport FinTech Innovation Conference:

> *I am very glad to see that the PoC Scheme was well-received and oversubscribed, with 160 applications received by the end of the application period. Upon a rigorous vetting process conducted by an independent advisory panel, a total of 93 projects were approved, using up the total grant of $10 million allocated for the scheme. These projects sought to provide practical and innovative solutions in the field ranging from wealthtech, regtech, insurtech and payment systems, to cross-boundary data analysis, remittances and know-your-customer processes, and many other areas.* [617]

SECURITIES AND FUTURES COMMISSION

In her speech at Hong Kong FinTech Week 2021, Julia Leung, SFC Deputy Chief Executive Officer and Executive Director of Intermediaries, laid out how the regulator sees the current technological transformation of the financial services industry:

> *The financial industry is also undergoing a kind of metamorphosis. Just like the hormones that trigger the metamorphosis of the caterpillar, technology has triggered the transformation of the financial industry. It has allowed firms to introduce a wide variety of innovative products and services which have enhanced the customer experience and helped achieve better investor outcomes.*[618]

Leung went on to say that there must be a clear regulatory framework to both encourage innovation and protect investors. "I want to emphasise that we will maintain our practical approach to provide a well-defined regulatory environment which fosters innovation, market development and investor protection," she said.

FINANCIAL REPORTING COUNCIL

In January 2022, the Hong Kong Financial Reporting Council (FRC) promised that it would do more to root out audit failures in the SAR. This comes as audit and accounting firms have faced scrutiny globally regarding their ability, or lack thereof, to detect accounting fraud and other irregularities.[619]

"In 2021, we initiated investigations into cases which are of high public interest, and cooperated with other regulators whenever possible in order to protect public interests and to protect public trust in the status of Hong Kong," Kelvin Wong Tin-yau, who serves as the chairman of the FRC, told the *South China Morning Post*.

COLLABORATION

In June 2021, the Hong Kong FRC and the SEHK signed a Memorandum of Understanding (MOU) as they both seek to improve financial reporting quality in the SAR.[620]

"The MOU establishes a joint, complementary, and collaborative framework for the FRC and the Exchange under which our collective regulatory efforts can better provide investor protection through high quality financial reporting," FRC CEO Marek Grabowski said.

In Focus

An Interview with F. Christopher Calabia

Q: You joined the DFSA, in October last year, during a time of challenge driven by Covid, among other things. What brought you to Dubai, and how are you settling in?

F. Christopher Calabia

A: The chance to join the talented and multinational staff at the Dubai Financial Services Authority (DFSA) — and to live and work in such a dynamic and innovative city like Dubai — made this role a truly extraordinary opportunity. Certainly, part of the job's appeal was the organisation's strong reputation internationally, even though it's a small agency. One reason for the DFSA's favourable standing is that our rules are aligned with global standards and best practices. Firms that conduct business in London, Sydney, Singapore, New York, or similar hubs feel comfortable with our approach to regulation and adapt quickly.

But the bigger appeal for me was the quality and experience of our board and staff and their willingness to try new approaches. In early conversations I had with insiders and external observers, the high quality and extensive experience of the staff came up again and again. When you speak with a DFSA regulator, in many cases you're talking with someone who has worked for years on regulatory issues in other major jurisdictions — or you're talking with someone who has been trained by regulators with that level of expertise. Moreover, I was impressed with the deep commitment the DFSA has to learning, responding quickly, and helping to shape the future of finance and regulation not just in the Gulf, but globally, too.

In that regard, my first months on the job were a crash course in the huge range of activities that take place in the Dubai International Financial Centre (DIFC), which is the special jurisdiction within Dubai that the DFSA regulates. The DIFC attracts many of the world's largest and most innovative firms, so learning is constant. That means that our rules and approach to regulation must keep pace as well. On that note, it's inspiring to see people from more than 20 different countries working together to build the future of finance and regulation at the DFSA. With people from many cultures, continents, religious and cultural traditions — and with expertise in many financial markets — I feel like I'm gaining new perspectives about the world from every conversation I have with someone here.

> The DIFC attracts many of the world's largest and most innovative firms, so learning is constant.

You are of course correct that I arrived in Dubai amidst a global pandemic. Many people and families the world over have faced significant difficulties and even heart-breaking losses. Dubai weathered this challenge well. For example, when I arrived at the DFSA in October 2021, it was the first time I had set foot in an office in almost 20 months. In contrast, most of my DFSA colleagues had long since returned to the office. We still had safeguards in place, such as physical distancing and masks. Yet after almost two years of looking at a screen during the pandemic, my first weeks being back in actual conference rooms and talking with real people felt surreal.

Q: Unlike many financial sector regulators, you come to your new role with the experience of having been in bank regulation but also with experience in bringing innovation to the fore in the financial sector. How do you see those earlier experiences informing your work at the DFSA?

A: I've been fortunate to enjoy a career path that has taken my family and me on unexpected and fascinating twists and turns. All of these experiences have prepared me for my new role at the DFSA.

When I began my career as an assistant bank examiner at the Federal Reserve Bank of New York, I was excited to join such an iconic institution promoting the public good. At the same time, I thought that the job of a regulator would be narrow and not very creative. I was so wrong! I learned quickly that a regulator's purview is broad, because financial services touch every sector of the economy. Moreover, given how dynamic and fast-paced the economy can be, I saw that being a regulator requires humility and a real love of learning to keep pace with, and even anticipate, risks and opportunities on the horizon.

Studying emerging markets and the needs of society's most vulnerable required me to examine some of my long-held beliefs about who should provide financial services and how.

I was lucky as well to have bosses and mentors who were willing to take a chance on me. They were enormously supportive of my interest in working on some of the most creative and international aspects of supervision. One early assignment involved joining a team that was evaluating a regional banking crisis in Asia during the early 1990s. We didn't have any established tools for thinking about how falling real estate prices there might affect firms' solvency, so we created basic scenario analyses on spreadsheets — a simple version of what regulators now call a stress test. This early focus on solvency and capital became a theme in my career, leading later to a secondment to the Basel Committee on Banking Supervision in Switzerland to support global dialogue on minimal capital requirements for banks as part of the "Basel II" capital framework. ▶PAGE 323

My career exposed me to several crises large and small, including the September 11 attacks and their impact on markets, and the 2008 global financial crisis. From those events, I learned that we often don't have a handbook for addressing unusual events. I also saw the courage and imagination regulators needed if they were to help shape better outcomes amidst such difficult circumstances.

As you mentioned, I did take a break from being a regulator to work at the Bill & Melinda Gates Foundation in global development for four years. Even there my assignment focused on building a regulatory and financial system that serves the needs of all. The Foundation has an initiative to improve access to financial services among unbanked and underbanked people. The team I joined had identified persuasive research showing that improving access to modern, digital, and formal financial services such as basic "mobile money" accounts on mobile phones helped families to lift themselves out of extreme poverty. Access to an account moreover helped prevent families from backsliding into poverty if they encountered setbacks like the loss of crops in a drought or the illness of a key wage earner. ▶PAGE 121

Studying emerging markets and the needs of society's most vulnerable required me to examine some of my long-held beliefs about who should provide financial services and how. Still, the evidence I saw was clear: traditional brick and mortar banks generally won't build physical branches in impoverished or remote regions because the expenses usually exceed the revenues. But mobile phones are ubiquitous in low- and middle-income countries. Mobile network operators in East Africa and the Philippines figured out early on that they could offer basic financial accounts profitably — even to low-income customers — and do so without a brick-and-mortar network.

Therefore, my work at the Gates Foundation involved sponsoring research and dialogue on how regulators could license innovative providers such as mobile network operators or FinTechs to offer basic digital accounts to unbanked and underbanked people. We tackled other questions, too, such as how providers could safely onboard low-income consumers who lack documents like birth certificates or passports often necessary to meet traditional customer due diligence requirements and "know your customer" (KYC) rules. We facilitated substantive discussions on regulatory standards with providers, innovators, FinTechs, consumer advocates, as well as global standards-setters who promulgate recommendations on prudential regulation and anti-money laundering.

Supporting research and dialogue on these issues, especially in sub-Saharan Africa and South Asia, exposed me to a wide range of innovations in financial services. My work often involved digital identity, mobile and online payments, as well as emerging products such as virtual assets and new approaches to cybersecurity. Many of these innovations could bring in new kinds of providers and a wider range of customers than the financial sector had served before. At the same time, I saw that we needed clearer thinking about the costs and risks involved in the innovations and how regulators could respond to these innovations constructively.

When I received the invitation to join the team at the DFSA, I could draw on a wide range of experiences in conducting regulation and supervision, in setting new regulatory policy, and in engaging in a dialogue about the future of finance and regulation. Of course, I still have a lot to learn about the region and about the wide range of activities that the DFSA regulates beyond banking, including reinsurance, securities activities, a stock market, and a commodities exchange. I'm fortunate to work with and learn from a wide range of experts who developed their skills and knowledge in a variety of markets worldwide.

Q: In past editions of our annual *Compendium*, there has been regular discussion of the need for taking an "ecosystem approach" to financial sector innovation: bringing regulators and firms together with technologists. Given your history, what are your own views in this connection?

> Dialogue across providers, innovators, technology providers, customers and regulators is key to building the future of finance and regulation.

A: I agree wholeheartedly that dialogue across providers, innovators, technology providers, customers and regulators is key to building the future of finance and regulation. A big part of my job at the Gates Foundation focused on creating space and opportunities for substantive and detailed discussion of what customers need, what providers and innovators can offer, and how regulators can ensure that these financial services are offered safely and soundly and do not abuse the financial system or consumers.

This dialogue across so many participants historically has been challenging to foster. When I was just getting started as a regulator myself in New York almost 30 years ago, I might have heard about some innovations or had occasional discussions with technology providers and proponents of new business models. But I didn't have a way to engage unregulated firms in an official capacity. Our day jobs were focused on regulated firms. Moreover, some regulators have traditionally sought to minimise "moral hazard" by avoiding discussions that might appear to offer unregulated firms advice on legal or regulatory matters. That's why some simple developments over the past ten years — such as regulators offering "office hours" for unregulated firms to discuss business models or new technology

— were revolutionary in some jurisdictions. Prior to the creation of office hours, innovation hubs, and tech sprints, regulators often didn't have an easy way to engage with technologists or innovators that were outside their remit.

This opportunity to engage the whole ecosystem is one of the key advantages we enjoy at the Dubai International Financial Centre (DIFC) compared to other jurisdictions. The DFSA regulates over 540 firms that are all operate within a 110-acre zone in Dubai. All of the regulated firms are close to us, both figuratively and physically, as are a good number of technology providers and other firms that support those providers. It's a lot easier for us to engage in dialogue with many participants in the DIFC's "ecosystem" than may be the case for more traditional regulators in other locations.

This opportunity to engage the whole ecosystem is one of the key advantages we enjoy at the DIFC compared to other jurisdictions.

For example, the future of payments is one of the hottest areas in finance. To facilitate prudent innovation in the space, the DFSA established a new licence last year for money services. The license permits the offering of domestic and cross-border remittances, electronic wallets, electronic retail and business-to-business payments, and account aggregation services. Although the DIFC is largely a centre for wholesale financial services, the new money services regime is attracting interest from innovators seeking to reduce the cost and improve the efficiencies of cross-border remittance payments. This new licence could potentially make it easier and safer for some of the large number of foreign workers in Dubai to send money home to their families, many of whom are from lower income countries. We are also seeing proposed payments apps that encourage financial planning by facilitating investments linked to payments, such as by rounding up what a customer spends at a store and investing that difference in the market. If successful, these are innovations that could have an impact on society.

Q: Reducing the flow of illicit funds is a matter of heightened attention worldwide. In March of this year, the Financial Action Task Force (FATF) put the UAE under increased monitoring, sometimes known as the "grey list." What are your priorities in this connection?

A: The DFSA has long been and remains fully committed to preventing financial crime in the DIFC. We are resolute in having zero tolerance for money laundering, terrorism financing and proliferation financing activities, nor for deliberate breaches of United Nations and UAE sanctions. We will continue to work closely with the Dubai International Financial Centre Authority (DIFCA) and alongside our fellow regulators and relevant government authorities to secure the stability and integrity of the financial system.

In that vein, in early February we issued our second Financial Crime Prevention Programme (FCPP) Report for 2019-2021, which was prepared and published in collaboration with DIFCA. The Report provides insight into the DFSA's supervisory and enforcement efforts on financial crime within the DIFC. The Report outlines the additional steps taken to align DIFC regulatory, supervisory and enforcement frameworks further with the FATF Recommendations by conducting monitoring programmes, thematic reviews, compliance assessments and notifications. All of these efforts underpin an intensive and sustained cycle of supervision to reduce and mitigate the risks of financial crime. As we note in the report, international assessors have spoken favourably about the DFSA's approach to preventing money laundering and abuse of the financial system.

Q: Many financial sector regulators have launched ambitious plans to become more 'digital' and 'agile'. In this regard, some are looking to the promise of new RegTech and SupTech capabilities. Is this something you find to be of interest? And what role might it play in your region?

A: As a small organisation, technology is a force multiplier for the DFSA. We have long developed technology internally to help us manage and interpret data that firms share with us. We've also developed online modules to help simplify firms' interactions with us so that they can upload requested information and share regular reports with us in a more seamless fashion. So "SupTech" and "RegTech" have been part of our approach almost since our founding.

"SupTech" and "RegTech" have been part of our approach almost since our founding.

Dubai and the UAE are highly focused on promoting the use of good technology to improve efficiency and effectiveness. In the DFSA, we can do a lot more within this area, so we're taking a close look at our own infrastructure and are advancing our "digitalisation strategy" so that we will become one of the most technologically advanced regulators. We are already among the first regulators to move much of our infrastructure to the "cloud," beginning with most of our communications and messaging platforms.

Our next step will be to move our data collection and analytical tools to the cloud as well. We'd like to simplify firms' interactions with us even more. We likewise want to make it easier for our staff to access and use information and data that firms provide — and to draw on other sources of data available in the marketplace. One principle we're following is that data should be entered only once: if a firm provides a figure to us through an online platform, any authorised user in the DFSA should be able to access and manipulate that data. Another principle is to have a "single source of truth" internally. Staff shouldn't need to access different platforms (and sometimes different technologies) to aggregate data collected across the DFSA.

Now we'd like to leverage external experts who can accelerate our digitalisation work and offer insights into technology and techniques that are state of the art.

While we're building that single source of truth, we're also developing and using various SupTech tools. We already have some analytical tools that help us screen data for easier decision making and plan to build more. We're using robotics principles automation (RPA) to process data quickly and efficiently. We rely on automated screening and background checks. Ultimately, we'd like to develop modules for early warning systems and potentially draw on new technologies like natural language processing to help handle "unstructured data" like text files. In the future, I'd like to leverage artificial intelligence to help us spot patterns and trends.

How will we do this? We're revising our roadmap now. To date, we've built much of our existing technology ourselves, as many regulators often do. Now we'd like to leverage external experts who can accelerate our digitalisation work and offer insights into technology and techniques that are state of the art. Some of our technology may be available off the shelf; some we may ask others to help us build.

We expect that this technology will help us to continue to improve our efficiency as regulators and increase our effectiveness. Our goal is to ensure that our staff spend less time gathering and manipulating data and more time analysing. That may mean that we will need to improve our skills, too: an irony about technology is that, the more you deploy, the better your skills need to be in order to use the technology well. Reducing tedious tasks will give our staff more time to think and speak with colleagues and firms, so I think our jobs as regulators will become even more interesting.

As we make this journey, we welcome others to join us. I'd like to share our lessons and hopefully our technology with other regulators, too. Some authorities may not have access to the resources and experience we have. Since financial services are global, it's in everyone's interest for regulators collaborate and cooperate to ensure that the global financial system is resilient, sustainable, and inclusive.

F. Christopher Calabia *was appointed Chief Executive of the DFSA on 1 October 2021. He joins the DFSA with nearly 30 years of experience in supervision and regulation, including serving for over two decades at the Federal Reserve Bank of New York and two years as a member of the independent Secretariat of the Basel Committee on Banking Supervision in Switzerland. Prior to his appointment, Chris worked from 2017-2021 at the Bill & Melinda Gates Foundation as the Senior Advisor for Supervisory & Regulatory Policy in Financial Services for the Poor. Any opinions expressed above are his own.*

Japan

INDUSTRY AND REGULATORY BACKGROUND

'Abenomics' & Corporate Governance

Prime Minister Shinzo Abe came to power in 2012, inheriting a Japanese economy that had been stagnant for decades.[621] He instituted a series of reforms, dubbed 'Abenomics': a three-pillared strategy based around monetary easing, fiscal stimulus, and structural reforms.[622]

Among these structural reforms — the "third arrow" of Abenomics — the government introduced both a new corporate governance code and an investor stewardship code. These aimed to increase shareholder profitability and power while seeking to unravel much of the corporate cross-shareholding that had characterized Japan's *keiretsu* system since the end of the Second World War.

In our previous report, we discussed the continuation of these reforms under the then-Prime Minister Yoshihide Suga, who took power in 2020 after serving under Abe for his entire term. Formally proposed in April 2021, these reforms seek to enhance board independence, promote diversity through the adoption of voluntary targets, and encourage a focus on sustainability and ESG.[623] Changed expectations with regard to corporate governance call on companies to treat human rights as a board-level concern[624], driving further commitment to ESG initiatives.[625]

These changes officially took effect in June of last year, ahead of a major overhaul of the Tokyo Stock Exchange (TSE).[626] In that same month, Toshiba investors ousted its chairman after an investigation revealed evidence that executives and officials from Japan's Ministry of Economy Trade and Industry (METI) had colluded to stifle foreign shareholders' voices.[627]

Some point to this shareholder action as evidence of the growth of shareholder activism in the country.[628] Others, however, suggest that the scandal exposed serious deficiencies in Japanese corporate governance, especially given the alleged collusion between corporate leaders and government officials, and are calling for change.[629] Both arguments reflect a marked increase in the prevalence of shareholder activism in the country in recent years, as Japanese institutional investors have signaled a new willingness to vote on shareholder proposals. This has the potential to change the corporate governance landscape of Japan greatly, as executives are more likely to be held to account by their investors.[630]

Some have called for reforms to Japan's stewardship framework to further facilitate this growth in shareholder activism. Under current rules, if an investor wants to make a suggestion to a firm in which it is invested, it must publicly report its suggestions to the Japan Financial Services Agency (JFSA) and declare that its investment is not "purely for investment purposes." However, in other countries, investors must only declare the stake they own in a firm, and are free to keep any activities they may undertake in relation to this investment private, including any suggestions they may make.[631]

Prime Minister Suga resigned in October 2021 after just one year in office. Despite his work in the digitalization and modernization of Japan, Suga was unpopular due to his administration's handling of the covid pandemic.[632] The newly-installed Prime Minister, Fumio Kishida, has since made it clear that he intends to steer away from Abenomics.[633]

This change in perspective is especially relevant to the corporate governance reform underway in Japan. For example, in a 2020 book, Kishida advocated for a "two-track system" which would differentiate requirements for big and small companies when it comes to governance. "It's not realistic to apply the same rules. Corporate governance is important for small- and medium-sized enterprises, but they can't do it in the same way as big companies," he wrote.

Hiroki Habuka, former Deputy Director for Global Digital Governance at the METI, has written about the importance of corporate governance, innovation, and data science to achieving "Society 5.0." Specifically, Habuka has advocated for "agile governance":

> *However, a society based on digital technology is extremely fast-changing, complex, and uncertain. In such a society, it is difficult for rules to keep up with the speed of changes in technology and business models, and there is a limit to how much monitoring can be done by the government alone. In such a society, a decentralised governance model that emphasises horizontal relationships among stakeholders such as businesses, individuals, and communities is considered necessary.*[634] ▸PAGE 173

Many investors have sought enhanced ESG data, ratings, and disclosures as a means of evaluating corporate governance. However, the usefulness of ESG data and ratings hinges upon the reliability of the data in question. Many have sought a consistent way to judge data provider reliability, in the same way they would for providers of financial data. In February 2022, the JFSA announced a subcommittee to work with ESG rating and data providers to address these data quality and reliability issues.[635]

In March 2022, the FSA indefinitely detained five employees of SMBC Nikko, one of Japan's largest brokerages, on suspicion of market manipulation. Some have pointed to this as a turning point, as the trial is likely to expose a culture that is pervasive throughout the industry.[636] However, others have criticized the FSA for what they deem as extreme interrogation tactics, including 10-hour investigations and home visits, which may have led to the death of one senior trader accused in the case.[637]

Japan's Digitalization Agency

Another key aspect of the structural reform discussed under Abenomics is the technology transformation of systems that are largely still based on paper, pencils, and fax machines.[638]

In early 2020, the situation for many Japanese regional banks seemed dire, with extremely low interest rates and stagnant local economies. In regions where the pandemic hit particularly hard, it presented a silver lining for the local regional banks. In 2018, less than a quarter of consumer transactions in Japan were conducted digitally. However, with the social distancing and remote operations mandated by the pandemic, Japan's aging population was forced to embrace new technologies and digital operations that they had previously avoided.[639]

One month after becoming Prime Minister Suga announced his intention to create an agency to lead the digital transformation of Japan. "We need to make a digital agency as an organisation which will have a function of strong command power with personnel of high ability from public and private sectors, and lead digitalisation in the overall society," he proclaimed.[640]

Takuya Hirai, previously a member of Japan's House of Representatives, was appointed as the new Digital Transformation Minister, and charged with leading the formation of the Digital Agency which would be tasked with modernizing the country's governmental and economic systems.[641]

In August 2021, Prime Minister Suga nominated Joi Ito, a tech entrepreneur, to run the digital agency. However, the nomination was rescinded when Ito's connection to alleged human trafficker Jeffrey Epstein was made public.[642]

When the current Prime Minister took office in October, Karen Makishima, a member of Japan's House of Representatives, was appointed to run the agency. While the work of the Digital Agency had begun under the previous administration, Makishima blamed its relative lack of progress on stifling "laws, systems and customs."[643]

Corporate Culture

Japan is a famously collectivist nation. Its *communal* culture as a nation has unique implications for the *organizational* culture of its firms. Daisuke Asaoka, a management and corporate governance professor at Kyoto and Meiji universities, described Japanese corporate culture as "collectivist community, where all ranks, from top management to newly hired graduates, share a destiny within a tightly bound, meticulous, longitudinal order and enjoy internal promotion under a lifetime employment system."[644]

Many organizations globally could only wish for this uniform sense of purpose and dedication among their ranks. However, while this sort of culture may make individual misconduct less likely, it also makes whistleblowing much more difficult. As a Japanese proverb expresses it, "the nail that sticks up gets hammered down."

Historically, those who blow the whistle on their firm have been treated poorly. While conditions have improved marginally, many whistleblowers still face reprisal. As such, there is a noted lack of psychological safety among many Japanese firms.

"That corporate misdeeds, some hidden for decades, are being revealed by whistleblowers in blue-chip Japanese firms suggests a sea change in organizational behavior in modern Japan. Such behavior and institutional change stand in apparent contrast to the traditional Japanese corporate culture of conformity to organizational norms and avoidance of confrontational behavior," Asaoka said.[645]

Gender diversity in Japan has seen an uptick in recent years. For instance, the JFSA announced in November 2021 that, for the first time ever, it had hired more female college graduates than male in its recruitment for the following year.[646] Many have pointed to diversity, equity, and inclusion (DEI) as critical factors contributing to the psychological safety in organizations. In May 2021, Norges Bank Investment Management, Norway's sovereign wealth fund, called for Japanese boards to focus more on diversity and independence in a letter to the JFSA. "We regard the protection of minority shareholders through good corporate governance as necessary to safeguard and promote the fund's long-term financial interests," the letter said.[647]

UAE

INDUSTRY AND REGULATORY BACKGROUND

Misconduct & Money Laundering

In January 2022, the Dubai Financial Services Authority (DFSA) fined the founder and CEO of Abraaj Group, Arif Naqvi, $135.5 million. Abraaj Group is a collapsed private equity fund manager which has been accused of fraud.[648]

Ahmed Al Sayegh, a minister of state in the foreign ministry, says that the United Arab Emirates (UAE) has significantly increased its ability to stop flows of dirty money, as the Middle East's main financial hub works to keep itself off a global money-laundering watchlist, maintained by the Financial Action Task Force (FATF).[649]

Inclusion on the FATF watchlist would probably not deter financial institutions looking to set up in the UAE, bankers said. However, the consequent reputational damage could raise costs for banks doing business with global counterparts, and complicate compliance issues for international lenders.

David Lewis, former executive secretary of FATF, said: "The UAE is a big complex jurisdiction, it's a nexus point for a lot of illicit funds, but they've got a high level of political commitment to deal with this and they've shown that to the FATF."

In March 2022, the FATF announced that it had added the UAE to its "grey list," subjecting the jurisdiction to increased monitoring.[650]

Concerns surrounding AML were heightened further in March as wealthy Russians sought safe havens for their funds as widescale global sanctions placed unprecedented pressure on them. "Russians are now unwelcome banking customers in Europe, even though the majority went there to get away from Putin," said Peter Gray, partner at ADG Legal in Dubai. "People are worried about what the banks will do — the banks are afraid of sanctions and expensive investigations and so are reluctant to continue business with Russian nationals, regardless of their political affiliation."[651]

In an attempt to improve corporate culture in the Dubai International Financial Centre (DIFC), the special economic zone for financial services in Dubai, the DFSA introduced a new whistleblower regime in April 2022. The Regime, which is similar to the UK Financial Conduct Authority's, seeks to provide protections to employees who raise concerns about misconduct and wrongdoing within the DIFC.[652]

DUBAI FINANCIAL SERVICES AUTHORITY

DFSA
Dubai Financial Services Authority

The Dubai Financial Services Authority (DFSA) supervises various financial institutions within the DIFC, including entities from the banking, insurance, and wealth management sectors. All firms, including banks, are subject to periodic on-site risk assessments, the frequency of which is determined by the risk profile of the entity. Such inspections will generally include evaluation of the following areas:

- Corporate governance;
- Strategy and business models;
- Financial and operational risks;
- Conduct of business risks to clients and markets; and
- Financial crime risks.

The DFSA has made clear that collaboration, both domestically and internationally, is essential to its regulatory methodology.[653] "To achieve our objectives, the DFSA fosters and maintains relationships with other regulatory agencies within Dubai and the UAE, as well as with international bodies, regulators and organisations," the DFSA writes on its website.

In April 2022, the DFSA signed a Memorandum of Understanding (MoU) with the Central Bank of the Republic of Mauritius to cooperate on regulatory functions and share knowledge on financial innovation. "Advanced technologies are an important and growing component of the global financial ecosystem," Fadel Al Ali, Chairman of the DFSA said. "As a global regulator it is imperative that we are sharing our experiences and expertise to further advance the development of our economies and safeguard the health of our financial systems. We welcome this opportunity to collaborate with the Bank of Mauritius on emerging technologies impacting the financial ecosystem."[654]

Driving Innovation

In its 2021 annual report, the DFSA laid out its key initiatives. Driving innovation, both internally and in the sectors it regulates, was one such priority. While the adoption of new technologies may be difficult, the DFSA believes that it is a necessity for any sort of organization to continue operating in the increasingly digitalized financial industry.[655]

In Focus

An Interview with Senator Andrew Bragg

The Crypto Challenge

Andrew Bragg

PARLIAMENT of AUSTRALIA

In April 2019, I made an address to Blockchain Australia—the peak organisation for digital asset businesses in Australia. I announced that the Select Committee I Chaired—then called the Senate Select Committee on Financial Technology and Regulatory Technology—would be extended under new Terms of Reference, saying the following:

> *When we first applied our investigative lens to the digital asset sector, we expected it to be one of the many exciting developments in Australia. But it has become clear that blockchain, and its attendant fields of digital assets and cryptocurrency, represent an altogether different challenge for policymakers.*

It was clear that Blockchain-based finance would be a significant opportunity for financial markets. It would also be a significant challenge for financial regulators. Consequently, a clear, certain, and comprehensive regulatory framework was urgently needed.

When I began this line of inquiry, it was a lonely crusade. One news anchor told me that some perceived cryptocurrency as the province of scammers and criminals. Others wondered why I was pursuing an area which seemed so obscure.

On the other hand, in the wider population, there was widespread recognition of the value of blockchain technology. According to one report, 17% of Australians owned cryptocurrency and 13% planned on buying it in the next 12 months. Another report found that 28.8% of Australians either own or are likely to own cryptocurrency.

Unfortunately, the necessary regulatory framework was lacking. The Australian Securities and Investments Commission's guidance said that if a digital asset "looked like" a financial product, it would be a security, and subject to the full raft of legal requirements. No one seemed to have any idea how this question would be determined in practice.

The inquiry required a root-and-branch re-examination of the entire regulatory architecture. These technologies were an existential challenge to the structure of financial regulation in Australia.

Different agencies are responsible for prudential and banking regulation (the Australian Prudential Regulatory Authority), monetary policy and payments policy (the Reserve Bank of Australia), securities regulation (the Australian Securities and Investments Commission), and competition policy (the Australian Competition and Consumer Commission).

This subject matter cuts across all these fields of authority engaging multiple issues at a given point in time.

As the Chair of the Australian Securities and Investments Commission put it to me at a parliamentary committee hearing, "the policy and regulatory challenges are very significant … There are some difficult policy questions to be answered. They have to be answered, frankly, by the government."

This issue cannot be addressed at the regulator level. It is the role of Parliament to make laws, and the role of regulators to enforce them. In other words, it was my job to kick this off in Australia.

In exploring answers to these questions, it will of course be necessary to attend to evolving company culture norms and the expected conduct of these new market participants. Our experience with such issues in the traditional financial sector, as outlined in this report, should be instructive.

Solving the Problem

The Committee was focused on a central question: how do we create certainty for the sector and protect consumers without imperilling technological development?

In answering this question, we conducted a rigorous inquiry.

- From May through until June 2021, the Committee received and reviewed 88 submissions, and consulted widely with the sector.
- Through August and September 2021, the Committee heard testimony from 71 witnesses across three hearing days.
- In October 2021, the Final Report was handed down. The Final Report made 12 recommendations, of which 11 were either noted or accepted by Government.

The Committee came up with 12 recommendations. By early December the Government had agreed to 11 recommendations of the Final Report, which was tabled in October. Seven of these recommendations related to digital assets. These related to five broad themes: the licensing of digital currency exchanges, a custody regime with minimum standards, greater transparency around 'debanking" of crypto businesses, and clarity on taxes and token classification. The Treasurer, the Hon. Josh Frydenberg MP, announced a formal timetable for the implementation of these recommendations.

Per the timetable, by mid-2022 we aim to:

- Complete consultation on the licensing of Digital Currency Exchanges.
- Finalise consultation on the custody regime.
- Receive advice from the Council of Financial Regulators on the causes and policy responses to de-banking.

And by end-2022, the Government will:

- Receive a report from the Board of Taxation on taxation of digital transactions and assets.
- Undertake a token mapping exercise.
- Examine the potential of Decentralised Autonomous Organisations (DAOs) and how they can be incorporated into our legal and financial frameworks.

This requires adapting, and where necessary, tweaking existing schemes and applying them to digital assets. It also requires legislative changes, in the form of a broad, principles-based delegation of regulatory power to a Minister. The same interests which are protected by existing financial regulations should be applied to the digital asset ecosystem. It is important that Ministers have their regulation-making powers clarified and where necessary expanded to address these issues. The process can allow for best practice to eventually solidify in response to evolving technological needs. This has been achieved at breakneck speed. Within nine months, we started a review and had it adopted by the Australian Government as national policy.

Making the Case

The global crypto-asset market is now worth $2 trillion. Modelling done by consultancy EY found that the right policy settings would see the jobs in this sector increase to 205,700 from the current level of 11,600 by 2030. Over the same time period, the sector would provide a further $68.4 billion contribution to GDP, an increase on the current figure of $2.06 billion.

Not acting presents a major detriment. Australia would lose control of digital assets, with markets and custody occurring in offshore jurisdictions. We would see investment and talent continue to leak offshore. Consumers would be left vulnerable to mass loss events.

Reform is an urgent national priority. This meant making these points as clearly and as often as we could.

Stakeholder engagement is critical. My office hosted a series of roundtable consultations with fifty-eight industry leaders, experts, peak body representatives, and officials from Treasury.

This is a brave new world but it can leverage long-standing principles.

Ever since 1792, when 24 merchants gathered under a Buttonwood tree in the City of New York and agreed to only trade with one another at a fixed commission, we have been developing ways of making financial markets stable, transparent, and competitive.

We don't want to overburden this sector, and stymie future developments. But we also want to ensure that this sector is not benefitting from regulatory arbitrage. A new crypto market licensee would require tests for capital adequacy, responsible persons, auditing rules, control frameworks, and disclosure requirements.

Similarly, the Committee proposed that the government establish a Decentralised Autonomous Organisation company structure. DAOs have the potential to disrupt and challenge the traditional limited-liability company. Jurisdictions with flexible corporation law are hosting DAOs within their jurisdiction. Other jurisdictions, such as Wyoming, have made explicit legislative provisions for DAOs.

There was a clear need to clarify the legal status of DAOs. Jurisdiction shopping is likely to accelerate, with investment being driven offshore. A lack of clarity around taxation will lead to losses in Government revenue.

The corporations law should be amended to address this, affording DAOs legal personality and recognition. But we need to maintain flexibility. Instead, it should establish minimum standards: responsible agents, clearly defined rights for members, standards for disclosure and assurance, clarification about the location of tax liability. All of this should account for the fact that DAOs are inherently self-regulating and transparent, with in-built systems of governance enforced by code.

Where to next?

We can already see the next big thing coming along the horizon: decentralised finance (DeFi). Replacing financial intermediaries with self-executing contracts promises a revolution in finance unseen since the first joint-stock companies were established in the 1600s. Regulators need to be ready for a disruption which will make the issues arising from crypto seem like the warm-up act.

Creating a comprehensive framework for the regulation of digital assets has forced us to undergo a root-and-branch examination of the entire financial regulatory system. In doing so, we have asked a series of basic questions:

- What interests are we protecting?
- What is international best practice?
- How do we create clarity and certainty without stymying innovation?

Beyond the digital assets space, this has been an invaluable conceptual exercise. By forcing us to re-apply the financial regulatory framework, we are rigorously evaluating it.

I have always maintained an outlook which is liberal in the most orthodox sense of the term, valuing individual liberty, free markets, and responsible government.

It is because of these principles that I was compelled to look at the digital assets and technology space. Governments can't run away from progress. Governments have no choice but to embrace it.

Using the levers available to lawmakers, we've been able to put forward a comprehensive reform agenda for digital assets. This exercise has forced us to re-examine and recalibrate the existing tax and regulatory settings. It has generational significance.

It also has significance for the wider economy. With our policies enacted, this could increase the contribution of digital assets to $68.4bn and employ over 200,000 Australians by 2030.

Much good has been achieved by the Senate Committee and the Australian Government. We have developed a plan which puts Australia in the strongest possible position to secure new investment and consumer protection in the digital assets arena. But, like all proposed reforms, it will only be as good as it's implementation and enforcement.

Senator Andrew Bragg *sits in the Australian Parliament as the Senator for New South Wales from the Liberal Party of Australia. In that capacity, he is Chair of the Standing Committee on Environment and Communications and also served as Chair of the Senate Select Committee on Australia as a Technology and Finance Centre, and the Select Committee into Financial Technology and Regulatory Technology. He has been a notable advocate on a range of issues, including indigenous reconciliation, LGBT rights, superannuation reform, financial regulatory reform, and tax policy.*

"[T]imes are changing, even more so as a result of Covid-19, and technological changes are disrupting the landscape of financial services," the DFSA wrote. "It is now a race to invest and increase the pace in developing the necessary capabilities to make the changes."

In June 2021, the DFSA hosted the third edition of "RegTech Live: Driving Compliance Through Innovation," an event in which the regulator laid out its expectations and supervisory priorities relating to innovation in the technology, cyber, suitability, and anti-money laundering risk spaces, while also providing a forum for industry and stakeholder engagement.[656]

FINANCIAL SERVICES REGULATORY AUTHORITY

The Financial Services Regulatory Authority (FSRA) of the Abu Dhabi Global Market (ADGM) has been a driving force in regulatory technology (regtech) innovation in the region. In a report titled "Powering the Future of Regulation," the regulator outlined its strategy and philosophy in this regard.[657]

"At the FSRA, we challenge ourselves to not just stay apace of transformation, but to guide the market in providing safe and robust products," FSRA CEO Emmanuel Givanakis wrote in the report. "As such, we have participated in raising the bar on international best practices and standards, and have taken inspiration from agile methodologies in order to better respond to new developments in finance."

Australia

INDUSTRY AND REGULATORY BACKGROUND

Echoes of the Hayne Royal Commission

In the previous issues of our annual *Compendium*, we have discussed the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry in great detail. The Commission was headed by Kenneth Hayne, a former Justice of the High Court of Australia, and has come to be known as the "Hayne Commission." The Commission's final report, issued in 2019, made 76 recommendations for reform, including 54 for the government, 12 for regulators, and 10 for industry participants themselves.[658]

As of January 2020, only 27 of the 76 recommendations had been implemented, and four had been abandoned entirely.[659] A year later, in January 2021, 44 recommendations had still yet to be implemented.[660] The government has received much criticism for what some see as a slow uptake on recommendations which would keep bank misconduct in check[661], especially considering the fact that Australian banks continue to struggle with conduct scandals (See the "Culture and Misconduct" subsection below).

In October 2021, the federal government introduced the last set of recommendations made by the Hayne Commission, establishing the Financial Accountability Regime (discussed in more detail in the "Individual Accountability" subsection) and the Compensation Scheme of Last Resort through legislation. These reforms will check off a further 6 recommendations from the list of 54 targeted to the government in the Commission's final report.[662] PAGE 179

"This is a significant milestone that provides consumers of financial services with greater confidence in Australia's financial system," Treasurer Josh Frydenberg said.

There have also been efforts to reform Australia's Corporations Act, which some have called "impenetrable." The Hayne Commission pointed to this needlessly complex legislation, and the loopholes embedded inside it, as a root cause of many of the misconduct problems the Commission's inquiry exposed. In response, the government formed the Law Reform Commission in 2020 to analyze and simplify the 13,000 page legislation.[663]

The government has faced pressure to expedite these efforts. "The royal commission is not done," Gerard Brody, CEO of Consumer Action Law Centre, said. "There are still some things not implemented, including this significant reform process. Hayne's comments and recommendations around exemptions, qualifications and loopholes in the law giving rise to opportunity for misconduct was probably the key theme [of the royal commission]."

As the government has worked to fix the issues illuminated by the Hayne Commission, there has also been pressure on banks to take ownership of improving industry culture and conduct themselves, rather than waiting for regulators to hunt down and punish firms for transgressions.

In August 2021, a coalition of consumer groups submitted 103 recommendations to the Australian Banking Association (ABA) in the course of its review of the Banking Code of Practice. Recommendations included guidelines for banks to monitor debt collectors in their interactions with vulnerable customers and to improve treatment of customers hit by natural disasters.[664] "Despite the lessons of the financial services royal commission, there still appears to be systemic and cultural problems within banks that are not being recognised as such," the submission says. "We are concerned that banks still too often report 'human error' as the main cause of code breaches, without properly identifying the root cause."

Some in the industry have supported the push for banks to take ownership of these challenges. ANZ chief executive Shayne Elliot criticized banks for "outsourcing challenges" to regulators. "My view about our industry is there's too much outsourcing of problems to regulators, so when they set the level our job is to go as close to that line as possible," Elliott said. "I don't think that's right, and we have to do a better job in working out what's right for us."[665] ▶PAGE 103

Culture and Misconduct

As in every other major financial market globally, Australia's largest banks have faced numerous conduct scandals in recent years. As a result, the country's regulators have utilized substantial fines, sanctions, and other punitive measures to punish firms and individuals for misconduct.

For example, following a series of highly public misconduct scandals at Australia's largest bank, Commonwealth Bank of Australia (CBA), the Australian Prudential Regulation Authority (APRA) announced in 2018 that it had found serious deficiencies in the bank's non-financial risk management. The regulator imposed a A$1 billion add-on to CBA's operational risk capital requirement and approved a Remedial Action Plan for CBA to carry out, with regular reporting on its progress.[666] As of November 2020, CBA was found to have made strides in improving its non-financial risk management, but still had a ways to go in order to have the capital add-on removed fully. APRA halved the capital requirement, keeping the remaining $500 million add-on in place until CBA has fully implemented its Remedial Action Plan and has adequately addressed all recommendations APRA set forth in 2018.[667]

In Focus

Strengthening Supervisory Assessments of Risk Culture

By WAYNE BYRES

Wayne Byres

In examining the lessons of the Global Financial Crisis, prudential supervisors quickly recognised that risk culture had been a critical determinant of financial success or failure. Prior to the crisis, an excessive focus on short-term financial success (the 'what') without sufficient regard to the way in which results were generated (the 'how' and the 'why') allowed excessive risk-taking to go unaddressed — with significant costs ultimately borne by shareholders, employees, creditors and taxpayers.

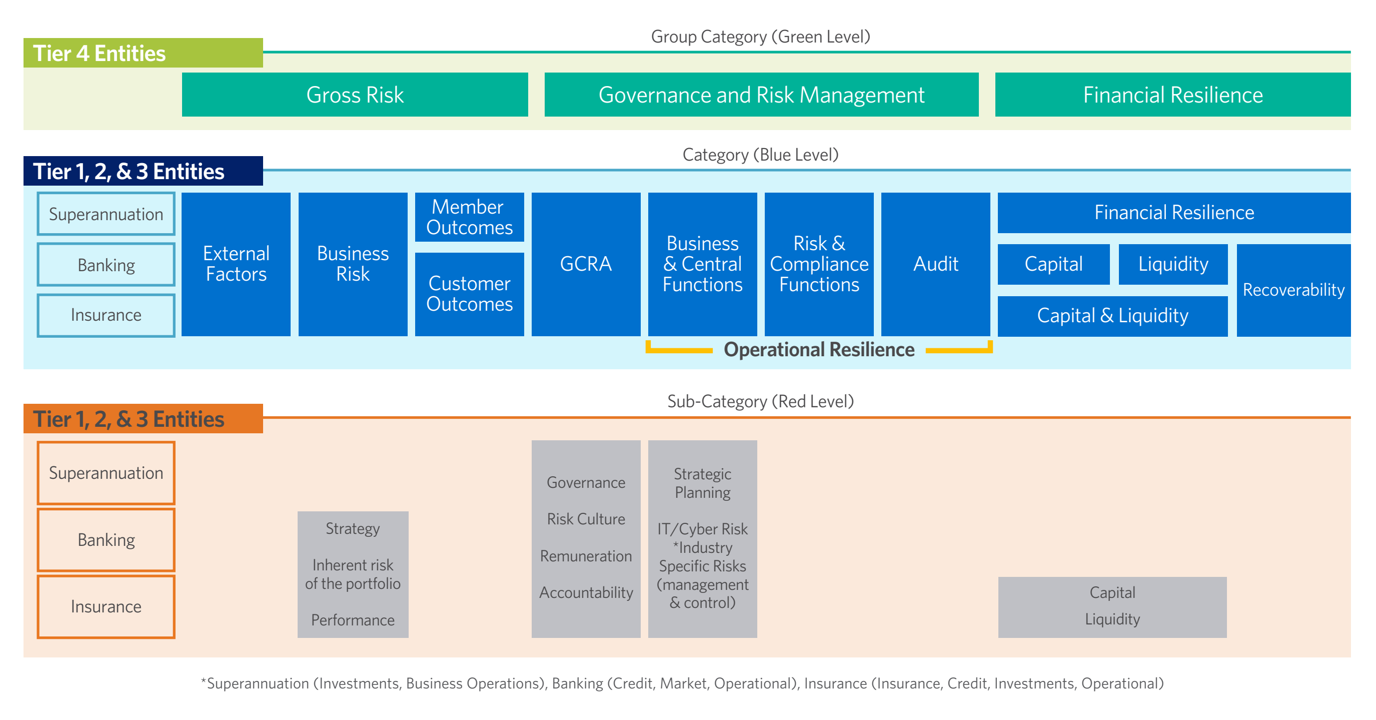
National authorities, and international standard-setting bodies, have therefore devoted considerable effort over the past decade to improving supervisors' capacity to understand and assess how the risk culture within an organisation influences its risk profile. However, unlike the traditional areas of prudential focus like capital and liquidity, where frameworks and metrics for risk measurement are well-established, assessing the behaviours, mindsets and motivations of people — both individually and collectively — is much more difficult.

In its 2019 Corporate Plan, APRA set out a strategic objective to transform risk culture across the entities we supervise. The word "transform" was not chosen lightly — it signalled a deliberate attempt to materially shift the dial on industry practices and behaviours. But in the aftermath of our own Prudential Inquiry into the Commonwealth Bank of Australia[1] and the Australian Government-initiated Royal Commission into the financial services industry, it was clear that incremental change would not address the wide-ranging deficiencies in risk culture that had been identified.

Broadly, we have sought to pursue this transformation through three key measures:

- increasing the importance and prominence of risk culture within our supervisory risk assessment model;
- developing a structured framework for assessing risk culture; and
- supplementing subjective supervisory opinions with more robust data-driven insights.

Our ambition has been to expand our supervisory toolkit, build frameworks and approaches, and ultimately to deliver better insights on risk culture — from which APRA is then better placed to target and pursue changes that are needed within financial institutions themselves, and strengthen the risk culture of the industry as a whole.



A stronger supervisory focus

In 2020, APRA introduced a new supervisory risk assessment model.[2] Amongst other things, it placed more weight on issues of governance, risk culture, remuneration and accountability, and — particularly for the larger institutions — required supervisors to be more systematic in the way they assessed those aspects of an institution's risk profile.

Although APRA is not a conduct regulator, the model also asks supervisors to explicitly consider customer outcomes as an indicator of risk. There can be direct risks to financial soundness and the community's trust and confidence in an institution from poor customer outcomes, as well as indirect impacts from the root causes of those outcomes, e.g. systemic deficiencies in governance, risk management or risk culture.

APRA's Risk Culture 10 Dimensions

Having asked APRA's supervisors to place a greater emphasis on the assessment of risk culture, it was important to support that with a methodology that enabled supervisors to make those assessments (i) in a structured way, and (ii) consistently over time and across entities of different shapes and sizes.

APRA therefore developed a framework, which we call the Risk Culture 10 Dimensions. These dimensions articulate the key aspects of an institution's risk behaviours and risk architecture that contribute to its overall risk culture. Underpinning each dimension is a maturity scale outlining behaviours and evidence that supervisors can look for and examine in order to make their assessment.

Data-driven insights

Another of APRA's strategic objectives has been to enhance data-driven decision-making across all that it does.

As noted earlier, there are aspects of prudential supervision where data is readily available, and risks can be readily measured and modelled as a foundation for robust risk management. When it comes to issues of behaviour and culture, however, data and metrics as a means of understanding risk are much more scarce. Developing analytical means of assessing the Risk Culture 10 Dimensions therefore provides considerable scope to materially lift the capability of supervisors and institutions to understand how and where action is needed.

Industry-wide Risk Culture Survey

One key initiative under this data-driven approach has been APRA's risk culture survey.

The survey is designed to provide insights from employees within financial institutions on perceived risk behaviours and the effectiveness of the risk management architecture they work within. The responses, over time, will help identify the extent to which positive changes to risk culture are (or are not) taking place within individual institutions, as well as identifying areas where risk culture can be improved. It also provides APRA with the ability to benchmark results across a number of institutions within an industry sector (for example, insurance, banking or superannuation), facilitating peer analysis and comparison. APRA is one of only a few regulatory bodies worldwide that directly collects such survey data.

APRA piloted the survey with 10 general insurers in early 2021.

In the pilot, every employee at each participating entity was sent a survey, amounting to approximately 11,600 potential respondents in total. Participation in the survey, which involved completing 43 questions, was voluntary, with all survey responses anonymised.

The average response rate from the institutions in the pilot was 62 per cent. A majority of the survey respondents (64 per cent) were employees with no management responsibilities, and just under half (46 per cent) had been employed with their institution for over five years.

In order to benchmark the institutions surveyed, a quartile approach was applied. Results for each risk culture dimension were presented as a percentage agreeable: that is, as a proportion of respondents that chose ‘agree’ or ‘strongly agree’ to the statements relating to a particular risk culture dimension. Benchmarking was then determined by assessing the results relative to quartiles; that is top quartile, interquartile range (the two middle quartiles) and bottom quartile results within the cohort.

When assessing each risk culture dimension, the lowest scoring dimensions across the sampled institutions were:

Risk Governance and Controls: which assesses the effectiveness of risk management oversight through systems such as governance structures, reporting and control processes. This is an area that is critical to building a strong risk culture and effective risk management within an entity.

Decision-making and Challenge: which assesses whether diversity of thought and constructive challenge is actively sought within an organisation.

Responsibility and Accountability: is the dimension that also had the largest variability in responses. This indicates that employees tend to have a wide range of experiences when responding to questions regarding, for example, being clear about the risks they are responsible for managing within their roles.

Risk cultures do not just vary between organisations: they also vary within them. As well as comparing between institutions, APRA was able to gain additional insights by examining how each business area within each surveyed institution rated relative to other business areas in the same organisation, as well as the same business area across all other surveyed institutions. For example, the analysis found that the business areas of Underwriting and Customer Service generated the weakest results, particularly in relation to the risk culture dimensions of Responsibility and Accountability, and Risk Governance and Controls.

On the other hand, employees in the Financial Control business area, together with those employees in Legal, Compliance and Risk, tended to provide the strongest results across all 10 risk culture dimensions. Of note, those business areas had the highest percentage of positive scores in the risk culture dimensions that Underwriting and Customer Service business areas rated lowest. While these business areas are likely to be naturally more risk aware and value a strong risk culture, there is an opportunity for organisations to identify what is working well in these areas (for example, training, leadership, communication) and apply these to areas where there is less favourable sentiment.

Participants in the pilot received a detailed report outlining their risk culture survey results. The report provided a range of information on the survey results, and measures of their outcomes relative to other participants.

Overall entity results by risk culture dimension

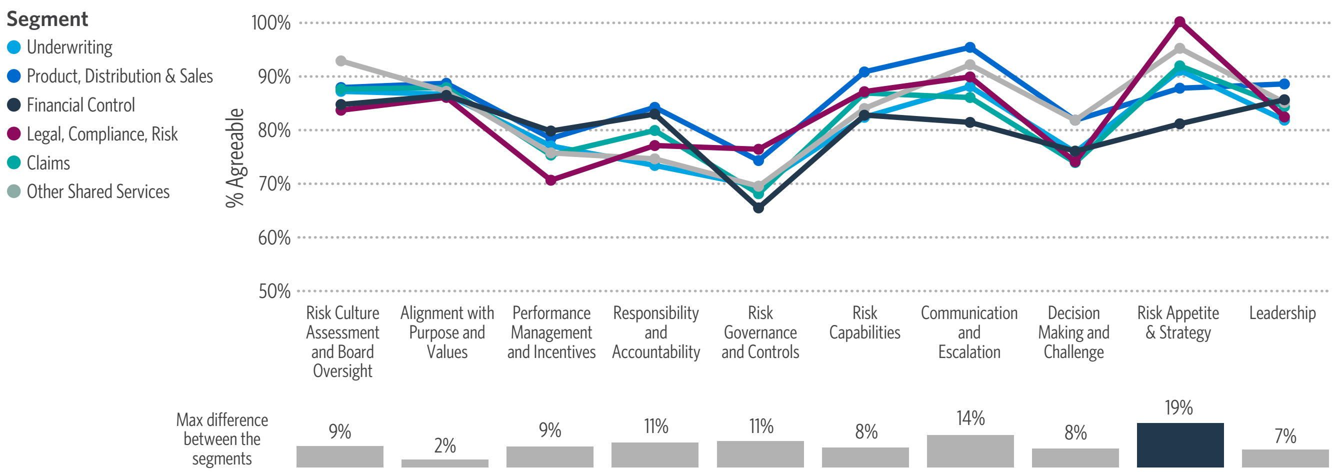
% Agreeable Top Quartile	% Agreeable Interquartile Range	% Agreeable Bottom Quartile

APRA Risk Culture 10 Dimensions

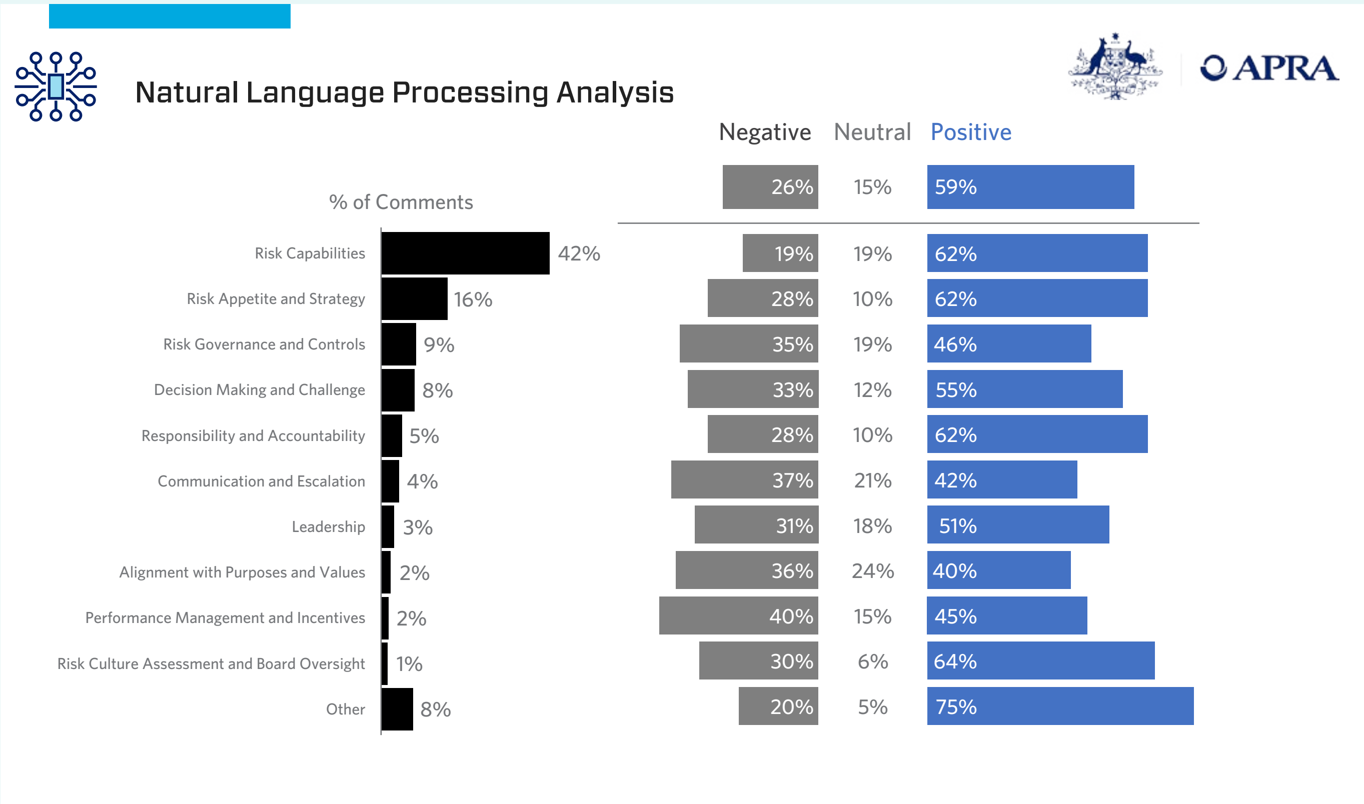
Entity	Risk Culture Assessment and Board Oversight	Alignment with Purpose and Values	Performance Management & Incentives	Responsibility & Accountability	Risk Governance & Controls	Risk Capabilities	Communication & Escalation	Decision Making & Challenge	Risk Appetite & Strategy	Leadership
Entity Results	81%	89%	78%	75%	62%	84%	91%	75%	86%	85%
Top Quartile Threshold	88%	89%	82%	78%	71%	86%	90%	77%	91%	85%
Rank (Out of 10)	9	1	4	6	10	5	1	5	7	2

- 3 dimensions in the **top quartile**, 5 dimensions in the **interquartile range**, 2 dimensions in the **bottom quartile**.

Variability in responses by Business Unit



Risk Appetite and Strategy, had the largest variability (19%) in responses between 'financial control' and 'Legal, Compliance and Risk'



Overall the benchmarking was well-received. For many institutions, this was the first time they were able to see how their employees' perceptions of various risk culture elements compared directly with their peers. Institutions were keen to understand the underlying factors that contributed towards their results, as well as the degree of variability amongst the individual business areas.

Of course, while the survey results provide an important perspective on an institution's risk culture, it represents only one of a number of qualitative and quantitative approaches that can be used. Nevertheless, APRA has found the pilot risk culture survey to be a rich source of insights.

The survey results will provide an important input to APRA supervisory assessments. APRA also expects that institutions will use the insights from the survey and compare them with their own internal indicators (such as employee survey results, risk culture metrics and internal risk culture reviews), and other data points (such as non-financial risk metrics) to build a more comprehensive picture of their risk culture.

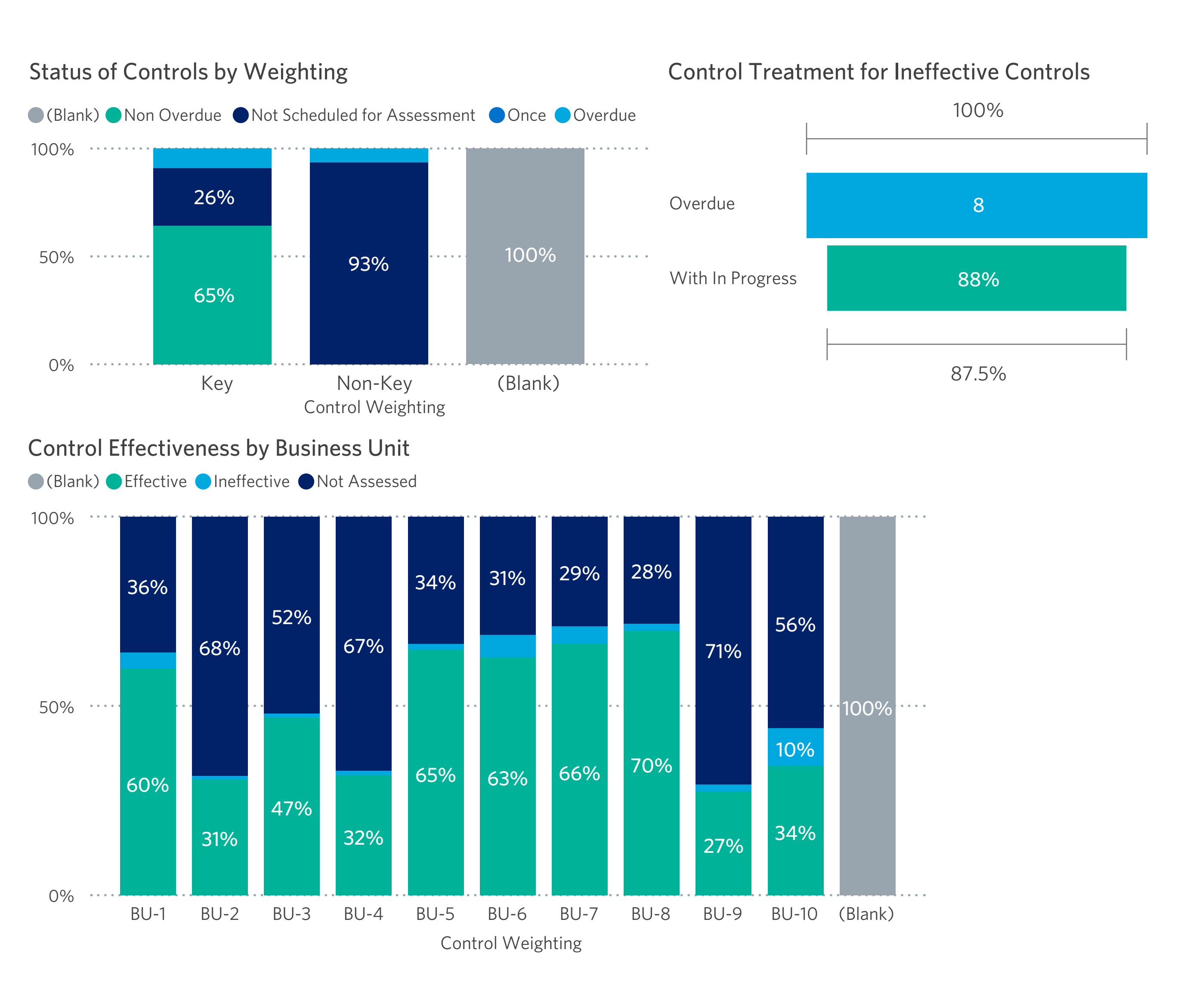
Between November 2021 and June 2022, APRA is surveying the employees at a further ~60 institutions across the banking, insurance and superannuation sectors. Longer term, the survey will be used as an important and ongoing supervisory tool for monitoring progress in improving the risk culture of the financial sector.

Natural language processing

As another means of using modern analytical techniques to assess risk culture, APRA has been building its natural language processing capability that can be used alongside the quantitative data from the risk culture survey. Where sufficient textual comments have been provided by respondents, APRA is seeking to utilise natural language processing to understand the overall sentiment of comments and, where possible, sentiment against some of the specific ten dimensions (e.g. the nature of the commentary related to leadership). This helps strengthen the insights beyond those gained from the Likert scale survey questions (e.g. a scale from strongly agree to strongly disagree).

Non-financial risk metrics pilot

Beyond the survey itself, APRA has been piloting with those institutions participating in the survey a new data collection on non-financial risk metrics. This pilot is being used to better understand the types of metrics — and their design and definition — that could be developed into a more formal data collection in the future. Examples of the sorts of metrics being examined include material risks outside of risk



appetite, overdue complaints, and the percentage of issues identified by the business, by the second line, and by audit.

Data Visualisation

Finally, with an increasingly data-driven approach, APRA has been trialling a number of data visualisation techniques to help convey key information from the various data points. In addition to the risk culture survey and pilot data collection, a PowerBI dashboard is used to collate and present information in new and informative ways. The chart above provides an example of the types of data that are presented. The dashboard also highlights the status of actions to address identified incidents and issues, including impact ratings, open/closed status, as well as how quickly actions were closed.

While APRA is interested in the specifics of corrective actions, the behaviours and practices surrounding timeliness of action closure and indicators for overdue dates are illustrative in terms of how risk and compliance are being managed in practice. This sort of information provides a useful validation — or challenge — to the risk culture survey results.

Conclusion

Assessing the risk culture of a financial institution will always be challenging. Some of that assessment will necessarily involve a degree of judgement. But APRA is actively working to blend that judgement with data-driven insights. In doing so, we not only aim to produce better supervisory assessments, but also to provide financial institutions themselves with better feedback, including valuable peer comparisons, that can help boards and senior executives better manage their own businesses. In doing so, we hope to be able to deliver on the transformation of risk culture across the financial sector that we have set out to achieve.

Wayne Byres *was appointed as a Member and Chair of APRA from 1 July 2014 for a five-year term. He was subsequently reappointed for a second five-year term commencing 1 July 2019.*

Mr Byres' early career was in the Reserve Bank of Australia (RBA), which he joined in 1984. After more than a decade with the RBA, including a secondment to the Bank of England in London, he transferred to APRA on its establishment in 1998. Mr Byres subsequently held a range of senior executive positions in APRA, covering both its policy and supervisory divisions. In late 2011, Mr Byres left APRA to take up the appointment as Secretary General of the Basel Committee on Banking Supervision, the global standard setting body for banks based at the Bank for International Settlements in Basel, Switzerland. He held this position until his return to Australia in mid-2014.

ENDNOTES

1 https://www.apra.gov.au/sites/default/files/CBA-Prudential-Inquiry_Final-Report_30042018.pdf

2 Supervision Risk and Intensity (SRI) Model | APRA https://www.apra.gov.au/supervision-risk-and-intensity-sri-model

In 2020, CBA was also fined $532 million, the largest civil settlement ever at the time, for breaking anti-money laundering (AML) and counter-terrorism financing (CTF) laws.[668]

CBA came under scrutiny again in 2021, when they were sued for allegedly violating the whistleblower rights of its head of group governance, Kara Nicholls. After requesting additional resources to deal with the burden placed on the group governance team in the wake of Australia's Royal Commission report, Nicholls claims that her concerns were largely ignored.[669]

Despite multiple reviews finding that her team lacked adequate resources and faced excessive workloads, CBA allegedly placed Nicholls on long-term leave late last year and chastised her for requesting additional resources rather than presenting strategic solutions. Nicholls alleges that, when she blew the whistle on the bank's lack of responsiveness to the group governance team's needs, she was fired.

These conduct issues are not isolated to CBA, or even to a small number of firms.

National Australia Bank (NAB), Australia's fourth largest bank, also faced scrutiny for its risk management practices following the 2019 leak of a document from NAB's auditor (EY) which criticized the firm for working to solve issues through "Band-Aid" fixes, rather than investing in the necessary long-term solutions.[670] In June 2021, the Australian Transaction Reports and Analysis Centre (AUSTRAC) informed NAB that it was considering enforcement action against the bank for what it saw as "potential serious and ongoing non-compliance" regarding the bank's AML obligations.[671]

Australia's second largest bank, Westpac Banking Corporation (Westpac), has also been the subject of regulatory scrutiny in the last few years. APRA called Westpac's non-financial risk culture "immature and reactive" after a culture reassessment demanded by the regulator identified ongoing issues, many of which had not changed since APRA's first culture assessment exercise, in 2018.[672] With this, Westpac was forced to launch a program to fix its risk culture and improve its management of non-financial risk.[673]

In 2020, Westpac settled with AUSTRAC, agreeing to pay a $920 million fine for its failing to properly report 19.5 million international transactions which breached anti-money laundering and anti-terrorist financing laws.[674] Later in the year, the bank faced further sanctions from APRA. The regulator required that the bank hold an additional 10% cash on hand until it completes an independent review of its liquidity risk management.[675] Westpac agreed to a court-enforceable undertaking that it would improve its risk governance framework after failing to make sufficient progress on its 2018 commitments.[676]

2021 was not substantially kinder to the firm. In May, the Australian Securities and Investments Commission (ASIC) announced a probe into insider trading at the bank.[677] In November, ASIC announced that it was launching six lawsuits against Westpac, citing "systemic failures" in its banking, superannuation, insurance and financial advice businesses.[678] ASIC recommended a fine of $113 million to the court.[679] In April 2022, this fine was upheld by the Federal Court, and Westpac was ordered to pay the whole $113 million.[680]

Despite all of this regulatory pressure, Westpac CEO Peter King announced that the bank's reform program would not finish until early 2024, with the design phase finishing up at the end of 2021.[681] In an interview regarding these issues, King acknowledged the seriousness of the firms' shortcomings, but asked for patience in resolving them.

"We need a change in the culture, culture takes time, but I've got to stay the course," he said. "I've got to fix this properly, I know that people would like to see that faster, but I've got to make sure it's a sustainable change in our culture."[682]

In November 2021, Australian wealth management firm AMP agreed to an enforceable undertaking with APRA. The undertaking, which concerns "historical matters," checked off the last of the referrals made to the prudential regulator by the Hayne Commission. Remediation costs for AMP were estimated to be between $40 and $45 million.[683]

While APRA was finished with its work relating to the Commission, ASIC still had one last referral. ASIC launched its last related case in late 2021, against ANZ. The bank was accused of failing to provide benefits to customers with certain accounts over a nearly three-decade long period. While ANZ has already had to repay nearly $200 million to affected customers, it may have to pay another $25 million fine if the federal court agrees that it is appropriate.[684]

As of December 31, 2021, Banks in Australia have paid or offered to pay a total of $3.1 billion to ASIC in relation to fees-for-no-serve or non-compliant advice cases. Just between July 1 and December 31st of 2021, a total of $1.3 billion was paid or offered.[685]

Of course, conduct issues are not unique to the banking sector. While this report largely focuses on misconduct within financial institutions, it sometimes helps to look outside for an example of what can happen when an organization fails to maintain sound culture.

In last year's issue of this report, we discussed in some detail a scandal surrounding Rio Tinto, in the wake of its destruction of a sacred aboriginal site at Juukan Gorge, in May 2020, during the course of its iron mining activities.[686] As a result of this scandal, Rio Tinto CEO Jean-Sébastien Jacques was forced to step down.[687]

As a part of work being undertaken by Rio Tinto's Everyday Respect task force, which was launched in March 2021, the mining firm commissioned Elizabeth Broderick, Australia's former sex discrimination commissioner, to examine its corporate culture. Broderick's report, issued in January 2022, included a survey of 10,000 employees. Nearly 30 percent of female employees and 7 percent of male employees reported having been sexually harrased at work. The Broderick investigation also found that nearly half of all employees had experienced bullying in the preceding five years, and 40% of Australian Aboriginal and Torres Strait Islander employees had experienced racism.[688]

This behavior was allowed to persist because of a lack of psychological safety in the firm, which the report also illuminated. "The minute you raise an issue about a senior leader, you're done," one employee said.[689] "I am really disturbed by the things we are learning about," Jakob Stausholm, Rio Tinto's current CEO, told the *Financial Times*. "As management, we own the culture and when we know these things we have an obligation to address them."[690]

Where are the auditors?

As public misconduct and accounting scandals have become more common in recent years, some have begun to question why auditors have not uncovered, or in some cases reported on, seemingly obvious accounting irregularities. As such, auditors have faced increasing scrutiny from regulators and the public.

In September 2021, KPMG Australia was fined $615,000 by the US Public Company Accounting Oversight Board (PCAOB) for widespread cheating on exams among its employees. According to the regulator, at least 277 personnel cheated on tests that specifically aim to ensure that staff have the proper skills for their roles and act with integrity.[691] "I was incredibly disappointed," Andrew Yates, CEO of KPMG Australia, said. "It reflects poorly on all of us in the firm. But as I've said before, I think we have great integrity and great intent. We've self-reported and been under a program of remediation."

Later in the year, the auditor was accused of conflict in its advisory work. In his testimony to a Legislative Council inquiry, investigating the troubled New South Wales Transport Asset Holding Entity, former KPMG partner Brendan Lyon said the firm worked to avoid its own quality-control processes in order to ensure that it continued to get work from the NSW government. When he raised this issue, Lyon claims, he was pushed out of the partnership.[692] "I had to choose between my own professional ethics and my partnership at KPMG," he said.

Seeking to reform its corporate culture, KPMG appointed its first ever Chief Purpose Officer in November 2021. Richard Boele, a long-time human rights campaigner and KPMG partner, was chosen to fill the role.[693] "When accepting the role, my key request was that we work to make the Chief Purpose Officer an integral part of KPMG Australia's DNA to endure beyond our tenure," Boele stated.

Who Watches the Watchmen?

In our 2021 *Compendium*, we described the complex environment in which Australian financial regulators have operated in recent years. Many see them as being held to opposing standards: chastised by the Hayne Commission for being too soft on misconduct in the banking sector[694], on the one hand, and subsequently criticized for hampering Australia's economic recovery and growth when acting more assiduously in their role as supervisors.[695]

Seeking to clarify the role of financial regulators, as well as to provide much called-for oversight over the regulatory bodies themselves, the Australian government began efforts to establish the Financial Regulatory Assessment Authority in early 2020.[696] In May 2021, the Financial Regulator Assessment Authority Bill 2021 was introduced to Parliament, and passed a little over a month later.[697]

In September 2021, the Australian government appointed Nicholas Moore, a former asset management executive and CEO of one of Australia's largest bankls, to chair the new three-person Financial Regulator Assessment Authority (FRAA). Two other inaugural members were announced: Craig Drummond, a long-time banker, and Gina Cass-Gottlieb, a corporate lawyer.[698] "Together, the inaugural members have an in-depth understanding of Australia's regulatory framework and first-hand experience working with ASIC and APRA over many years. They also have strong organisational experience which will assist in their assessment of the operational performance of both ASIC and APRA," Treasurer Josh Frydenberg wrote in a related statement.[699]

In December 2021, Gina Cass-Gottlieb was appointed to chair the Australian Competition and Consumer Commission (ACCC), leaving her position on the FRAA in March 2022.[700] In March, Fiona Crosbie, Chair of the law firm Allens, was appointed to replace Cass-Gottlieb[701].

Frydenberg issued a "statement of expectations" for ASIC in August 2021. In the document, the Treasurer stated that the government expects ASIC to "identify and pursue opportunities to contribute to the government's economic goals, including supporting Australia's economic recovery from the COVID pandemic."[702]

The government has also faced criticism from extracting more than A$1 billion in profit from ASIC, as it receives far more in fees and charges than it puts back into the regulator as funding. Much of this revenue comes from an "annual review" process, where the regulator sends all Australian companies a 1-pager of their own information, and charges them for the "review," attaching what some call exorbitant late fees if not paid on time. ASIC also charges steep prices for adding information to its register of businesses, and charges businesses and individuals to access this data.[703]

All of this led many to fear that reforms instituted by the Australian government will pull the teeth from regulators which, only a few years ago, were deemed "weak, hesitant and timid." The Hayne Commission encouraged the regulators to seek out enforcement options whenever they saw misconduct. Now, some onlookers fear regulatory laxity, contending that ASIC is more of a "lap dog" than a watchdog, working to support economic recovery rather than protecting the financial consumer and the financial system's integrity.[704]

However, others have argued that you can ease regulatory burden without easing regulatory oversight. While discussing banking regulation for the new era with ASIC Chair Joseph Longo at the Australian Banking Association Conference in March 2022, APRA Chair Wayne Byres argued that, while it will be a long process, there are plenty of ways that regulators can work to ease burden without weakening the system:

> *We absolutely have a strong system. But what all of that reform has, unfortunately produced, and many people in this room know this very well, is a rather large and unwieldy rulebook... So can we step back and have a look at it? Can we streamline it? Can we make it easy to understand and navigate? Can we easily make it easier for us and financial institutions to update, understand what they have to do, and make it easier to adapt as new things come along? That's an ambitious task, it'll be a multi-year task, but I think there's plenty of scope.*[705]

In November 2021, the FRAA announced the scope of its first review into ASIC. "The FRAA's first review will be a targeted assessment of ASIC's effectiveness and capability in strategic prioritisation, planning and decision-making, ASIC's surveillance function, and ASIC's licensing function," it said in a statement released by Federal Treasurer Josh Frydenberg. "The first review will also examine ASIC's use of data and technology in each of these areas of focus."[706]

APRA and ASIC are not the only regulators which have been under review in the past year. In June 2021, a senate inquiry was launched to examine AUSTRAC and the big four banks to determine the efficacy of Australia's anti-money laundering regime.[707]

Personal Accountability

As is revealed in this *Compendium*, there has been a global trend toward holding executives accountable for the misconduct that occurs under their purview. Australia is no exception. A survey by the consumer advocacy group Choice found that 9 in 10 Australians want executives to face fines when they have broken the law.[708]

In our 2020 report, we discussed in some detail the Financial Accountability Regime (FAR), the impending successor to Australia's Banking Executive and Accountability Regime (BEAR). FAR has been billed as expanding Australian financial regulators' ability to hold executives accountable, to include extending the number of potentially accountable persons in an organization and introducing individual responsibility regarding a firm's compliance.[709]

In July 2021, the Australian government released an "exposure draft" of the FAR legislation. Under the new regime, accountable persons in an organization will be required to conduct business with honesty, integrity, and with due diligence. However, the new consultative draft did not give regulators as many accountability tools as had the original January 2020 draft.[710]

When it was originally announced, the regime included an ability for regulators to levy fines of up to $1 million against executives. However, despite the widespread desire of Australians to see executives held accountable in this manner, that provision was removed. The FAR reforms are slated to come into effect in 2023, three years after having been announced.[711]

In February 2022, stakeholders pushed the government to pass legislation establishing the FAR as well as a Compensation Scheme of Last Resort Levy (CSLR), a scheme which would require banks to set aside money to pay victims of financial misconduct. "Labor will not help the government break its promise to the Australian people to ensure there's a compensation scheme of last resort for victims of financial catastrophe," Labor financial services spokesman Stephen Jones told the *Australian Financial Review*.

Some in the government have expressed doubts about the scheme, however. Liberal Senator Andrew Bragg warned that it may represent a 'moral hazard' for Australians and the economy, as consumers might put money in risky investments with unwarranted confidence that they would be compensated if those investments went poorly.[712]

Later in February, the Australian Senate Economics Committee recommended that bills related to the FAR and CSLR be passed.[713] "The committee agrees that the bills are vital to improving the operating culture of entities in the financial services sector and will ensure increased transparency and accountability across the banking, insurance and superannuation industries and will overall, improve protections and access to redress for consumers," it wrote.

Despite this work, some have expressed fear that executives continue to be insufficiently held to account by regulators. In March of this year, ASIC declined to press charges against 10 former Crown Resorts executives for breach of duties, for instance, despite several government inquiries alleging that Crown was involved in misconduct related to money-laundering. This decision came in the same week that AUSTRAC opened a case against Crown Resorts for breaking anti-money laundering laws.[714]

Governance experts warned that this will contribute to the public's view that executives are not held personally accountable for their failings.[715] However, ASIC said that letting the executives off was the "right call," as the claims were old and there was a lack of hard evidence to convict the executives of wrongdoing.[716]

AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION

By any standard, ASIC had a turbulent 2020. As discussed in the previous edition of this report, the agency was accused of wrongdoing when it was uncovered that it had paid $180,000 to cover the cost of managing taxes for James Shipton, who was Chairman at the time, and rental fees for his deputy, Daniel Crennan.

In both instances, the costs were related to their relocation to Sydney to take up their ASIC roles, and though both felt that they had acted consistently with ASIC's expectations and were later exonerated, the two men nevertheless opted to repay the monies personally.[717] After continued public outcry, Shipton and Crennan both stepped down, to ensure that the regulator could continue its duties in protecting Australian consumers.[718]

In April 2021, ASIC announced that Joseph Longo, formerly a lawyer at Herbert Smith Freehills, would take the job as ASIC's new chair.[719] "He knows the organisation, and he's a level-headed, calm, considered professional, and we look forward to him leading that organisation at an important time," Treasurer Frydenberg said of Longo.

ASIC has done more than most global regulators to hold firms accountable when their conduct harms consumers and injures trust in the financial system. The regulator has, however, made clear that it does not intend to regulate or mandate any specific culture work. ASIC Commissioner Cathie Armour stated that the regulator is much more concerned with conduct outcomes, and that it is not ASIC's job to assess whether firms have "good" culture.[720]

Enforcement Strategies

In its enforcement report for June-December 2021, ASIC outlined its enforcement outcomes and priorities for the period. The document showed an increase in civil penalties, investigations, and corporate penalties. However, it also showed a notable decrease in bannings and liability for individuals.[721]

The regulator also released a report on its enforcement efforts related to the Hayne Royal Commission. In the report, ASIC stated that among the Commission's 13 referrals, six ended in civil cases, two ended in criminal prosecution, and 5 investigations led to no action being taken. A further 32 case studies recommended by the Commission led to 12 civil cases, four criminal cases, one referred criminal brief, two cases with no further action, and another seven which are still in progress.[722]

ASIC's new deputy chair and head of enforcement, Sarah Court, took on her role after leading the Australian Competition & Consumer Commission (ACCC) in mid 2021. Just a few months into her work with ASIC, Court said that she was shocked at the obstructive and delaying tactics employed by banks.[723] "It shouldn't take us years to get from A to B; from a breach report or a consumer complaint through to litigation," she explained. She is looking to take fast deterrent actions that send a clear message to the industry.

While the "Why not litigate?" strategy employed by ASIC under James Shipton has "had its day" according to Court, she stated that lawsuits and fines will still be a part of ASIC's enforcement strategy.[724] ASIC Chair Joe Longo agreed that, despite the removal of this phrase from its strategies, the regulator still intends to litigate where appropriate.[725]

ASIC's new breach reporting obligations took effect in October 2021, requiring that financial services firms not only report "significant" breaches, but also "reportable situations," to include any internal investigations which last longer than 30 days. They will also be required to report any suspected breaches by their business partners or distributors.[726]

In the past, firms had had the latitude to determine what was to be regarded as a "significant" breach that required reporting to regulators. As a result, there was an average of four years between a breach taking place and regulators learning of it. "Today's remediation tally reveals how much consumer harm these delays caused, and ultimately at great cost to those firms," ASIC Deputy Chair Karen Chester said.

Speaking at the Australian Institute of Corporate Directors' Governance Summit, in March of this year, ASIC's Joe Longo addressed the regulator's view on corporate governance. Longo said that, looking ahead, ASIC would focus attention on corporate governance and non-financial risk management failures which cause harm to customers and investors.[727]

"This includes directors failing to identify and manage the risk attaching to a company's business activities; failing to ensure that appropriate resources are allocated to deal with risks; or failing to respond to indicators that risks are not being properly managed," Longo said. "When we talk about non-financial risk, this includes things like significant reputational harm caused to a company through its conduct, and that may impact upon its license to operate; or where a company engages in breaches of the law that attract significant monetary penalties."

Longo explained that in its supervision of these risks, and other risks the regulator cares about, ASIC would seek to be a leader in the adoption of new supervisory technologies.

Investment in Data

In August 2021, ASIC called for risk officers to demand more funding to update critical data systems. ASIC's Karen Chester pointed to under-investment in these systems as a root cause for companies missing huge operational risks to their business.[728] "Compliance breaches happen in all organisations and businesses," Chester said. "But ASIC is looking to firms to shift their culture, to act faster on breaches and ensure they are given the attention they deserve. Under the new law," she added, "firms are obliged to identify and report breaches and remediate consumers in a timelier manner. To do so may require you calling out the need for investment in data and systems."

Chester doubled down on this view in a speech in October of last year:

> *So perhaps today's tough-truth is the legacy underinvestment in data and systems. For we know from our work that this is proving to be the root-cause of Boards missing risk landmines. And recent history tells us many firms missed these landmines, with commercial reputations blown up in public inquiries and Royal Commissions.*[729]

ASIC has also promoted the adoption of new uses for the data that firms are currently collecting. In January this year, it announced its Business Research and Innovation Initiative (BRII), a program through which it would work with five regtech firms to address corporate disclosure challenges. The firms will work with the regulatory agency to develop new tools to analyze compliance with disclosure and anti-market manipulation regulations.[730] "Working towards an innovative solution has the potential to transform ASIC's ability to harness technology to reduce regulatory burden, while enhancing market integrity," ASIC commissioner Cathie Armour said in a related statement

AUSTRALIAN PRUDENTIAL REGULATION AUTHORITY

In its Corporate Plan 2021-2025, APRA detailed its planned work in the financial sector, with improving resilience — both financial and operational — being one of its principal priorities. While some of its operational resilience work will focus on cyber risks, APRA also sees governance, risk culture, remuneration and accountability (GCRA) concerns as key components.[731] ▸PAGE 297

In an April 2022 speech to the American Chamber of Commerce in Australia, APRA Chair Wayne Byres discussed how regulators must adapt to be able to effectively supervise the increasingly digitalized and decentralized financial system:

> *Getting the regulatory framework just right — now and into the future — for a financial system that is rapidly evolving is a challenging task. That well-worn phrase that "predictions are hard, especially about the future", applies to all I have talked about today.*
>
> *What we know is that the digitisation of finance is reshaping the financial system, at speed. The move towards a more digital, decentralised financial system has the potential to deliver major benefits: faster, more efficient payments, lower costs to businesses, job creation and economic growth. It also poses risks, given the financial system's propensity to instability and community harm if not carefully managed.*[732]

Risk Culture

Like other global regulators, APRA acknowledges the importance of organizational culture for successfully managing compliance and conduct risk. Much of APRA's work focuses specifically on what it terms "risk culture", defined as "an entity's attitudes and behaviours towards risk management," it explains. "Specifically, it is the behavioural norms and practices of individuals and groups that shape an entity's ability to identify, understand, openly discuss, escalate and act on its current and emerging risks."[733]

In the last decade, the Australian Prudential Regulation Authority (APRA) has shifted its expectations markedly as regards the management of firm governance, culture, remuneration, and accountability (GCRA).[734]

Tamara Scicluna, executive director at Australian risk management firm Rhizome, says the Hayne Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry served as a tipping point, accelerating scrutiny of GCRA issues.

In 2018, APRA asked 36 entities to complete risk management self-assessments, and this year followed up with them to see what had changed.The regulator will follow up to ensure progress has been made in 2022. While the financial services sector has come a long way on GCRA issues, Scicluna argues that more work needs to be done.

"It's recognizing that it's not just about the frameworks and systems that you have in place to deliver good outcomes for members," she said. "It's also about understanding that even with that architecture in place, things can break down, because of the way people work in practice."

APRA Suzanne Smith, executive director of the superannuation division, explained why risk culture is a matter that warrants supervisory concern:

> *A single serious accusation of misconduct can cause immense damage to an organisation's reputation, eroding public trust, deterring customers and investors, or attracting financial penalties such as fines. That in itself is a prudential risk. APRA's chief concern when it comes to misconduct, however, is what it says about an institution's culture, and whether that culture potentially enables or even encourages damaging behaviour.*[735]

In May 2021, APRA piloted a survey among 10 insurers, seeking to gather information surrounding governance, risk culture, remuneration and accountability (GCRA). The survey consisted of 40 questions focused on attitudes, and employees' ability and desire to speak up when things go awry.[736] The survey focused on 10 factors of risk culture: leadership, risk appetite and strategy, decision-making and challenge, communication and escalation, risk capabilities, risk governance and controls, responsibility and accountability, performance management and incentives, shared values, and risk culture assessment.[737]

"We plan to use the survey to identify themes across the industry that are impacting risk culture, as well as particular institutions that we might want to look at more closely," APRA CEO Wayne Byres said.[738] That same month, Suzanne Smith warned superannuation funds that APRA would be paying close attention to culture and instances of misconduct. APRA described the risk culture at these funds "immature."[739]

APRA released the results of its survey pilot, run in October of last year, and announced that it would be running the same survey with 60 more entities over the following 12 months.[740] However, this announcement was met with some criticism due to the lack of research surrounding the 10 factors, scant data accompanying the survey results, and a seemingly high failure rate.[741]

Going into 2022, the regulator placed work on operational risk at the top of its priority list, naming cyber security and risk culture as areas which will receive substantial attention. APRA also stated that it plans to conduct risk culture "deep dives" at a small number of large institutions, continuing its work on the risk culture survey.[742]

Regulation rarely keeps pace with the leading edge of innovation (and nor should it be expected to): more typically, the regulatory frameworks and supervisory methods we use today are a product of the financial institutions of yesterday.

In February 2022, APRA issued guidance for compliance risk management, stating that it is essential that it "remains a priority for senior management and boards." In its guidance, APRA highlighted the need for financial institutions to:

- Have a clearly defined approach to managing compliance risk,
- Have established processes to support compliance risk management practices, and
- Specify clear accountability for managing compliance risk.[743]

Innovation and Regtech

APRA's Byres spoke in December 2021 about the regulatory and supervisory lessons learned from the covid pandemic. In this speech, Byres argued that regulators must seek to adjust more quickly to the rapidly changing financial system they seek to regulate:

> *Regulation rarely keeps pace with the leading edge of innovation (and nor should it be expected to): more typically, the regulatory frameworks and supervisory methods we use today are a product of the financial institutions of yesterday... So, I'll conclude by emphasising that, as important as it is that we continue to support our financial systems, economies and communities through the cost and disruption that COVID-19 has created, we can't allow it to cause us to fall any further behind the rapid change in the structure of the financial system that is occurring at the same time.*[744]

The agency has also announced plans to revolutionize its approach to financial industry data collection. In March, APRA laid out its five-year data collection roadmap, aiming to deepen and broaden the data it collects from regulated firms. "Access to high quality data is essential for APRA to monitor whether entities are meeting their prudential requirements, and to identify and address emerging risks in a timely manner," APRA Deputy Chair Helen Rowell said.[745]

APRA has already begun this work in the superannuation sector. In March, the agency completed phase 1, in which it addressed data gaps and began collecting more data on choice products and investment options. In April, it launched Phase 2, focusing on increasing the granularity of the data it collects across all superannuation business operations. "APRA will use the additional data to strengthen prudential oversight of the superannuation industry," APRA's Margaret Cole said. "This will, in turn, support the work APRA is doing to improve outcomes for members and increase supervisory intensity where trustees are underperforming or where improvements in practices are needed."[746]

AUSTRALIAN TRANSACTION REPORTS AND ANALYSIS CENTRE

Australian Government
AUSTRAC

During a recent panel discussion, Jack Haldane, director of supervision for the Australian Transaction Reports and Analysis Centre (AUSTRAC), criticized banks for over-relying on consultants and experts to fulfill their reporting requirements, adding that many institutions fail to understand their own reporting programs because they are implemented solely by third parties. "These are resources that are there to supplement what you're already doing, not replace or outsource what that compliance function should be doing," he said.[747]

AUSTRAC called out banks for deficiencies in their AML/CFT programs, including filling reports out incorrectly, failing to file them promptly, or lacking a detailed understanding of their responsibilities under AML/CFT regulations. The regulator also stated that it would pay close attention to governance going forward, and would spend more time going through board papers and reports from senior management. Firms that document their governance arrangements well, AUSTRAC argues, will be "set up for success." It will be interesting to see how AUSTRAC proceeds in efforts to better appreciate what questions boards are putting to management around such issues, and what ability management has to produce credible responses.

These are resources that are there to supplement what you're already doing, not replace or outsource what that compliance function should be doing.

The regulator has also encouraged banks to invest in their IT systems. In an interview with the *Australian Financial Review*, AUSTRAC CEO Nicole Rose blamed underinvestment in technology for many of the breaches the regulator has investigated and punished. Rose believes that the billions in fines AUSTRAC has levied has spurred banks to invest more in these systems.[748] "I suspect there wouldn't have been the support for them to spend — they've spent millions of dollars now on remediating their systems, and that's going to continue for the next couple of years," she said.

It will be interesting to see how AUSTRAC proceeds in efforts to better appreciate what questions boards are putting to management around such issues, and what ability management has to produce credible responses.

In September 2021, AUSTRAC released several anti-money laundering risk assessments, giving Australia's major banks and other domestic banks "High" risk ratings, stating that banks have a "mixed record" of applying risk mitigation strategies. The regulator called out governance and assurance around these risks as a key concern for compliance.[749]

AUSTRALIAN COMPETITION & CONSUMER COMMISSION

ACCC AUSTRALIAN COMPETITION & CONSUMER COMMISSION

In a February 2022 speech, Rod Sims, Australian Competition & Consumer Commission chair at the time, said that strong enforcement is critical to ensuring compliance and gaining the respect of the industry. "We do need to communicate with the regulated community, to let them know the expectations and what's going on," Sims said. "But that only works if you've got respect, right? Nobody's going to listen to the messages you're sending if you're a soft touch."[750]

New Zealand

INDUSTRY AND REGULATORY BACKGROUND

Culture and Conduct Concerns

Westpac has faced many challenges in Australia in recent years regarding its conduct and treatment of customers. However, in the past year, the bank has also faced scrutiny from the Reserve Bank of New Zealand, where ex-deputy governor Geoff Bascand called for major reforms in Westpac's risk governance processes after an Oliver Wyman report commissioned by RBNZ found major shortcomings in the bank's processes.[751]

"In some cases, issues that had been acknowledged by the board for several years had not received due attention or effective remediation," Bascand said. "The report found there had been historic underinvestment in risk management capabilities at the bank with investment appearing reactive, rather than strategic."

In March 2022, the RBNZ commended ANZ, one of New Zealand's largest banks, for the improvements it had made since it was censured in 2019 for its controls and attestation process relating to internal models that calculate operational risk capital. "The review noted that there has been a marked uplift in the overall capabilities within ANZ in respect to the attestation process, with heightened focus and scrutiny from management, executives and ANZ's board," the RBNZ said.[752]

In that same month, New Zealand's three AML/CFT Act supervisors, RBNZ, the Department of Internal Affairs (DIA) and the Financial Markets Authority (FMA), provided a joint update on its expectations for firms' compliance with the sanctions placed on Russia in response to its invasion of Ukraine. "Understanding beneficial ownership of legal persons or legal arrangements, and undertaking enhanced CDD [customer due diligence] where required, are key parts to determining whether you may be providing services to persons or entities that are subject to the Russia Sanctions," the RBNZ, DIA and FMA said.[753]

Conduct Regulation Reform

In December 2019, the New Zealand government introduced a new bill which would establish a regulatory framework for the conduct of financial institutions, dubbed the Financial Markets (Conduct of Institutions) Amendment, or CoFI, bill. The legislation includes a number of provisions, including requiring that financial institutions be licensed in their conduct toward customers, to be monitored and enforced by the FMA.[754]

Other requirements in the bill are that firms implement fair conduct programmes to ensure the fair treatment of customers and that firms comply with new regulations of incentives. The new incentive regulations would prohibit sales incentives based on volume or value targets.

Lawyers in the financial services sector have warned their clients that they must prepare for a tougher regulatory environment as a result of this impending legislation. "Proactively make sure your approach and systems and processes are right at the front end," Lloyd Kavanagh, a partner at law firm MinterEllisonRuddWatts, said. "There have been lots of reports in the media over the past year of formal warnings or directions being given [to firms] whereas in the past, regulator would have said 'ok, you've brought this to us, fix it and don't make another error.'"[755]

FINANCIAL MARKETS AUTHORITY

FMA
FINANCIAL MARKETS AUTHORITY
TE MANA TATAI HOKOHOKO - NEW ZEALAND

In March 2021, the FMA announced that its CEO, Rob Everett had resigned and would be leaving the regulator at the end of the year.[756]

"Looking ahead, the FMA's regulatory remit is expanding with the implementation of financial adviser reforms and the introduction of new legislation to provide for the regulation of conduct for banks and insurers," FMA Chair Mark Todd said. "The timing of Rob's departure creates an opportunity for the next CE to advance this work."

Later in the year, the FMA announced that it had found its new chief executive in Samantha Barrass, an experienced regulator who previously worked in the UK and its territories, who would take the helm in January 2022.[757]

Conduct

In its Annual Corporate Plan 2021/22, the FMA makes clear that conduct is one of its foremost regulatory priorities. With the CoFI bill anticipated to pass in 2022, the FMA is preparing for its new powers to regulate conduct in financial institutions. The FMA is also seeking to ensure that the regulated institutions are prepared for the new standards set in the bill.

In July 2021, the FMA released findings from its evaluation of New Zealand fire and general insurers' responses to the 2019 Life Insurer Conduct and Culture review. Responses from the sector were poor, according to the FMA, with only two out of 42 insurers meeting expectations.[758]

"We were disappointed that the reviews were not conducted adequately on many occasions," FMA Director of Banking and Insurance Clare Bolingford said. "We put this down to firms not really understanding the conduct risk that they are running in practice and how their customers can come to harm."

The FMA urged firms to reach out with questions on the CoFI Bill as it awaited its second reading in September 2021.[759]

RESERVE BANK OF NEW ZEALAND

RESERVE BANK
OF NEW ZEALAND
TE PŪTEA MATUA

The RBNZ announced a thematic review of governance in financial institutions to be conducted in 2022 with the help of the FMA. The review will cover 32 firms across 4 sectors, many of which are large Australian firms who have faced similar scrutiny in their home market. The regulators intend to focus on the board of each firm's ability to "effectively govern and provide oversight" for risk governance practices.[760]

South Africa

FINANCIAL SECTOR CONDUCT AUTHORITY

South Africa's Financial Sector Conduct Authority (FSCA) received an explicit mandate to regulate culture and conduct under the Financial Sector Regulation Act of 2017, with a specific focus on banking set out in a 2019 statement supporting a new banking Conduct Standard.[761]

The FSCA's approach to culture and conduct aims at pre-empting emerging risks, within banks and other financial institutions, as well as related risks at an industry level. Such risks will be relayed to the FSCA through a new reporting framework, permitting supervisors to gather and analyze information that reveals conduct risks and identifies related trends at any particular bank. This framework may develop into a more comprehensive market conduct framework over time.

In May 2021, incoming FSCA Commissioner, Unathi Kamlana, said that he plans for the regulator to develop better ways to deal with conduct risk and protect consumers more

In Focus

Cooperation Is the Only Way to Win the Race against the Machine

By FRANCESCA HOPWOOD ROAD


Francesca Hopwood Road

The pace of change in technology is remarkable and accelerating. This has prompted questions as to how the global community of central banks and supervisory agencies is to keep abreast?

The Innovation Hub, set up by the Bank for International Settlements in 2019, is part of that response. The Hub's purpose is to engage with critical trends in technology and to develop in-depth knowledge with a view to creating public goods that improve the functioning of the global financial system.

> The thrust of these Centres has been to drive cooperation and collaboration with their host central banks and with partners in the public and private sectors and academia.

The Innovation Hub focuses on six key areas of work: central bank digital currencies (CBDCs), next generation financial market infrastructures, technology applications for regulation and supervision (RegTech/SupTech), open finance, green finance and cyber security. The first three Innovation Hub Centres, in Switzerland, Hong Kong and Singapore, have already delivered a number of important projects, like Jura, Dunbar, Ellipse and mBridge[1].

The thrust of these Centres has been to drive cooperation and collaboration with their host central banks and with partners in the public and private sectors and academia, so as to deliver valuable contributions that enhance understanding and capability of new technologies. The Hub allows for harnessing expertise and insight within the central banking community, facilitates collaboration across the world, and enables partnerships. This recognizes that the challenges and opportunities of technology and innovation require a global response, leveraging multiple skillsets and perspectives.

At the start of 2021, phase 2 of the Innovation Hub expansion began, with the addition of four new Centres in London, Stockholm, Toronto and the Eurosystem. It is my great privilege to be the inaugural head of the London Centre, hosted by the Bank of England.

London is renowned as a leading global financial centre. The city drives financial innovation by harnessing its thriving tech ecosystem, world-class universities, research institutions and deep knowledge of financial markets. Physically located at Threadneedle Street, the BIS Innovation Hub London Centre is connected to the wider fintech communities across the UK, playing an innovative role by leveraging the UK fintech community's talent and expertise, and by building strong partnerships.

From my previous vantage point, as head of RegTech & Advanced Analytics (SupTech) at the UK's Financial Conduct Authority, I saw the transformational impact that technology was having in the markets we regulated and the response it required. I understood the transformative power SupTech had, as technology helped regulators by automating manual processes to increase efficiency. Critical insights, derived from data, helped them better understand emerging risks and, ultimately, to take better decisions.

There was also growing international curiosity about and appetite for experimenting with SupTech solutions. The BIS's work in assessing the breadth and maturity of SupTech tools has been an important contribution to our general understanding of these developments. It has also served to highlight progress, and challenges that remain: scaling from proofs-of-concept to viable products; shifting from manual to digital; and the implications this poses for investing in new skills.

So, I am an advocate — albeit a clear-eyed one — for the role SupTech can play. And this, in part, is what drew me to the role at the London Centre. The BIS Innovation Hub offers the unique opportunity to work in a global network spanning 7 Hub Centres, leveraging the BIS's breadth of activity and expertise, and offering the opportunity to identify areas in which to build and add value. The BIS's convening power can foster partnerships, across sectors and geographies, in pursuit of a common endeavour to harness technological advances in ways that support the remit of the central banking community, while keeping up the pace with all this fast-moving technological development. ▶PAGE 375

The BIS's convening power can foster partnerships, across sectors and geographies, in pursuit of a common endeavour to harness technological advances.

This is true for SupTech and RegTech as well as for the Hub's other key areas of work. A divide could start to creep in between those countries with access to more resources and skills, better technology and data, and countries without those things. ▶PAGE 121 So, optimisation is important. The Singapore Centre's work on Project Ellipse (see box) has shown the potential in this field. The recently launched Open Tech initiative is another important step supporting collaboration and partnership.

What role can the London Centre in play in facilitating collaboration and partnership to support optimization and realization of the value of SupTech and RegTech? There are several ways to come at this: optimizing areas like Natural Language Processing or network analytics; and increasing the focus on Anti-Money Laundering and Financial Crime, for example.

The London Centre will have other areas of activity as well. Our first two projects — Rosalind and Meridian — will focus on retail CBDC and next generation financial market infrastructures, respectively, adding to the body of knowledge and technical expertise that the BIS Innovation Hub has been steadily building. Project Rosalind aims to develop prototypes for an application programming interface (API), to explore how it could best enable a central bank ledger to interact with private sector service providers, to safely distribute and settle retail CBDC payments. It will also explore some of the functionalities required to enable a diverse and innovative set of use cases to be developed by the private sector. By exploring these elements, the project will seek to contribute knowledge about how best to lay the foundation for building a robust and vibrant ecosystem. Project Meridian will develop a prototype synchronisation operator, an intermediary platform that connects counterparties and coordinates the settlement process directly in central bank money. The objective is for final settlement to be faster, cheaper and more seamless.

We have ambitious and exciting plans, and our portfolio will continue to build and expand over the coming year, in moves to include SupTech and RegTech as well. I hope the London Centre adds to the huge role that the Innovation Hub is already playing.

Francesca Hopwood Road joined the BIS Innovation Hub in February 2022 to lead the London Centre. Prior to this, she was Head of RegTech & Advanced Analytics at the UK's Financial Conduct Authority where, amongst other things, she was responsible for the TechSprint programme including the Global Women's Economic Empowerment TechSprint in 2021 and developing new innovation tools like the Digital Sandbox and a range of SupTech offerings.

Project Ellipse: Real-time Data for Real-Time Developments

By JOY WANN

Joy Wann

A core principle for effective banking supervision is the development of forward-looking assessments of banks' risk profiles, to identify and assess early on issues that may arise in the future and to be able to intervene if needed.

To develop such forward-looking assessments, supervisors need access to current, timely, and relevant data that can inform them of emerging risks. However, what supervisors get is completely different: regulatory reporting that is burdened by fixed templates, infrequent collection and aggregated data. This does not support new tools or applications that could enable real-time or early warning analytics.

In January 2021, the BIS Innovation Hub Singapore Centre and the Monetary Authority of Singapore launched Project Ellipse to explore solutions that could address these issues. Project Ellipse is building a single regulatory data and analytics platform that combines structured regulatory data with unstructured sources of "real-time" data. Advanced analytics are then run on those integrated data to provide supervisors with early warning indicators, as well as prudential metrics.

Cooperation with multiple stakeholders was crucial for moving this project from a proof-of-concept to a working prototype. We collaborated with the Bank of England, the International Swaps and Derivatives Association, FNA, and other central banks and regulatory authorities around the world.

Over recent years, financial institutions and the official sector have increasingly explored the use of technology to support new business models and to solve regulatory and compliance requirements more effectively and efficiently. There is now widespread recognition of the potentially significant benefits and opportunities regtech and suptech offer regulated entities and supervisory authorities alike: improved efficiency, reduced manual processes, and more effective use of data.

Authorities globally are actively exploring the use of regulatory and supervisory technology, largely through innovation centres and sandboxes. Many are exploring similar problem statements and technology solutions, but there have been limited opportunities to share their applications and learnings with other institutions.

In consonance with the Innovation Hub's mission of fostering international cooperation and building on central banks' innovation efforts, the Ellipse platform will be shared with authorities globally, to encourage further development and testing. Project Ellipse will be the first BIS Innovation Hub pilot to launch a collaborative community, through the BIS Open Tech initiative: a platform for sharing statistical and financial software as public goods, promoting international cooperation and coordination. These software tools are developed according to international best practices and standards, and can be reused and further developed in a wide variety of environments.

By joining forces through a collaborative community, central banks and regulatory authorities can work together to create new applications that serve common use cases and priorities, and to reduce duplication of effort. Ultimately, by working together, authorities can scale up these solutions faster so that, collectively, they can better prepare to meet the challenges of the digital age.

Joy Wann is an Advisor for the BIS Innovation Hub Centre in Singapore, where she is the project lead for two of the Innovation Hub's projects on regulatory data analytics and climate-related financial risks. Prior to joining the BIS Innovation Hub, she was a Member of the Secretariat for the Basel Committee on Banking Supervision (BCBS) from 2015 to 2020.

ENDNOTES

1 For further information about the Innovation Hub, see here.

effectively: "Given the sheer number of financial institutions, you need to have a well-designed risk-based framework, which will be informed by market surveillance."[762]

The final "new banking conduct standard," which was published in July 2020, came into full effect by July 2021.[763] The core of the new conduct standard for banks is a set of 'Treating Customers Fairly' outcomes, including various requirements for product design, governance and advertisements. In the statement supporting the conduct standard for banks, the FSCA states that they will monitor compliance with the standard using proactive supervision, covering emerging risks within the institutions and systemic risks in the sector.[764]

In August 2021, finance Minister Enoch Godongwana appointed Katherine Gibson and Farzana Badat as Deputy Commissioners of the FSCA. "The Minister wishes the new FSCA Executive Committee, under the leadership of Commissioner Kamlana with Deputy Commissioners Ludin, Badat and Gibson, all the best in ensuring that the FSCA will successfully execute its mandate of protecting financial sector customers through their fair treatment by financial institutions," the Ministry of Finance said.[765]

Bank for International Settlements

BIS

In June 2019, the Bank for International Settlements (BIS) launched the BIS Innovation Hub, "to identify and develop in-depth insights into critical trends in technology affecting central banking; develop public goods in the technology space geared towards improving the functioning of the global financial system; and serve as a focal point for a network of central bank experts on innovation."[766]

As a part of its initial phase of work, the BIS established Hub centers in Hong Kong, Singapore, and Switzerland.[767] After its first year of operation, the Innovation Hub announced new hubs to be launched in Toronto, London, Frankfurt and Paris, and Stockholm in the following two years. They also announced a strategic partnership with the Federal Reserve Bank of New York.[768] In June 2021, the London innovation hub launched in collaboration with the Bank of England (BOE),[769] as well as the Nordic innovation hub in Stockholm alongside Denmarks Nationalbank, the Central Bank of Iceland, Norges Bank and Sveriges Riksbank.[770]

The BIS Innovation Hub has also launched several initiatives with regulators and central banks in the past year. In May 2021, the Innovation Hub, in partnership with the Bank of Italy, launched the second G20 TechSprint Initiative, focusing on developing innovative solutions to challenges in green and sustainable finance.[771]

Later in the year, the Innovation Hub announced that it would be partnering with the Monetary Authority of Singapore (MAS), the BOE, and the International Swaps and Derivatives Association (ISDA) to establish a data and analytics platform to improve bank supervision.

The Initiative, dubbed Project Ellipse, would first involve exploratory efforts by the four organizations to establish some standards for cross-border regulatory reporting.[772] "This would reduce compliance burdens placed on those financial institutions to respond to template-based regulatory reporting requests from different supervisory regimes for similar exposures," the BIS said.

In its 2022 Work Programme, the Innovation Hub announced that, alongside its ongoing projects, the London and Nordic centers would launch their first projects in the coming year, including work on Central Bank Digital Currencies (CDBCs) and the use of data to detect illegal transactions.[773]

In March 2022, the Innovation Hub announced the completion of "Project Dunbar", a collaboration with the Reserve Bank of Australia, Bank Negara Malaysia, the Monetary Authority of Singapore, and the South African Reserve Bank to develop a platform for international settlements using multiple central bank digital currencies. "A common platform is the most efficient model for payments connectivity but is also the most challenging to achieve," Andrew McCormack, Head of the BIS Innovation Hub Centre in Singapore, said. "Project Dunbar demonstrated that key concerns of trust and shared control can be addressed through governance mechanisms enforced by robust technological means, laying the foundation for the development of future global and regional platforms."[774]

That same month, the London Hub launched its first two projects: "Project Meridian" and "Project Rosalind." Meridian centers on developing a "intermediary platform that connects counterparties and co-ordinates the settlement process directly in central bank money," while Rosalind focuses on contributing knowledge on "how best to lay the foundation for building a robust and vibrant ecosystem" of APIs.[775]

The BIS has also done work on promoting innovation and the adoption of AI outside of the Innovation Hub. The BIS's Jermy Prenio and Jeffery Yong published a paper titled "Humans keeping AI in check — emerging regulatory expectations in the financial sector," which outlined the current state of regulator guidance related to AI globally and called for a more coordinated effort by regulators and supervisors to crystallize this guidance into standards which can be used in practice.[776]

"The challenges and complexity presented by AI call for a tailored and coordinated regulatory and supervisory response based on the AI model's implications for conduct and prudential risks," the authors wrote. "The more AI model's use can potentially impact authorities' conduct and prudential objectives, the more stringent the relevant reliability/soundness, accountability, transparency, fairness and ethics requirements should be."[777]

Basel Committee on Banking Supervision

The BCBS published its "Principles for Operational Resilience" in April 2021. The principles focus oned governance, operational risk management, cyber security and more. The BCBS also revised its Culture & Conduct Risk in the Banking Sector Principles for the Sound Management of Operational Risk (PSMOR) to reflect the relationship between operational resilience and operational risk.[778]

Later that same month, the BCBS published its "Basel Committee work programme and strategic priorities for 2021/2022." The three key themes the BCBS planned to focus on in the following year are COVID-19 recovery and resilience, analysis of structural trends and mitigating risks, and strengthening supervisory coordination and practices.[779]

The BCBS has also focused on the use of technology to manage operational risk, as well as the additional operational risks the technology itself may introduce. In a March 2022 Newsletter, the BCBS wrote:

> *Banks are increasingly exploring opportunities for using AI/ML. AI/ML technology is expected to increase banks' operational efficiency and also facilitate improvements in risk management. While significant opportunities are emerging from the increasing use of AI/ML in many areas of banking, there are also risks and challenges associated with these techniques. Banks are still in the process of developing best practices for risk management. Given the increasing adoption of*

In Focus

An Interview with William Coen

William Coen

Q: After a 20-year career with the Basel Committee on Banking Supervision, to include serving as Secretary General, you'll have had a lot of experience with systemic risks across the financial industry. To start, perhaps you can offer some of the perspective that imparted?

A: The regularity with which financial crises occur and the central role of deficient governance in these events are the first things that come to mind. I am reminded of Mark Twain's quotation that history may not repeat itself but it often rhymes. Quite a bit of research has been conducted — in Basel, by central banks, the IMF, and others — suggesting that, on average, a financial crisis will occur somewhere in the world every seven years or so. With each financial crisis, whether or not it's global in scope, there is an element of deficient corporate governance involved. Sometimes, those deficiencies are so severe or pervasive that the crisis turns into a global event.

With each financial crisis, whether or not it's global in scope, there is an element of deficient corporate governance involved.

Before I arrived in Basel, I had worked for a bank, the Federal Reserve System, and the U.S. Office of the Comptroller of the Currency. I've gotten to see first-hand the important role of governance and how poor governance can lead to financial market distress systemically as well as idiosyncratic stress at the firm level.

It has been fascinating to see how the focus on governance has evolved over the 35 years that I have spent in the industry. In the 90s, the Asian financial crisis was followed by the bursting of the dotcom bubble. The 90s was also characterized by the Great Moderation, which ended with the global financial crisis of 2007. It is always interesting — and necessary — to explore what factors contributed to a crisis, but it is perhaps more important to study what happens after a crisis.

After those events in the 90s, for instance, many escaped unscathed — despite exposure to the firms or the countries that were at the heart of it all — and they attributed their success to superior risk management skills and sound strategic planning. Perhaps, but good fortune certainly played a role in many cases. We usually come away from this sort of close-call thinking, "Wow, what a learning experience!", and conclude that we will not let anything like that happen again. But, of course, it always does. Complacency plays an important role in this.

From a risk management perspective, the use and role of internal models expanded dramatically during the Great Moderation. In the 90s, regulators began to consider how the global regulatory framework (i.e., "Basel I") could be updated to reflect advances in modelling and provide incentive for banks to make the necessary investment in improving their risk capabilities. These efforts were enshrined in Basel II, which was finalized in 2004. Concurrently, many had this sense of, "We weren't part of the dotcom issue. We weren't too badly hurt by the Asian crisis. And our models allow for better risk management. So, we've got things figured out." There was a false sense of security and that, of course, contributed to the global financial crisis.

To be clear, when we are talking about these governance lapses and deficiencies, it is not just at the firm level. During the Great Financial Crisis (GFC), we saw lapses and deficiencies in accounting standards, rating agency practices, supervisory oversight of firms, the regulations that were — or weren't — in place, among other shortfalls. At the firm level, boards of large banks, senior management, and risk management staff also were culpable. In hindsight, it was the "perfect storm."

I do believe that, for all those just mentioned, there was a certain sense of complacency that caused them to take their eye off the ball. As the global financial system began to recover from the GFC — and I saw this up close — the Basel Committee was putting the final touches on the Basel III framework, which revised significantly the global regulatory standards for banks. Part of my role was to promote and praise the virtues of the new global regulatory framework for liquidity, capital, and risk management. There were some who asked, "Why do we have to adopt these new standards? The global financial crisis had nothing to do with us. We didn't get too badly burned by the GFC." And, even among those who had been hurt by it, I heard the view expressed, "We learned a lot from this and it will never happen again!" And, so, this story of complacency continues to repeat itself.

If you can't measure or effectively manage a risk, then the prospects of regulating it are even more challenging. This is where we are today with risks related to poor governance.

Q: Given this cautionary note regarding complacency, what do you expect to see as we start to emerge from the worst of the covid-pandemic?

A: I think the financial system has handled the covid disruption very well and many attribute it to the banks having come into the period of stress in much better shape, in part at least because of Basel III. But Basel III was not the sole reason for financial systems' resilience as there was an enormous amount of official sector support provided during the pandemic. As covid-related financial stress appears to be easing, there is already evidence that underwriting standards are beginning to relax. I am concerned that complacency may once again be rearing its ugly head.

An important development that warrants careful observation is the ongoing full and consistent implementation of the Basel III standards that was delayed due to the pandemic. Global standards like Basel III are implemented at the local level — transposed into local rules, regulations, directives, or law — and the final product is, out of necessity, prescriptive. The use of less specific global "principles" leads to a potentially uneven playing field among internationally active banks and makes it easier to circumvent or arbitrage the rules. To avoid this, the global standards have to be specific, and that's led to quite a bit of prescriptiveness.

I like to make the distinction — and it's a critical one — that there's regulation, the rules of the road, and there's supervision, the oversight of firms and enforcement of the rules. It's often said that financial sector supervision is more of an art than a science. So, the question is whether official sector incentives that will contribute to better, more effective governance are best pursued through regulatory approaches (e.g., the prudential regulatory framework) or by supervisory means. The short answer is both regulatory AND supervisory approaches are the way to tackle this issue. Are we at the point where we could deploy both approaches? That's more difficult to answer in the positive.

As the expression goes, "If you can't measure it, you can't manage it", and if you can't measure or effectively manage a risk, then the prospects of regulating it are even more challenging. This is where we are today with risks related to poor governance. But operational risk offers a relevant parallel that is instructive. "Op risk" was long viewed as a material risk for banks, but the methodologies for managing it were not well developed and related data were scarce. In 1999, the Basel Committee proposed an explicit regulatory capital charge for operational risk.

Operational risk management methodologies have come a long way since then. By becoming part of the global prudential framework, the Basel Committee's proposals spawned a tremendous amount of research and study on how to measure and more effectively manage that risk. I suspect that is where we are today with governance issues. There is still much that can be done to improve the way we think about and measure, let's call it, governance risk.

I've made the distinction between regulation and supervision. There is a third element and that is stress testing and scenario analysis. These took on much greater prominence following the GFC and are now an important feature of banks' strategic planning. Likewise, the official sector — central bankers, bank regulators, bank supervisors — is considering how to make best use of stress testing at a broad institutional level.

In Basel, one of the groups I chaired regularly reviewed potential triggers of the next global financial crisis. A pandemic always featured on the list — though not on the scale of COVID-19. We also considered geopolitical disruption, a cyber-attack on a broad scale, and many other potential triggers of stress. This is a good practice — to start testing assumptions, hypotheses and combinations thereof, as well as a firm's or financial system's state of preparedness. Does the firm or system have sufficient capital to withstand a severe but plausible disruption? Will there be sufficient liquidity available, and what will be the impact on funding, asset quality and profitability?

Will governance follow a similar trajectory? We know how important good governance is, but can we measure it in a consistent manner and ultimately craft a regulatory standard that (i) recognizes the risk of loss arising from poor governance and (ii) provides incentive for a firm to improve its governance? At present, this is not possible. But can a financial institution take relevant assumptions and run a stress test or scenario analysis? That kind of an assessment should, after all, have an impact on its expectations for growth and its capital needs. We're moving in that direction, and I think that's a very positive development.

Q: Where is the main impetus for this coming from? Is it a matter for the official sector? And if this is up to the industry, then who? The board? C-suite? Risk? Compliance?

A: One view holds that risk governance is everyone's responsibility. Which, in practice, makes it no one's responsibility. Having spent most of my career helping to craft prudential rules, or helping to enforce them, I am of the firm belief that a private sector solution is usually superior to an official sector solution.

One view holds that risk governance is everyone's responsibility. Which, in practice, makes it no one's responsibility.

At the same time, however, many of the deficiencies that were laid bare by the GFC could only be addressed by the official sector. For example, Basel III includes reforms related to higher minimum standards for the quantity and quality of regulatory capital; liquidity and funding standards; and a minimum leverage ratio standard. These and other global reforms could only have been taken forward by the official sector. Another example is the Task Force on Climate-related Financial Disclosures — the TCFD. Financial institutions are well aware of the importance of climate risk and the broader climate change issue given the attention it receives from investors, rating agencies, and other stakeholders. Sometimes it takes a bit of a push from the official sector to get everyone moving in the right direction, collectively.

There's often a first mover problem at play here. With stress testing around governance, ideally, financial institutions' boards and senior management would choose to do this on their own. But even if they were to take that initiative, there's still an important role for central banks and supervisory authorities. For example, a regulator — as a result of its horizontal reviews and observations of firms' governance practices — could say to a firm, "your stress testing efforts are laudable and noted but here are some other factors you ought to consider." A financial institution therefore has primary responsibility to continuously improve its governance, but there is an important complementary role for the official sector.

Sometimes it takes a bit of a push from the official sector to get everyone moving in the right direction, collectively.

A while back, I chaired a Basel Committee group on corporate governance, and I recall the impressive work by the Dutch central bank in applying behavioral science as part of the supervisory process. Some of the considerations they brought to the supervisory process very usefully advanced the oversight of financial institutions. The Federal Reserve Bank of New York was also doing some very helpful work around horizontal reviews, and I know the ECB is conducting something similar now. These are excellent trends in the official sector, to work more closely with firms and to provide the necessary impetus to move in what they view to be a healthy direction.

Q: Does your call for vigilance over complacency tie in with the ESG agenda that has had such prominence in the last year?

We see time and again the deleterious impact that poor governance has on bank performance and even on financial system stability.

A: Good governance has long been recognized as a critical element of a well-run financial institution and these days it can be overshadowed by the intense focus on the environmental and social dimensions that comprise the ESG agenda. Both the E and S components have rightfully attracted much attention and efforts in these areas are moving in the right direction.

There are some interesting ways in which people are now thinking about the S component and it's not just about workforce demographics. What about diversity? Inclusion? Equity? Are employees at all levels, genders, and ethnicities receiving the same opportunity to engage with senior staff? Are they being groomed equitably for future leadership roles? Many companies are trying to answer those question with data and analytics. Given the global efforts conducted to address environmental concerns, it is safe to say the E component of ESG has traction, and I believe the S component does as well. At the same time, we see time and again the deleterious impact that poor governance — the G piece — has on bank performance and even on financial system stability. So by all means let's continue to give due regard to environment and social issues but not at the expense of paying less attention to governance.

It's now fashionable to talk about the importance of good governance, but this is something the Basel Committee and its members have been promoting for decades. The first paper it produced on governance resulted from lessons learned from the Asian crisis in the late nineties. So, this is something that's been on the minds of the official sector for a long time. But I'm not alone in seeing this cycle of complacency repeating itself, time after time. I am firmly of the view that there should be a call for greater vigilance, and I am glad that we are seeing more vigilance on the topic of good governance.

Q: What's the role of the regulator with respect to incentivizing good governance? And in connection with all the non-financial risk issues you outlined above?

A: The regulatory community has a very useful role to play with respect to governance and all material non-financial risks. Let me reiterate the important distinction between regulation and supervision. Robust supervisory oversight by regulatory authorities is, in my view, the more effective tool to promote better governance at financial institutions. Minimum requirements always attract much attention given their financial impact on a firm. While we are not yet to the point where we can quantify governance risk for purposes of designing a regulatory capital requirement, I would argue that rigorous supervisory oversight can be more effective and enduring in providing the necessary impetus for improvement. Financial indicators, such as high profitability or strong capitalization levels, are not reliable indicators of sound governance, and can even mask weaknesses that can be detected through the examination / inspection process.

Financial indicators, such as high profitability or strong capitalization levels, are not reliable indicators of sound governance, and can even mask weaknesses.

An effective supervisory oversight program can also have longer term benefits. Those in the bank oversight function focus on other non-financial factors such as the effectiveness of the board and senior management, succession planning, and business strategy. How effective is a bank's stress testing process and how are the results factored into previously formulated strategic plans? What are the firm's plans for growth, sustainable earnings, and the development and launch of new products? A rigorous supervisory process can help ensure that strategic planning and other governance practices produce tangible, actionable results rather than window-dressing exercises. The role of those having oversight responsibility is to ask, okay, so how do you put these considerations and results into practice? That reality check is a useful role in the prudential process.

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this technology as well as the potential risks, the Committee is analysing banks' use of AI/ML and potential implications for bank supervision.[780]

Financial Stability Board

FSB FINANCIAL STABILITY BOARD

In his final letter to the G20 in October 2021, as Chair of the Financial Stability Board (FSB) and Vice Chair for Supervision at the US Federal Reserve, Randal K. Quarles wrote that an increasingly digitalized financial system presents both opportunities and risks, and that work must be done to ensure that regulation encourages innovation while mitigating these risks.[781]

"The COVID Event gave a boost to the use of digital financial services, in particular various forms of digital payments," Quarles wrote. "Growth in this area reinforces the need to assess the financial stability implications of financial innovation, particularly innovation with a technological component. We should also ensure that supervisory and regulatory frameworks and approaches provide a solid foundation for harnessing the benefits of such innovation while containing their risks."[782]

Also in October, the FSB published its Financial Stability Surveillance Framework for addressing vulnerabilities in the financial system. The framework centers of four key principles:[783]

- focus on vulnerabilities that may have implications for global financial stability;
- scan vulnerabilities systematically and with a forward-looking perspective, while preserving flexibility;
- recognise differences among countries; and
- leverage the comparative advantages of the FSB while avoiding duplication of work.

Later in the year, the FSB published a progress report on the implementation of its Principles for Sound Compensation Practices and their Implementation Standards in financial institutions.

Therein, the FSB identified emerging trends which contribute to firm culture and risk management:

> *Use of non-financial measures as well as disclosure of compensation-related information have increased to shape and promote a sound risk culture and positive behaviours, as well as to contribute to robust risk management. This is largely a result of firms' own initiatives, driven predominantly by stakeholder expectations.*
>
> *In particular, firms are increasingly incorporating environmental, social and governance (ESG) aspects in those non-financial measures to drive accountability for delivering outcomes. Other types of common non-financial measures include those that support prudent risk management, including operational incidents, anti-money laundering (AML) and know-your-customers (KYC).*[784]

In December 2021, Klaas Knott, President of De Nederlandsche Bank, took office as Chair of the FSB, succeeding Randal Quarles. "Under Randy's leadership, the FSB demonstrated its vital role as a coordinating mechanism for financial authorities in the global response to COVID-19," Knott said. "I look forward to continuing the important work of the FSB at a time when the financial system is confronted by both structural changes and the need to provide financing to sustain a balanced economic recovery. The FSB, with its broad membership and diverse expertise, is uniquely placed to oversee further enhancements to the resilience and functioning of the financial system at this critical juncture."[785]

In the "FSB Work Programme for 2022," the organization laid out that it would be prioritizing work on emerging risks to financial stability, such as the

In Focus

Financial Markets Standards Board: A Change Agent at the Heart of Wholesale Financial Markets

By TED MACDONALD & CHRISTOPHER RICH

Ted MacDonald

Christopher Rich

FMSB

The need to bring people to the table to agree a way forward, virtually or in person, has never been more important. It's what Financial Markets Standards Board (FMSB) has been doing for the wholesale fixed income, currencies and commodities markets since its inception in 2015. Collaboration, education and internationalisation are the watchwords of this unique body that looks not only at misconduct but the behaviours that drive it — and ways to interrupt history repeating itself.

What is FMSB?

Step back to 2015 and the UK's Fair and Effective Markets Review (FEMR) describing a 'regulatory void' between high-level principles and granular operational rules which needed to be filled with clearer guidance for market participants.[1] It also noted the opportunity to address conduct risks arising in unregulated markets. To achieve this, FICC Markets Standards Board Limited (FMSB) was created: a private sector, market-led organisation.[2] The name was updated in Q2 2022 to replace FICC with 'Financial' to reflect the changing market.

A central recommendation of the Fair and Effective Markets Review was that the participants in the wholesale fixed income, currencies and commodities (FICC) markets should take more responsibility for raising standards of behaviour and improving the quality, clarity and market-wide understanding of trading practices within these markets.

The Review called directly on the senior leadership of FICC market participants to create FMSB, with participation to be drawn from a broad cross-section of global and domestic firms and end-users at the most senior levels and involving regular dialogue with regulators and other key stakeholders.

Overarching objectives

In addition to immediate tasks related to the identified deficiencies with Libor and the foreign exchange market, higher-level objectives given to FMSB at creation were:

- forward-looking identification of emerging risks,
- addressing areas of uncertainty in specific trading practices,
- adherence to standards, including by way of governance requirements, and

- contributing to international convergence of market standards.

Since launch, FMSB has established a vibrant, highly participative membership and formed specialist committees and working groups by topic. These industry experts debate issues and develop Standards and Statements of Good Practice and undertake Spotlight Reviews. These are made available to all in the global community of market participants and regulatory authorities.[3] FMSB has no enforcement powers but members formally agree to be bound by the Standards that they help create.

Setting Standards

Analysis, sharing best practice and standard setting result in three types of publication:

- Spotlight Reviews: are a deep dive into a specific topic that seeks to illuminate emerging issues in FICC markets, considering challenges market participants face as well as possible mitigants. The Reviews may inform future areas of structured work.

- Statements of Good Practice: Set out clear expectations and guidance on good practice in relation to broader areas of uncertainty in wholesale financial markets.

- Standards: Set out Core Principles and accompanying guidance on the most important aspects of practice where ambiguity risks undermining the transparency, fairness and effectiveness of markets. The Membership not only agrees to abide by these standards but also attests that they have done so annually.

Membership Growth

While initially established in the United Kingdom, the FEMR report made it clear that global markets need global standards, and it was always the intent to structure FMSB as a fully global initiative in terms of scope and membership. To that end, it continues to forge collaborative links with regulators, similar standard setting bodies and key market stakeholders around the world.

The breadth of FMSB's membership is a strength and one of its key differentiators. Membership comprises banks and liquidity providers representing about 80% of global FICC revenues; Exchanges, Central Counterparties (CCPs), and market infrastructure providers variously representing 30-60% of EMEA volumes; Asset Managers and Hedge Funds representing AUM >$10 trillion; Corporate members that exceed $100 billion in annual issuance; as well as Partner members being other standard setters or industry stakeholders.

FMSB's success derives from high levels of engagement from this group, as subject matter experts drawn from the membership do the work of establishing Standards, creating Statements of Good Practice and conducting Spotlight Reviews. This is central to the process of setting authoritative standards that are 'owned' by the industry. The Membership is supported by a legal entity Board, an active Advisory Council and Standards Board and a small but expert Secretariat.

FMSB has a clear sense of purpose:

By improving their transparency, fairness and effectiveness, FMSB seeks to support well-functioning, trusted global wholesale financial markets that in turn support sustainable economic growth for governments, corporations and investors.

FMSB has become a leading agent for change at the heart of the global financial services ecosystem.

MYLES MCGUINNESS
FMSB CEO

Producing guidelines, practical case studies and other materials that promote the delivery of transparent, fair and effective trading practices serves to increase trust in wholesale financial markets.[4]

In addition to its unambiguous purpose, FMSB has a number of distinctive characteristics that supports continuing membership growth including:

- absence of lobbying;
- a global vision with exclusive focus on wholesale markets;
- breadth of expertise of existing membership;
- being a practitioner-led group in terms of priorities, due diligence and effectiveness; and
- close relationships with regulatory authorities.

True to its mandate

FMSB's strategy for 2022-24 remains anchored to serving the original objectives set out in FEMR, which remain as relevant today as they were in 2015. Current strategy therefore focuses on three themes:

- collaboration — finding more ways to collaborate selectively with standard-setting bodies and regulatory authorities to augment the impact and reach of FMSB's work as well as enlivening a more forward-looking approach to risk identification and mitigation.
- internationalisation — expanding the effective international reach of FMSB, not just through private sector participation, but also by expanding new and existing relationships with regulators that have country or product-specific mandates; and

Unique facets

FMSB is a privately funded non-profit global standard setting body; it is not a regulator or an industry lobby group. There are many theoretical advantages to a structure which is practitioner led in the effort to strengthen conduct and effectiveness in existing and evolving markets. These include:

1. Market participants are naturally closest to the latest developments with access to cutting edge expertise giving them informational advantages to assist in developing high quality standards;
2. Active participation in the standard setting process can foster willingness to observe those standards and promote adherence among peers and market counterparties;
3. Promotion of market efficiency is the priority, versus supervisory strategies that may be driven by other, wider priorities and short-term political influences;
4. Transcendence of national borders can be done more easily than public authorities anchored to local jurisdictions;
5. Market-led initiatives can react more quickly than authorities with finite or purpose-specific resources and other priorities; and
6. Gaps can be closed that might otherwise remain unaddressed as a result of overstretched public budgets.

- membership — maintaining and actively growing the level of participation from a broad cross-section of firms, end-users and stakeholders.

The effectiveness of this strategy is based on the premise that FMSB continues to produce high quality, impactful publications.

Memorandum of Understanding

One regulatory initiative, completed in 2021, was the creation of a Memorandum of Understanding [MOU] with the Bank of England and the Financial Conduct Authority on roles and expectations.[5] The MOU is of symbolic significance and underlines FMSB's close regulatory ties. Key tenets of the MOU are active discussion of our strategy and priority setting at the formative stage as well as arrangements for the authorities to provide input into our standards.

We all know the wholesale markets are international by their very nature, and we would welcome opportunities to explore similar arrangements with other regulators and standard-setting bodies.

FMSB's impact

We have been busy! Since its inception, FMSB has published 9 Standards, 11 Statements of Good Practice (including Transparency Drafts) and 10 Spotlight Reviews.

Clarifying Trading Practices 2015-2020

Early efforts focused on clarifying trading practices that were associated with post-crisis misconduct, notably related to foreign exchange and Libor.

These contributions cover topics such as reference prices, the new issue process for the fixed income markets, surveillance in foreign exchange markets, monitoring of electronic communications, conduct risks associated with the execution of large trades and conflicts of interest.

Responding to Events 2020-2021

LIBOR cessation and the need for risk management frameworks around hybrid working are two of the more significant recent challenges that financial market participants have faced. FMSB has published Spotlight Reviews to assist firms in identifying and mitigating conduct risks associated with the LIBOR transition as well as on work of the Sterling RFR Working Group to set a Standard for the use of Term SONIA. Similarly, having published a remote working risk register complete with key mitigants, FMSB followed up with a Spotlight Review to support firms in addressing risks caused by the broader dynamism around the pivot to hybrid working.

Human behaviour sits at the heart of all these events, and FMSB also includes this and wider issues applicable across financial organisations. A significant early contribution was an incisive analysis finding recognisable patterns in misbehaviour that took place hundreds of years ago, which also occur in today's world. Importantly, these patterns have transitioned across to ultra-high-speed and technologically advanced markets. This behavioural risk analysis is being updated for release in H1 2022. Such leading-edge output reflects the commitment and drive of the FMSB Board, the Advisory Council and the Standards Board, but also the high level of engagement and expertise of well over a dozen working groups comprised of over 300 individuals drawn from the most senior levels of active market participation as well as academia and legal services.

Behaviour-pattern Conduct Analysis — 2022 Update

Imagine that you have clear insight into a market that will have a spike in demand for a particular product. If you could build sufficient inventory, or otherwise gain control of that product, then you could control or significantly influence the price in your favour. This is called 'cornering the market'. It has played out many times over the years and now it can even be attempted in today's high-speed electronic markets.

But this story, and many other forms of market abuse, go back a long way…

> *During 600 BC, Thales, a philosopher and astrologist, predicted that the next year's olive harvest would be more bountiful than usual, meaning that the right to use olive presses (used to convert olives into oil) would be selling for a higher rate. Thales then took whatever little money he had and went to all the owners of the olive presses and made a small deposit with each of them to use their presses exclusively during the harvest time. When the harvest really did produce a bumper crop Thales, having cornered the market, made a killing by charging the other merchants whatever he wanted for the use of olive presses.*

In 2018 we published a comprehensive report charting the course of misconduct and manipulation of wholesale financial markets from the earliest days of modern capital markets. In our update this year we have added new cases and summarised 19 types of misconduct used to manipulate or distort markets that can explain all the activity we have studied over the past 232 years. These 19 types of misconduct are logically grouped into six simple behaviours summarised below. It is important to note that these misbehaviours appear across any product or geographic location and have been adapted to work in high-frequency trading and within complex algorithms.

1. Price manipulation	2. Circular trading	3. Misuse of inside information
• Spoofing/layering • Ramping • Pools • Corners/squeezes • Bull/bear raids	• Wash and matched trades • Money pass and compensation trades • Parking	• Insider dealing • Unlawful information disclosure

4. Reference price influence	5. Improper order handling	6.Misleading customers and/or markets
• Manipulation of submission-based fixes • Manipulation of transaction- based fixes • Portfolio price manipulation / window dressing • Triggering or protecting barriers	• Disclosure of client order information • Front running • Cherry picking • Triggering or protecting stop losses and limits	• Disseminating inaccurate or false information to clients or markets

It is important for firms to consider the history of misconduct as the infractions do repeat, as do the behavioural attributes and the context or conditions that become enablers.[6]

Future activity and focus on emerging risk

Attention has now shifted to identifying and addressing emerging risks consistent with the original mandate from FEMR. The identification effort reflects a synthesis of the collaborative engagement with the membership, reviewing strategic trends, assessing recent market events, gathering expert practitioner input and taking note of key new regulatory initiatives globally.

The wide range of potential further work and publication topics includes:

ENVIRONMENTAL, SOCIAL & GOVERNANCE (ESG)

The high degree of noise around ESG risks and mitigation efforts elevates the need for resolution around key principles. The development of risk management frameworks and incisive metrics for ESG is now an essential topic for boards. Carbon markets may well emerge as a driving force in risk mitigation and need coordinated attention.

OPERATIONAL RESILIENCE

Whole-firm or venue-level resilience or risk of extended outages is a growing concern. The challenges and opportunities associated with evolving hybrid working models are not fully addressed. Business model and technology changes can drive higher efficiencies, for example, in post-trade processes, but can also drive unintended consequences and become disruptive.

DIGITISATION / ELECTRONIFICATION OF MARKETS

Whole market segments can rapidly shift almost entirely to electronic trading. New platforms may find themselves neighbours with entirely new segments such as wholesale crypto markets. The risk management frameworks around algorithmic models for trading or support processes are complex.

The majority of FMSB publications to date focus on issues pertaining to market fairness. Addressing 'effectiveness' in financial markets is becoming increasingly important. This could include building on the recommendations of the Bank of England's Post-Trade Taskforce to drive process efficiencies. We could also investigate opportunities with other authorities for practitioner-led standards to fill regulatory gaps. A UK example is seen in the follow-up on the Wholesale Markets Review and Future Regulatory Reform agenda.

The development of risk management frameworks and incisive metrics for ESG is now an essential topic for boards.

These topics have emerged from trends and events across the global industry, as well as from discussions held among FMSB membership, regulators and other stakeholders.

BREXIT

UK and global financial centres are still in the process of responding to the market, legal and infrastructure impact of Brexit. This presents opportunities to contribute both internationally and domestically:

- **Internationally:** FMSB has shown that it can deliver consistent conduct standards governing wholesale market business. This is all the more important in a world where technical regulatory standards may diverge. Why, for example, should large trades be processed differently in one market versus another?

- **Domestically:** The UK Treasury is consulting on the Future Regulatory Framework and there is ongoing work to consider the role of the UK in wholesale markets. This may result in a re-orientation of domestic financial regulation potentially presenting opportunities for the industry to lead on certain developments and fill gaps that cannot be addressed expeditiously by overstretched public budgets.

Striking a balance

By its strong start, FMSB has demonstrated an ability to channel the power of industry-led solutions in collaboration with regulators and international standard setters to support the development of fair and effective markets without a constant need for more restrictive regulation.

After dealing with the pre-identified problems related to foreign exchange and Libor (2015-19), and quickly responding to urgent market events (2020-21), FMSB is now shifting to focus on emerging issues and is well-poised to contribute.

The wholesale financial markets are changing in rapid and complex ways due to technological advances, new products and business models, hybrid operating models, and the sheer scale of challenges such as ESG, climate change and data not to mention the impact of major geo-political events. FMSB is well placed at the heart of the wholesale financial services ecosystem to continue as a key agent for change. If your organisation has an interest in our work, please contact us.

The global FMSB membership is actively growing. If your organisation has an interest in our work, we invite you to look at our web site and Annual Report and to contact us about how you could get involved as a Full, Associate or Partner Member. We also look forward to welcoming a number of additional global, national or product-specific regulators to our collaborative efforts.

***Edward D. (Ted) MacDonald** is a member of the FMSB Secretariat, is an accredited mediator and maintains active links with Ivey Business School and its Leader Character programme. As a financial services practitioner, he has held senior roles in business origination, risk management, board-level governance, and more recently, regulation.*

***Christopher Rich** is FMSB's General Counsel and has overall responsibility for all FMSB Working Groups and their publications including Standards, Statements of Good Practice and Spotlight Reviews.*

ENDNOTES

1 Fair and Effective Markets Review: Fair and Effective Markets Review published | FCA

2 FMSB Website: FMSB.com

3 FMSB Annual Report: Standards & Publications

4 FMSB Standards & Publications: Standards & Publications

5 MOU — Bank of England, Financial Conduct Authority & FMSB: 20211109_FMSB-MoU_FINAL.pdf

6 Behavioural Cluster Analysis July 2018: BCA

war in Ukraine, as well as continuing its existing work to improve financial stability, such as addressing cyber and operational resilience risks.[786]

International Association of Insurance Supervisors

The International Association of Insurance Supervisors (IAIS) is a voluntary membership organization made up of insurance supervisors and regulators from over 200 jurisdictions worldwide.[787] In recent years, IAIS has emphasized the importance of culture and conduct in the insurance industry. Indeed, conduct and culture are listed as part of the organization's top priorities over the coming four years.[788]

For instance, in its 2020-24 strategic plan, IAIS writes, "A holistic approach to market conduct and prudential supervision is called for, recognising that conduct and culture issues could lead to financial soundness and stability concerns."[789] In its 2021-2022 Roadmap, the organization intended to publish a paper detailing the importance of insurer culture and another examining the use of key indicators to assess conduct-related outcomes.[790]

To put these plans into action, IAIS released a draft paper on insurer culture for consultation in June 2021. Following this consultation, the organization released the final version, entitled "Issues Paper on Insurer Culture," in November 2021.[791]

Therein, IAIS explained that conduct and prudential risks have long been seen as separate, but emphasized that conduct risks are now recognized as prudential concerns in and of themselves. "The collective set of norms, practices, decision-making and behavioural elements that make up an insurer's culture directly influences how that insurer manages both types of risks," IAIS writes, marking firm culture as a "critical intersection point to help prudential and conduct supervisors gain a more universal or 'integrated' view of vulnerabilities."[792]

"While prudential risk management ostensibly focuses on the mitigation of adverse consequences for insurers themselves, conduct risk management is primarily concerned with the alleviation of potentially unfair treatment or harm to customers," the IAIS wrote. "Conduct risks may not always appear to constitute immediate or direct threats to the soundness or stability of insurers, and consequently may not initially attract the attention of prudential supervisors. Nevertheless, it is increasingly being recognised that the poor management of conduct risks can lead to significant prudential concerns and vice versa."

In January 2022, IAIS released its 2022-23 Roadmap, detailing its plans to expand upon this work over the next year, including finalizing guidance on the use of key indicators and data to monitor conduct risks proactively, so as to enable "more timely responses to emerging conduct trends and risks."[793]

Financial Markets Standards Board

Much as the UK's Financial Services Culture Board (FSCB) was launched as a consequence of the GFC, the FICC Markets Standards Board (FMSB) was born out of governmental concern following a series of high-profile conduct scandals. In 2014, the BOE, FCA, and HM Treasury launched a review into the Fixed Income, Currency and Commodities (FICC) markets. The Final Report, published in June 2015, made 21 recommendations to improve the fairness and effectiveness of FICC markets. One such recommendation was to establish a "FICC Market

In Focus

Ensuring Trustworthy AI for Business and Finance: An OECD Perspective

By YOSHIKI TAKEUCHI

Yoshiki Takeuchi

Artificial intelligence (AI) is transforming many aspects of our lives, including how we provide and use financial services. AI-powered applications are now a familiar feature of the fast-evolving landscape of technological innovations in financial services and regulation (FinTech and RegTech).

AI applications can facilitate transactions, drive market efficiency, reinforce financial stability and promote greater financial inclusion. Banks, traders, insurance firms and asset managers increasingly use AI to generate efficiencies by reducing friction costs and to improve productivity levels. This trend looks set to continue, with global spending on AI forecasted to double from just over USD 50 billion in 2020 to more than USD 110 billion in 2024.[1]This kind of innovation strengthens economic growth and supports higher living standards.

At the same time, AI poses real risks to business and finance. It raises questions around human determination; security and safety; accountability; the impact on competition and market power; and the divides in AI capabilities across countries and firms. These challenges are particularly complex in the financial sector, where sensitive data and life-altering decisions are often involved.

We have reached a critical juncture for the deployment of AI-powered FinTech. Policy makers and market participants must redouble their engagement on the rules needed to ensure trustworthy AI for trustworthy financial markets. Getting the policy settings right will be an important element of optimising the strength and the quality of the post-pandemic recovery. It is up to us—governments, business, and the international community — to strike this balance, together. ▸PAGE 365

This was one of the key messages of the 2021 OECD annual Business and Finance Outlook, which looked at AI in business and financial markets.[2] It examines the growing importance of AI applications in key policy areas of finance, responsible business conduct, competition and international investment. It also considers how AI is used in the public sector for market supervision and enforcement.

A key finding of the Outlook is that increasingly complex AI algorithms that are difficult—or even impossible—to explain could amplify existing risks already present in financial markets or give rise to new risks. These risks in the financial sector can have indirect effects for our collective efforts to bridge the digital divide between various constituencies in our societies and ensure that no one is left behind in the digital transformation. At the same time, there is growing awareness that existing financial regulations may fall short of addressing systemic risks presented by wide-scale adoption of AI by financial firms.

This leads to our second key finding: We have reached a critical juncture for the deployment of AI applications in business and finance. Financial regulators are grappling with whether and how to adapt existing rules, or create new ones, to keep pace with technological advances in AI applications, while striking the right balance between consumer protection and supporting innovation. ▸PAGE 291 As noted in the Outlook, we must ensure that AI applications in business and finance are consistent with our common values — such as openness, transparency and fairness. We also need common approaches between countries in order to avoid fragmentation, to provide regulatory consistency and certainty, and to ensure a level playing field.

As AI applications become more closely stitched into the fabric of how we do business and finance today, the use of trustworthy AI becomes increasingly important for ensuring trustworthy businesses and financial markets.

This leads to our third and final key conclusion: The international community must reinforce efforts to facilitate multilateral engagement on implementing trustworthy AI. We need the strength that comes from multilateralism. As AI applications become more closely stitched into the fabric of how we do business and finance today, the use of trustworthy AI becomes increasingly important for ensuring trustworthy businesses and financial markets.

The *OECD AI Principles*, adopted by the OECD in 2019, are the ideal foundation for these efforts. They are the world's first intergovernmental standard on trustworthy and responsible AI.[3] The G20's human-centred, democratic values-based AI Principles (also adopted in 2019) draw from our own Principles.[4] Under these Principles, the OECD is aiming to reinforce efforts to facilitate multilateral engagement on the following key recommendations, that:

- AI should benefit people and the planet by driving inclusive growth, sustainable development and well-being;
- AI systems should be designed in a way that respects the rule of law, human rights, democratic values and diversity, and they should include appropriate safeguards — for example, enabling human intervention where necessary — to ensure a fair and just society; ▸PAGE 173
- there should be transparency and responsible disclosure around AI systems to ensure that people understand AI-based outcomes and can challenge them;
- AI systems must function in a robust, secure and safe way throughout AI systems' life cycles (across design, data and models; deployment; and operation and monitoring) and potential risks should be continually assessed and managed;
- and organisations and individuals developing, deploying or operating AI systems should be held accountable for their proper functioning in line with the above Principles.

The OECD stands ready to work with our partners in a collective effort to apply these values-based principles to the challenges facing regulators, participants and consumers of AI-powered FinTech by serving as a forum for data and analysis, best-practice sharing, and advice.

Yoshiki Takeuchi *is the Deputy Secretary-General of the Organisation for Economic Co-operation and Development (OECD). His portfolio includes the strategic direction of the OECD policy on Tax, Financial and Enterprise Affairs along with the Centre for Entrepreneurship, SMEs, Regions and Cities. He also represents the OECD on the Financial Stability Board.*

ENDNOTES

1 International Data Corporation (2020), Worldwide Spending on Artificial Intelligence Is Expected to Double in Four Years, Reaching $110 Billion in 2024, According to New IDC Spending Guide, https://www.idc.com/getdoc.jsp?containerId=prUS46794720.

2 OECD (2021), OECD Business and Finance Outlook 2021: AI in Business and Finance, OECD Publishing, Paris, https://doi.org/10.1787/ba682899-en.

3 Available online here as part of the OECD.AI Policy Observatory: https://oecd.ai/en/ai-principles

4 See online here: https://oecd.ai/en/wonk/documents/g20-ai-principles

Standards Board with participation from a broad cross-section of global and domestic firms and end-users at the most senior levels."[794]

The FMSB was subsequently founded as an industry association, with the stated goal of improving public trust in wholesale FICC markets by raising global standards of conduct for its participant firms. In 2022, the FICC Market Standards Board changed its name to the Financial Markets Standards Board, to reflect the changing market. Progressing from its initial work, the FMSB is increasingly extending its collaborative activity and impact across the globe. It has five working Committees (ESG, Electronic Trading & Technology, Post-Trade, Conduct & Ethics and Market Practice) with additional publications imminent.[795]

In its 2020 Annual Report, released in June 2021, the FMSB made clear that it saw the hybrid working environment as both an opportunity and a risk for its members. "The mass 'work from home' responses enacted almost overnight increased the operational and conduct risks for our members, and all market participants, but also showed purpose, agility, ingenuity and an appreciation of social issues and empowerment that we should look to build upon in the future," FMSB Chair Mark Yallop wrote. "In particular, the need to create new remote working protocols illustrated the crucial role that culture plays in ensuring fair and effective business practices and good controls."[796]

The Board expanded upon these views in a report entitled, "Hybrid Working in FICC Markets — Future Risk Management Frameworks." The FMSB named controls, competency, and culture as key drivers of conduct in the financial markets, explaining that it is essential to analyze how each is affected by new hybrid and remote working arrangements to ensure good conduct outcomes.[797]

In April 2022, the Bank of England and the UK's Financial Conduct Authority published a report entitled "Charting the Future of Post-Trade," which was the culmination of their Post-Trade Task Force's work and made several recommendations for improving current post-trade processes. The regulators also announced that the FMSB would be taking forward the work of the Task Force and helping to facilitate the adoption of the recommendations in the market.[798]

"Through our membership, which is made up of participants in wholesale markets, and our unique standards adherence process, FMSB is well placed to build on the Task Force's output and embed it in the industry," FMSB CEO Myles McGuinness said. "We intend to follow the Task Force's established areas of focus on i) Non-Economic Trade Data (LEIs) ii) Client on-boarding, and iii) Uncleared Margin. We will also work with other practitioner groups who focus on specific aspects of the Task Force's work to ensure the final output reflects industry best practice."

Organisation for Economic Co-operation and Development

In the Organisation for Economic Co-operation and Development's (OECD) "Business and Finance Outlook 2021" report, Dr. Mathilde Mesnard, Acting Director of the Directorate for Financial and Enterprise Affairs, argued that governments, regulators, and firms will need to work together to develop AI uses that work to benefit society, while mitigating the risks these technologies may pose.[799]

"At this critical juncture, it is incumbent upon us all to recall certain pillars of good policymaking," Mesnard wrote. "Stakeholder engagement in an inclusive policy process is key. Public-private dialogues can help to identify mutually acceptable solutions that nurture innovation and experimentation in AI-based FinTech

In Focus

A Greening of Our Ongoing Conduct and Culture Journey

By STUART P.M. MACKINTOSH

Stuart Mackintosh

'Culture and conduct in banking — isn't that old news?' I am sure I am not the only person to have gotten that type of reaction when the subject is raised today. The answer is a clear 'No', and the case for continued focus is a very strong one indeed.

The G30's work, along with that of many others including the outstanding team at the Federal Reserve Bank of New York ▸PAGE 199 and smart bank executives across America, makes it clear that the bank conduct and culture journey is never over. It is an ongoing, evolving, shifting process. Creating and sustaining desired culture and conduct requires a process and mindset, not a single destination. It needs constant attention from the board and senior managers, who must exhibit and model a firm's culture, and these priorities must be reflected in messaging, training, and performance appraisals throughout the company at all levels. ▸PAGE 61

Vigilance against bad behavior and toxic cultural developments in major firms (both banking and non-banking) cannot let up because failures still occur, and material fines, reputational damage, and fallout result. Addressing and avoiding poor risk assessment, a foolish a search for yield, poor cultural norms, or serious wrongdoing must be an ongoing exercise. Think of the WireCard debacle in Germany. Or Archegos's collapse and multi-billion-dollar losses in Switzerland and the US. ▸PAGE 137

Or consider the massive payout by Boeing's insurers for the failure of its board over the company's lax safety culture. Such failures demonstrate that the focus on best practices, on measurement, on establishing what is and is not acceptable within a firm's culture, must continue.

Importantly the contours of the landscape in which firms operate and are profitable is constantly changing. This too requires cultural and conduct shifts and evolution.

For instance, seizing the opportunities that the green transition offers firms necessitates a wholesale adjustment in strategies, business goals and, yes, also in conduct and culture. Many firms — now almost a majority thanks to Mark Carney's efforts — have signed up to net zero plans and to scope 1, 2, and 3 TCFD reporting. They have a great deal to do.

How are they going to implement and monitor measurable greenhouse gas outcomes year-to-year, business unit to business unit? This will require a reimagining of the firm's goals and its internal processes, including many aspects of its employees' conduct and culture. Employees must understand the new goals, how they affect businesses, product design, their clients and emerging opportunities for profitable ventures. Firm and employee performance against green targets will need to be measured. Those results will need to be audited.

This essential green transition requires significant and lasting step-changes in bank conduct. Getting to net zero requires that we embed and internalize firm-specific short, medium, and long-term net zero goals. For this to be real and effective, cultural changes in most firms will be necessary. This green transition we have all embarked upon cannot be about box ticking, or it will not be effective, and our goals will be missed.

Just as a firm's internal conduct norms depend on the strategies and goals established at the C-suite level, so too outcomes depend on how the altered strategies are reflected in expected conduct. Firms must increasingly walk the environmental talk, or their employees will see through green-tinted statements and view them as mere greenwashing and virtue-signaling rather than representing real, meaningful change. This is already becoming visible firm-to-firm.

A good observer, analyst, investor, or employee can tell if a firm and its leadership are serious about the transition. Increasingly, as net zero reporting and real results becomes standardized and demanded by our communities of investors and customers, firms that fail to live up to the greening social contract they have with society will be penalized.

As the ESG wave rises and rises, and as the great asset transfer from baby boomers to millennials and young Generation X & Y investors gets underway, pressure on firms to make the leap on green conduct and culture will build. That wave will swamp those who deny the shifting greening of conduct and cultural norms that is part of the evolution of banking and its place in society.

There are, of course, many other aspects of banking conduct and cultural evolution. From the impact of the #MeToo movement, to Black Lives Matter, to increasing gender diversity and inclusion, the landscape in which banks operate and within which they must grow and prosper is constantly shifting.

And the war in Ukraine drives home anew how important it is that the financial sector speeds its support of a transition to green tech and renewables — as a mechanism to protect the West and the world from rent-seeking autocrats with distorted narratives and massive militaries.

The key message here is the work is never done. That good leadership on conduct and culture requires consistent focus, openness to change, and vigilance to poor outcomes. It is never easy, and it does not end. But that is what makes banking and life interesting and worth living.

***Stuart P.M. Mackintosh** is the Executive Director of the Group of Thirty an international financial think tank comprised senior figures from central banking, the financial sector, and academia. Author of several books, most recently Climate Crisis Economics, his research focuses on climate change, macroeconomic and systemic risks, global governance issues, and the international political economy.*

while also addressing shared risks and challenges to long-term market stability, competition and the primacy placed on consumer protection and trust."

OECD Deputy Secretary General Yoshiki Takeuchi discusses the key findings from the "Business and Finance Outlook" herein. "We have reached a critical juncture for the deployment of AI-powered FinTech," he writes. "Policy makers and market participants must redouble their engagement on the rules needed to ensure trustworthy AI for trustworthy financial markets. Getting the policy settings right will be an important element of optimising the strength and the quality of the postpandemic recovery. It is up to us — governments, business, and the international community — to strike this balance, together." ▸PAGE 337

The report lays out four factors of trustworthy AI in the financial sector: transparency, fairness, data governance and accountability. The OECD makes clear that, if these factors go unattended to, it is possible that AI could end up operating as a negative force, increasing discrimination and unfair practicies.[800]

International Organization of Securities Commissions

In April 2021, IOSCO published its "Work Program 2021-2022." The organization plans to focus on risks created or exacerbated by the covid pandemic: "The COVID-19 pandemic has created economic and social situations, such as job losses, financial strains, physical and social isolation, and active online engagement, which can increase conduct risk and magnify retail investors' susceptibility to scams and frauds."[801]

Later in the year, IOSCO published guidance on regulating and supervising the use of AI by market intermediaries and asset managers. The guidance recommended the implementation of requirements for:

- appropriate governance, controls, oversight and accountability frameworks over the development, testing, use and performance monitoring of AI and ML
- robust, consistent and clearly defined development, testing, and monitoring processes to enable firms to identify potential issues prior to full deployment of AI and ML
- ensuring staff have adequate knowledge, skills and experience to implement, oversee, challenge the algorithms and outcomes of AI and ML, and conduct due diligence on any third-party providers
- third party providers relationship management, including to monitor and oversee performance and ensure accountability over outsourced functions
- appropriate transparency and disclosures to investors, regulators and other relevant stakeholders
- controls in place to ensure that the data that AI and ML performance is dependent on is of sufficient quality to prevent bias and sufficiently broad[802]

In early 2022, IOSCO issued a report outlining lessons learned during the covid pandemic regarding operational resilience. In the report, IOSCO makes clear that operational resilience is not just technical in nature, but also relies on the resilience of processes, premises and personnel. The report recommends that regulated entities update their business continuity plans and implement a governance framework that supports operational resilience in novel situations.[803]

Financial Action Task Force

In March 2022, the Financial Action Task Force (FATF) appointed T. Raja Kumar, Senior Advisor to Singapore's Minister for Home Affairs, to replace Dr. Marcus Pleyer as president of the Task Force. This would represent the first Singapore presidency of the body.[804]

"Singapore strongly supports the outstanding work of the FATF in establishing and implementing global standards to combat money laundering and terrorism financing," Lawrence Wong, Singapore's Minister for Finance, said. "Raja has a long history of contributing to the FATF's work. I look forward to Raja, as President, bringing together law enforcement authorities, financial sector and other AML/CFT supervisors, as well as private sector stakeholders to achieve effective outcomes. Raja's experience and leadership will enable him to effectively lead the FATF's mission in the years ahead."

That same month, the FATF announced new anti-money laundering (AML) guidelines, asking governments to establish "beneficial ownership register or a sufficient alternative." This would allow governments to see who ultimately owns a company, making it more difficult for criminals to launder illicitly obtained funds through shell companies.[805]

"The strengthening of the international standard on beneficial ownership registry comes at a critical time — just a week after Russia's invasion of Ukraine," Maíra Martini, an expert on corrupt money flows at Transparency International, said. "Transparency in company ownership is essential for authorities to trace assets of those connected to the Kremlin."

United Nations

As discussed in earlier issues of this annual report, in 2019 the United Nations Environment Programme Finance Initiative (UNEP-FI) published its "Principles for Responsible Banking," listing Governance & Culture as one such.

Aiming to align the business strategies of banks with societys' goals, to provide a framework for a sustainable banking system, and to demonstrate how this contributes positively to society,[806] the Principles were launched with the participation of 130 banks from 49 countries,[807] collectively representing $47 trillion in assets. Signatories, now numbering some 220, agree to complete a self-assessment and to report to the UN annually.

In October 2021, the UNEP-FI published a report on the progress made by its member banks in adopting the Principles. The report showed that 93% of them are analyzing the environmental and social impacts of their operations.

"The Principles for Responsible Banking are a crucial framework for the global banking industry to respond to, drive and benefit from a sustainable development economy," Inger Andersen, Executive Director of UNEP said. "Sustainable finance is about creating prosperity for this and future generations, and this report shows early signs of progress made worldwide, while outlining steps to further accelerate action in critical areas."

The UN has also promoted the use of Behavioral Science to solve the problems organizations face today. "Behavioural science is part of a wider methodological and practical transformation process that includes data, digital transformation, innovation, and strategic foresight to ensure that the UN applies the best tools to confront contemporary and future challenges," the UN wrote in a Guidance Note from the Secretary-General.[808]

Global Financial Innovation Network

In 2018, the UK FCA and a dozen other regulators and related organizations formed the Global Financial Innovation Network (GFIN) to improve cross border knowledge sharing among participants. The organization has now grown to more than 70 members, adding more than 20 members since just the beginning of 2020.[809]

In its December 2021 “RegTech & SupTech Update,” GFIN outlined a few of the major themes that emerged in the course of its “Showcase Day,” during which the participating members of various work-streams came together to discuss the opportunities and challenges that regulators encounter in regulatory technology (regtech), regulatory reporting, and supervisory technology (suptech). One important theme was that suptech progress has been hindered by regulatory agencies’ reluctance to share information externally.[810]

THE ACADEMY

"The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood."

JOHN MAYNARD KEYNES

1953

The Academy

An Interview with Sir John Kay

Sir John Kay

Q: The title of your recent book, with Paul Collier — *Greed is Dead* — is a clear shout-out to the infamous Gordon Gekko line in the movie *Wall Street*, "Greed is good." What should we infer from the title, and what prompted you to write it at this time?

A: On reflection, Paul (Collier) and I should perhaps have added a question mark to the title *Greed is Dead* (?). Our claim is not that greed is no longer widely seen in the worlds of business and finance; sadly, it is all too evident. Our claim is that the intellectual framework that appeared to provide justification for Gordon Gekko's claim is crumbling. (Gekko was himself echoing Ivan Boesky's assertion that "greed is alright by the way…you can be greedy and still feel good about yourself").

We might trace that intellectual framework back to Milton Friedman's notorious 1970 article in the *New York Times Magazine*; 'The Social Responsibility of Business is to Maximze its Profits.' Or to Lewis Powell's memorandum to the American Chamber of Commerce, written in the following year, which stressed the need for business to promote sympathetic academic research to counter the anti-business propaganda generated in the 1960s by authors such as John Kenneth Galbraith and Ralph Nader. The memorandum was the trigger for the establishment of several conservative think tanks and set a tone for much of what was taught in leading business schools.

But we see a change. The revision of the statement of corporate purpose by the Business Round Table in 2019, which dropped an insistence on shareholder primacy in favour of a broader stakeholder perspective, was a symbolic moment. And the repetition of this sentiment by Larry Fink, CEO of BlackRock, the world's largest asset manager, was also significant. We have also seen several important books, written from several different perspectives, each rejecting the emphasis on selfish individualism prevalent in the last half century.

While our book was in press, Jonathan Sacks, former Chief Rabbi of the United Kingdom, published *Morality: Restoring the Common Good in Divided Times*, a book whose sentiments uncannily resembled our own. And we have since had an opportunity to read Robert Putnam's *The Upswing*, Michael Sandel's *The Tyranny of Merit* and Rebecca Henderson's *Reimagining Capitalism in a World on Fire*. These authors are Harvard Professors of politics, philosophy, and business, respectively. We seem to have caught an intellectual tide!

Q: What does this imply for a 'command and control' approach to management, or for the idea that the behavioral predilections within an organization depend on a 'tone from the top'? How does this tie to the criticism you sound in your book regarding the prevalence of systems of surveillance and monitoring to control risk?

A: If 'command and control' structures were an effective means of large scale economic organisation, then the Soviet Union would have been a rip-roaring success — and back in the 1960s many people in the West thought it was! We know better now — or at least we should. Market economies did far better through a subtle combination of cooperation and competition, through a disciplined pluralism that allows for novelty and experiment but is ruthless in cutting off failed experiments.

Adam Smith famously wrote that it was not from the baker's benevolence but his self-love that we receive our supper. But he also wrote that a central human aspiration was to be 'deserving of love' — by which he did not mean self-love, but the respect and affection of others. And Smith was also scathing of 'the man of system…apt to be very wise in his own conceit…often so enamoured with the supposed beauty of his own ideal plan of government, that he cannot suffer the smallest deviation from any part of it'.

The effective leader is part of a ratifying hierarchy — one that validates decisions rather than imposing them.

The Wealth of Nations begins with a description of a pin factory, chosen to illustrate the superior productivity of cooperative activity relative to individual effort. In, fact that is the central message of Smith's work.

But benevolence, though necessary, is not enough. The social philosopher Charles Handy has written of 'proper selfishness' and it is a useful phrase. I am also impressed by Margaret Blair and Lynn Stout's concept of the 'mediating hierarchy'. All organisations need some hierarchy — people need to know when decisions have been taken and what they are. But the effective leader is part of a ratifying hierarchy — one that validates decisions rather than imposing them.

And that is the context within which the 'tone from the top' operates. Think of Johnson & Johnson's Tylenol experience, for instance, when junior managers reacted to the cyanide spiking of some capsules by immediately withdrawing the product from drugstores across America — in justified confidence that senior management would back them up. This is rightly a classic business school case. Surveillance and monitoring would have contributed nothing in this instance. A robust safety culture did.

Q: You raise an interesting discussion in the book, arguing that trust in the state and trust in politics are inextricably entwined. Would you expand on that? What might this suggest with regard to trust in the financial industry — to include that in regulators and in individual firms — particularly with regard to the culture and misconduct related issues at the center of this report?

A: There is perhaps no product for which trust from consumers is more important than medications such as Tylenol — we ingest a chemical about which we know nothing, on the basis of the doctor and manufacturer's claim that it will do us good. The pharmaceutical industry has been one of the great successes of modern business — manufacturing drugs and vaccines which have saved and improved the lives of millions, most recently during the pandemic.

Johnson & Johnson's 'credo' was the background to the company's actions over Tylenol. The credo begins, "We believe our first responsibility is to the patients, doctors and nurses, to mothers and fathers and all others who use our products and services". It is paralleled by George Merck's famous declaration that, "We try never to forget that medicine is for the people. It is not for the profits. The profits follow, and if we have remembered that, they have never failed to appear." In my judgment this is the real meaning of corporate social responsibility. ▸**PAGE 103**

Statements such as these, sincerely intended, defined a 'social contract' between the industry and society, in which firms were allowed extraordinary profitability in return for behaving as exemplary corporate citizens. For a decade, from the late 1980s to the 1990s, Merck was repeatedly voted 'America's most admired company' in a survey conducted by *Fortune* magazine.

But that social contract has been broken, as Merck pursued growth and quarterly earnings at cost to its reputation, as companies like Purdue Pharmaceuticals, and even Johnson & Johnson, were implicated in America's tragic epidemic of opioid addiction. Other pharmaceutical businesses, such as Turing and Valiant, incurred opprobrium for price-gouging. Even after the successful development of a covid vaccine, the pharmaceutical industry is found by Gallup's polling to be the least trusted of all American industries.

The parallels with the loss of trust in financial services are too obvious to need to be spelled out. Like pharmacology, banking illustrates the best and worst in the relationship between business and society. And the obloquy these industries currently experience illustrates a decline in the quality of that relationship, and the public's confidence in it, which we have seen deteriorating over the last fifty years. Today, we see the paradox that Facebook and Google each have more than two billion customers — more than any company in the history of the world has dreamt of attracting — and yet their practices are denounced in news articles every day.

We love the product as we hate the producer.

Q: You write that effective organizations, public and private, work to promote diversity, within teams and between them. Does this suggest that diversity becomes a matter of governance? If so, what might that imply in terms of appropriate disclosure requirements?

A: Joe Henrich, an evolutionary psychologist (and yet another Harvard professor), has described 'collective intelligence' as 'the secret of our success'. It is a perspective on economics that I find highly illuminating. Collective intelligence — a phenomenon that distinguishes humans from all other species — is a term describing the observation that we have problem solving capabilities as a group far greater than any of us do, or could, individually.

One consequence of the development of this collective intelligence is that effective decision-making benefits from the knowledge and contributions of many. Within the mediating hierarchy, ideas and proposals are the subject of constant — constructive — challenge.

This requires diversity of thought, which does not necessarily correlate with the quotas prescribed by the box-tickers of the corporate governance establishment. Norway is the country that has gone furthest in the implementation of this imposed diversity, resulting in the phenomenon of the 'gyldne skjorte' (golden skirts), the similarly minded women who flit effortlessly between Oslo boardrooms. ▸PAGE 371 What is needed is independence of thought, a characteristic which, having no objective measure, ticks no boxes.

What is needed is independence of thought, a characteristic which, having no objective measure, ticks no boxes.

Q: I found your comment that effective hierarchies work from the bottom up thought-provoking. If that is the case, whom shall we hold accountable when malfeasance occurs? Does responsibility not lie with those at the top, as contemplated within the UK's Senior Managers Regime and UK legal notions regarding a "directing mind and will" within a firm?

A: Rebekah Brooks, former editor of the *Sun and News of the World* newspapers and (after her acquittal on criminal charges) chief executive of Rupert Murdoch's News UK, declared herself "shocked and appalled" when she heard allegations of phone-hacking by journalists at the papers. She was "sickened that these events are alleged to have happened," adding, "Not just because I was editor of the *News of the World* at the time."

If the context were less serious the convoluted nature of the legally dictated prose would be amusing. Brooks was found not guilty because she had no *specific* knowledge of the criminal offences.

The Serious Fraud Office brought cases against both Barclays Bank and some of its senior executives over the murky transactions in which the bank preferred to be bailed out by the Emirate of Qatar rather than by the British government. The criminal case against the bank failed, essentially because Barclays was thought too diffuse an organisation to have a directing mind and will. And the case against the executives also failed, because the allegedly fraudulent misrepresentations had been made by and on behalf of the bank, rather than by any particular individuals. Thus, no crime had been committed by anyone.

The state of US law is equally unsatisfactory. Jed Rakoff, attorney and then judge in the Southern District of New York, the principal forum for both the commission and prosecution of financial crime, has identified and explained the shift that has occurred from the charging of individuals to the (generally deferred) prosecution of corporations. The General Counsel of the business acknowledges the concerns raised by a regulator or prosecutor. A bargain is struck, in which the company agrees (usually without admitting fault or liability) to implement some revamped compliance programme and to disgorge a financial penalty. The deferred prosecution deal puts any further action on hold, and no further action occurs. Until the next time.

The concept of the 'directing mind', which may be relevant for the typical small business, is inappropriate in the context of large, complex organisations characterised by a mediating hierarchy. We need to pursue corporate crime on the basis of the strict liability of responsible individuals.

We need to pursue corporate crime on the basis of the strict liability of responsible individuals.

While some crimes are distinguished by the intention of the individual — we treat murder very differently from deaths in road accidents — many are based on strict liability. If I drive at 50 miles per hour in an area with a 30 mph speed limit, I commit an offence. Period. Even if I did not know there was a speed limit, was taking a desperately sick child to hospital, or feared I might be late for an engagement with the Queen. My state of mind might mitigate the sentence the Court will impose, but not the fact of my guilt.

The Senior Mangers' Regime introduced in the UK is a significant attempt to apply this approach, moving towards holding executives strictly responsible for the misdemeanours of their subordinates. But the provision has been watered down in the face of the misleading claim that the measure reverses the presumption of innocence. Its implementation has led to yet more box-ticking bureaucracy. But the line of attack is the right one. There should be no room for the bogus apology of "I am sorry the bank went bust while I was chief executive of it".

Q: You close your book with the assertion that businesses are the most important communities we have, and the argument that "the social responsibility of business is to conduct business in a socially responsible way." Perhaps you might expand on that?

A: Defining the appropriate boundaries of the firm — when to impose hierarchy, when to prefer market-based transactions — has been a preoccupation of business economists since the seminal 1937 article for which Ronald Coase was awarded the Nobel Prize. Yet as scholars looked outside the US and UK, they realised that other cultures blurred these distinctions. So, for example, how should observers characterise the geographic clusters of Northern Italy or the *keiretsu* of industrial Japan? And then the new millennium saw not just the emergence but the dominance of America's own cluster in Silicon

Valley. The growth of 'hollow corporations', such as Apple or Nike, which made nothing themselves but instead orchestrated the activities of others. And of businesses such as Facebook and Google whose customers were also their suppliers. Of global franchise operations such as McDonald's and Hilton, which offered branding and expertise to semi-autonomous franchisees. Of companies in the gig economy, such as Uber and Deliveroo, which claim that almost none of their personnel are employees. And then, in 2020, everyone started working from home. The boundary between what is firm/not firm is not well defined.

The individualistic philosophy which has dominated political and economic thought in the last half century has polarised agency between individuals and the state, and neglected the central role which communities of all kinds play in social and economic life. It is time to reassert that latter perspective, and to recognise that the successful firm is a community, and indeed one of the most important communities in modern society. It consists of a group of people working together for a common objective, which is not the maximisation of shareholder value. How did we ever come to think otherwise?

Sir John Kay *is one of Britain's leading economists. He has been a Fellow of St John's College, Oxford since 1970. In 1979 he became research director and then director of the Institute for Fiscal Studies, establishing it as one of Britain's leading think tanks. Author of many books, most recently* Greed Is Dead: Politics After Individualism*, his work is centered on the relationships between economics, finance and business.*

The Academy

"Cogs & Monsters"

An Interview with
PROFESSOR DIANE COYLE

Diane Coyle

Bennett Institute for Public Policy Cambridge

Q: Your latest book is entitled *Cogs & Monsters*. Why this title, and why this book, at this time?

A: We are the cogs: although it has moved on from the days when the Phillips Machine literally modelled the economy in a mechanistic way, conventional economics treats us as individual decision makers acting predictably. Its approach is 'methodological individualism', in the jargon of social science. The monsters populate the as-yet unmapped world of today's economy, just like the blank areas on old maps labelled 'Here Be Monsters'. One of the important features of digital technology, in particular, is that it makes it more likely there will be spill-overs from anybody's decisions onto others in the economy — in the various ways I describe in the book.

(For movie fans, there's a hint of a reference to *Gods and Monsters*, and the toast to Dr. Frankenstein's new world!)

Q: Early into the book you reference Keynes' famous quip about policy-makers being enslaved to "some defunct economist," and go on to warn of a bigger worry — that today's policy-makers "are often the slaves to a simplified version of the predominant conventional wisdom of the current generation of academic economists." Can you expand on this?

A: Like any other discipline there are tides and trends in economic thought. A good example would be the ascendancy of rational expectations and efficient market types of models in the 1980s, when this became the approach that was set out in textbooks and taught in many universities. Most students of economics, including those who go on to policy jobs, as many do, have the ideas prevailing from their student days cemented in their minds. If you learned your economics then, your starting point will always be the presumption of 'free' markets being best, never mind that such an abstraction doesn't exist. This is human nature, but it explains Keynes's comment.

However, the issue is a bit more complicated because events and ideas and actions reinforce each other. The dominance of the rational, market-oriented approach was a reaction to the economic crisis of the late 1970s, stagflation and oil price shocks, unemployment, and industrial unrest. The prior 'Keynesian' model, of government management of the economy, seemed to have run out of road. Policy makers responded by making decisions in line with the new way of thinking, such as deregulation of markets, and particularly financial deregulation. Inevitably, the translation loses nuance when the ideas are put through the sausage-making process of politics and bureaucracy. Eventually — and this might take decades — the simplified version causes the problems that lay the ground for the next crisis.

We seem now to be at one of those points where there is a switch under way in the shared mental model about how the economy operates. Many people have quoted Gramsci: the old world is dying, the new one struggling to be born.

Q: You raise a provocative question in the book: "Why is there no Government Chief Anthropologist?" What does anthropology have to contribute to economics and to economic policy-making?

A: There's an interesting recent example of anthropology making a significant contribution to public policy, in the response of western experts to the 2014 Ebola outbreak in West Africa. Funerals were one way the disease accelerated, and anthropologists familiar with the affected countries were able to advise medical and public health experts how to alter funeral practices in ways consistent with local imperatives. Closer to western economies, quite a few tech companies employ anthropologists and other social scientists as well as economists, and of course psychology has long been important in the business world.

In government, though, economists have held sway since the post-war era, and are both numerous in policy-making and influential in the way economic thinking has shaped how policies are devised and justified. Just think for example how often a policy is adopted because it is expected to increase GDP. And, in many countries, there are government chief economists or prominent economic advisory councils. This has led to an overly-narrow way of thinking about the problems governments want to tackle.

For example, cost-benefit analysis is a useful tool for thinking about whether to introduce a regulation or make a major public investment. But why should economic efficiency be the only criterion for making the decision? It might be reasonable to decide that an 'uneconomic' museum or gallery has benefits in terms of community pride or sense of identity (and indeed sometimes unanticipated economic regeneration benefits as a result — think of the Guggenheim in Bilbao for instance).

Policymakers are getting more interested in social psychology for sure, not least because of the need during the pandemic for people to change their behaviour. Anthropology is a natural companion discipline. There's a broader point about the way useful knowledge in some important domains of policy and research crosses disciplines. In the areas I work on, engaging with computer science and engineering is essential. For other economists it might be epidemiology, or environmental science. Yet, in general, economists are more inward-looking than other social scientists — for example being less likely to cite research from other disciplines.

Q: Throughout the book, you observe that "individual human choices have a social as well as environmental context" and argue that context matters more than cognition in shaping decisions. Can you say more? What might this imply in the practical terms of managing day to day operations in organizations made of up human decision-makers?

A: It should not be news — although it seems it is to some of my fellow economists — that our decisions are strongly influenced by our social environment. Social norms can be powerful: think how quickly smoking has gone out of fashion, or gay marriage has become widely acceptable. There are norms in choices about what career to pursue, such as gender norms (females study psychology, males economics), or in purchasing decisions (as marketers exploit constantly). A category of some kinds of goods — 'positional goods' that are in absolutely limited supply (such as Old Master paintings or country estates) — are valued largely for reasons of social status.

Decisions by others can sometimes be far more constraining than this. One of the well-known 'traps' in economic development is the low-skill trap: individuals do not bother getting more education and training because the jobs in their area are low-skill jobs and there would be no return to their effort; but employers only offer low-skill jobs because the pool of potential applicants has a low general level of qualification.

Even what you might think of as a wired-in feature about decision-making, whether or not we make rational choices, is in fact shaped by context. I was set thinking about this by reading about what's known as 'biological markets theory'. This concerns the fact that all kinds of creatures (pigeons, rats, monkeys, even fungi) act as if they are the ultra-rational *homo economicus* of economic textbooks in the way they allocate resources (generally their food). Behavioural economics has demonstrated that, often, people do not act like this, but rather operate with Daniel Kahneman's 'fast thinking' — intuitive and 'biased' heuristics. And people have limited bandwidth, so if they are stressed in some areas of life, they can make poor decisions in others. Yet we surely don't think humans are somehow 'less rational' than pigeons?

It seems that the decision-context shapes the kinds of choice being made; the greater the uncertainty and the further into the future people have to look, the more likely they are to use rules of thumb rather than calculation, or to be influenced by social norms and expectations. What I take from the literatures in psychology and biology is that we have a lot yet to learn about the way people take decisions, and how our internal wiring for making decisions and the external context interact.

The greater the uncertainty and the further into the future people have to look, the more likely they are to use rules of thumb rather than calculation, or to be influenced by social norms and expectations.

Although I've been focusing on policy, the same considerations apply to management, too. Managers need to think about the decision context in which their employees and suppliers are making choices. In an economy that's increasingly intangible, and where investment in intangibles is increasing the lead of the most successful companies over the rest, the social environment within companies is incredibly important.

It's only if there's a high level of trust, if skilled employees have the authority to use information and take decisions, that companies will thrive. Across most OECD countries, the divergence between the frontier firms and the rest is growing, and many companies seem to find it hard to organise themselves in ways that can use new technologies productively.

Q: The topic of trust in institutions features in much current commentary in the mainstream media. You call this out in your book and tie it to a need "to put the social, not the individual, at the heart of the study of economics." Can you say more? How does trust in institutions tie in to shifting economics towards a sociological perspective?

A: Economists often talk about the importance of 'institutions' in determining the success or otherwise of an economy, in quite an abstract way. Trust is one way of thinking about whether institutions will be successful, because the existence of trust reduces the costs of economic transactions and decisions. As well as the example I just gave, it means it matters less if there is asymmetric information (say, when a supplier knows more than the purchasing company about the technical specifications and performance of a component). At a larger scale, it makes it easier to use tax revenues to pay for public goods, such as the education system.

Yet there is surprisingly little role for trust in much of modern economics. There is no consensus about how to define and measure it — perhaps because it does overlap with sociology, or perhaps management studies and political science. It's a significant gap in my view: how can we continue to assert 'institutions' matter without investigating in much greater detail what this means? Shouldn't we be measuring trust as a standard economic statistic?

Q: You make a sobering comment late in the book: "we are in a period where there are no clear worldviews to shape policy decisions," warning that this *rudderlessness* occurs amidst, "profound voter discontent and loss of trust." Where does this leave us? How do you see things unfolding near term in this regard? In the longer term?

A: As mentioned above, this seems to be a period when a received set of ideas in public debate and reasoning about the economy is losing traction. There is polarising debate about economic policy areas such as monetary policy, or competition policy, after decades of broad and technocratic consensus about how to operate these. The last time there were such debates was during the late 1970s and early 1980s, a similar period of crisis-prompted questioning. There are other forces, including rising nationalism and geopolitical tensions and of course the pandemic, but there's no doubt that there is quite a widespread challenge to decision-making by 'experts' or 'elites'.

You could take either the pessimistic view that this polarisation will lead to political instability and continuing slow economic growth — which means slow or no improvements in living standards. Or you could be optimistic and conclude that this moment is an opportunity to adopt a more socially-oriented public philosophy that will better fit the kind of economy we have now, with the many ways in which individual choices affect others. I don't know which way things will go, but one prediction I will make is that there is likely to be an unsettled decade ahead.

Q: As you close your book you instruct that economists must work far more so with people in other disciplines, among them, the social sciences and computer sciences. As this series of reports reflects, bank regulators (among others) have been placing increased emphasis on behavioral science and data science in connection with the governance and supervision of culture and conduct risks. What words of advice might you offer them as they continue to explore these ideas?

A: My advice would be to think more broadly. There is a tendency for technocratic regulators to decide that their problem is that their tools don't work so well anymore, so they need new tools: more and better data, algorithms, and what they take to be more realistic assumptions about how people take decisions. This is dangerously simplistic.

Better assumptions and data are good things, but this is a misdiagnosis of the problem. Indeed, I could foresee a backlash against what people might see as manipulation by experts and decisions by computers against which there is no appeal. Governance and culture need broader insights from history and sociology, say, or even philosophy. Regulation is a difficult task, aiming to influence the behaviour of very many individuals acting within a structure of their company and broader financial markets, so not one that can be done mechanistically. There is no easy fix.

Shouldn't we be measuring trust as a standard economic statistic?

Q: Lastly, you have said that we need to stop pretending that economics is based on 'truths' rather that value-laden thinking. You tie this in with the demise of trust in experts. Indeed, this is the closing point in your book: we need to adopt a Political Economics perspective. What do you mean?

A: Mainstream economics was greatly influenced in the 1930s by logical positivism, the philosophy that knowledge consists only in logic and empirically verifiable facts. It therefore sets aside questions about distribution, with a definition that 'efficiency' requires that no single person is made worse off by a policy or transaction. So, a policy that reduced the income of a millionaire by $1 and increased the income of the poorest 10% by $100 would not be 'efficient' on this definition.

This is, needless to say, a value-laden criterion for judging policies, but the choice of the word 'efficiency' misleads even economists into thinking that they are able to make objective judgements about what is a 'better' policy. This explains why so many advocate for independent central banks, or competition authorities, so as to make 'objective' decisions outside the biases and bear-pit of politics. Trying to be impartial is clearly desirable. Fooling yourself that you are impartial is not. Economics started out as Political Economy and that is what it will always be in practice.

Diane Coyle *is Bennett Professor of Public Policy and co-director of the Bennett Institute at the University of Cambridge. Author of many books, most recently* Cogs and Monsters: What Economics Is, and What It Should Be*, her research focuses on the digital economy, and the measurement of economic wellbeing. She has held many policy roles, and is currently a Fellow of the Office for National Statistics and academic adviser to the Competition and Markets Authority.*

The Academy

Trust and the Scale of Management

By ROBIN DUNBAR

Robin Dunbar

We are apt to forget that, as a species, we have only lived in settlements of any size for around 8000 years, and in large scale complex societies for considerably less than half that time. For most of our history back into the mists of time, we lived as hunter-gatherers. The basic building blocks of hunter-gatherer societies are living (or camp) groups of just 30-50 people; several such camp groups cluster together to form a local community (of 100-200 people), several of these in turn make up a tribe of typically 1000-2000 people (formally defined by the language they speak).

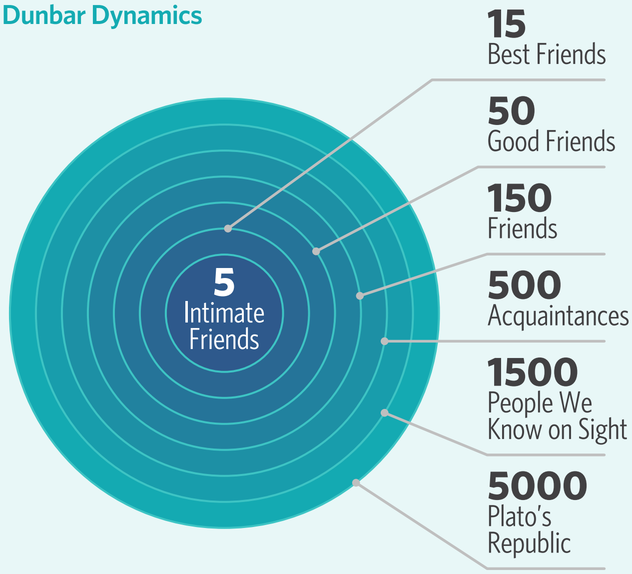
Beyond the tribe, the world was largely anonymous and rather menacing. Our psychology is designed for this small-scale world. Nonetheless, we have been able to exploit some features of that small-scale psychology to enable large settlements, and even modern nation states, to survive — tolerably well, even if somewhat imperfectly. In large measure, this has been because of two key features of our social psychology that build on very ancient roots. We share with the anthropoid primates (the monkeys and apes) a unique form of sociality based on what amounts to an implicit Rousseauian social contract. We club together in a group so as to share the costs of surviving in a world that, thanks to predators and raiders from our own species (predators by another name), is not always conducive to survival. As an individual, you are not obliged to bear a share of those costs, but avoiding them is only possible by leaving the group — hence losing access to the benefits. Importantly, everyone loses by your departure, since the benefits are directly related to the size of group we can maintain as a coherent social entity.

Maintaining a social contract of this kind depends crucially on trust — trust that others will not exploit your generosity in bearing some of the costs incurred or stab you in the back when you least expect it — metaphorically or literally. The problem is that, like reputations, trust takes time to build up but can be lost instantly by one false move. Trust is something that exists only between individuals: even when those individuals are sometimes seen as an institution, what we envision is not the institution but the individuals that make it up. Like all other primates, we build up trust by spending time with someone and interacting directly with them.

Time is fundamental to this process. Trust does not arise from what you tell me but from what you do and the way you behave towards me. In primates, that is mediated by grooming. Grooming creates a sense of bonding and trust through specialised neural systems in the brain. In humans, this mechanism has been amplified and expanded to include a suite of peculiarly human social behaviours that trigger the same brain system: laughter, singing, dancing, feasting, the performance of communal rituals and storytelling. It is the sense of warmth and emotional closeness generated by these activities that creates the sense of trust.

The frequencies with which we (and, of course, other primates) interact with each other in these ways is very structured. We typically devote 40% of our total social time to just five people, and around 60% to just 15 people. Beyond this, we devote rapidly declining quantities of time to those outside these circles. The way we distribute our time (and, indeed, emotional capital) exhibits a very distinctive pattern that yields a series of concentric circles around the individual at very specific group size — 5, 15, 50, 150, 500, 1500 (where these circles, or layers, are counted cumulatively).

Dunbar Dynamics



These groupings reflect three interrelated aspects of natural human social organisations: frequency of contact, trust and scaling. The frequency with which people interact at a personal level — the casual meetings over the water cooler — determines the level of trust they have in each other. Time, however, is always a limiting factor in life: if we invest equally in all our relationships as organisation size increases, we would quickly find ourselves with many very weak, casual relationships that offer little in the way of trust. Instead, we deliberately partition our time so that most of it is focussed on those few individuals that really matter. In this way, a spider's web of strong contacts is built up that allows us to exploit a friend-of-a-friend effect. That way, I get the benefit of your friend without necessarily having to invest heavily in them as well as in you. I rely on their sense of obligation to you to motivate a degree of obligation on their part to me.

However, even this effect has its natural limits. The friend-of-a-friend effect diminishes inexorably with every successive link in the chain. Eventually, it inevitably drops to zero. Nick Christakis's seminal studies of the data from the Framlingham Heart Study[1] have suggested that, in fact, these network effects are quite shallow, extending only to friends-of-friends-of-friends: the Three Degrees of Influence Rule. Beyond that, it is not possible to identify any significant influence due to personal relationships.

One solution we have exploited historically has been the capacity to form a commitment to a group. In this respect, humans differ radically from monkeys and apes. The latter become members of a group by virtue of their commitment to the individual members. Of course, humans do that too, but we also have a very distinctive capacity to form a more anonymous commitment to the group, whoever else is in it. This clubbishness allowed us to radically increase the size of our social groups, and paved the way eventually for the creation of organisations.

To aid with this form of group bonding, we exploit various cultural traits to leverage group membership. Uniforms and badges, particular styles of speech or the use of semi-private acronyms, stories of the organisation's foundation myth — all these play a seminal role in allowing us to create organisations of considerable size. These traits are based on the same set of relationships that we use to bond our more conventional friendships — a set of traits that we refer to as the Seven Pillars of Friendship. The Seven Pillars are a set of cultural dimensions that define the quality, or emotional closeness, of a relationship — shared language, location, education, hobbies and interests, religious and political views, musical tastes and sense of humour. If I don't have to explain my joke to you, it is because you belong to my community and are familiar with the community's style of humour. The more Pillars you and I share in common, the closer our relationship is likely to be and the more altruistically we will behave towards each other.

The Pillars are, in effect, a short cut to trust. They allow us to identify someone who belongs to our community within minutes of first meeting them. More importantly, it is remarkably nuanced in its targeting of communities: the more Pillars we share, the smaller and closer that community will be. It is the mechanism that underpins corporate identity as well as national identity. Indeed, the religion Pillar seems to work especially well on the transnational scale.

It is important to appreciate that the religious Pillar extends beyond mere membership of a particular religion. It includes political and moral views, and might be better envisioned as your worldview — how our community sees the world and the way it works, how we should behave towards each other, and why we belong to that particular community (something that often has a religious dimension, of course). One feature of religions, of course, is that they have foundation stories as well as moral injunctions. Those foundation stories commonly consist of two parts: the discovery of some novel way of thinking about the world and how to behave within it, and a story of struggle to be heard and become established.

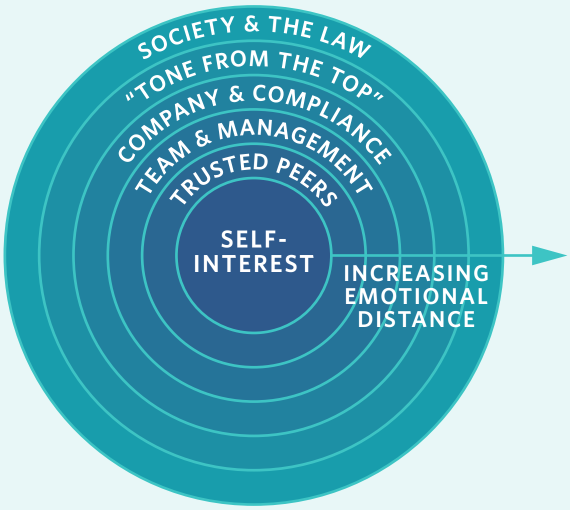
It will not escape notice that many businesses have exactly these kinds of stories as part of their corporate history — and I am not referring to those meaninglessly absurd 'mission statements' that every organization feels obliged to display in the entrance foyer. This is about the sense of organization as a community of like-minded folks. Someone invented a novel product that offered a social or economic benefit; there was a struggle to fund its development, and then break into the market. Some businesses exploit this corporate foundation story more effectively than others. Businesses are not alone in this, of course. Every government agency, every hospital, every school, every university has its own history and social check book: the organisation was founded to provide a common good for the citizenry, and its employees have an esprit de corps built around this service. That creates a form of internal loyalty that takes precedence over anything that the person at the top might say.

The deep psychological significance of these kinds of historical and corporate motivations is important for creating a sense of belonging. But it is not the whole story. It is all very well creating a sense of corporate belonging, but an organization is not an anonymous beehive. They are human creations, and hence they are necessarily social. The internal dynamics of any business is subject to the same stresses of scale as those that threaten to destabilise our social networks. When both get too large, they start to fracture and fall apart.

The internal dynamics of any business is subject to the same stresses of scale as those that threaten to destabilise our social networks. When both get too large, they start to fracture and fall apart.

In our normal social world, we mitigate this problem through the fractal structure of our social networks. This fractal structure, reflected in the layers at 5, 15, 50 and 150 and beyond, provides a degree of structural stability in networks through a friends-of-friends effect. This is because the layers seem to consist not of individuals but of three distinct subgroups — hence the 'rule of 3' that seems of operate in the structure of the layers. These are my own subgroup from the layer below, a more distant family subgroup (perhaps cousins and their parents) and a less close friend subgroup, with each subgroup forming its own discrete network that maintains it as a cohesive unit. So, instead of having to maintain relationships with everyone in each layer, all I have to do is maintain a relationship with my own subgroup and rely on the links some of these have with the other two subgroups to keep the three subgroups bonded. This pattern seems to be repeated in successive layers. And we see something similar at work within organizations.

The Rule of 3 at Work



This model has been exploited by the military in the structure of modern armies, with the 'rule of 3' being maintained by several further layers beyond those we would find in social networks — bonded by a combination of a sense of camaraderie at its lowest levels and a common sense of purpose, foundational story and totemic figurehead at the higher levels. It seems to work very efficiently in terms of structural cohesion, and there is now evidence that the particular layer sizes that form its core are natural 'attractors': they are network sizes where information flow is especially efficient. It is the kind of model we need to think about in organizations.

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The Academy

AI, Organizational Alignment and Culture

By DAVID KIRON

David Kiron

MITSloan Management Review

In the early 2000s, I worked briefly with professor Robert S. Kaplan at Harvard Business School. We wrote a case study together on Worldcom's accounting fraud, one of the largest, most costly deceptions in the history of commerce. At the time, professor Kaplan was famous: his work on the Balanced Scorecard had changed the way people think about business. I was a lowly researcher, fresh from grad school in philosophy, who knew neither what a Balanced Scorecard was nor that this approach to tracking financial and non-financial information was a big deal. It was a wonderful experience (for me): I got to learn from a great thinker and person.

A few years ago, professor Kaplan agreed to an interview with myself and my MIT colleague Michael Schrage for a research project that we were doing on next-generation key performance indicators (KPIs).[1] He was a natural interview candidate. He had helped develop and popularize the concept of KPIs and how to use them; such as to communicate strategic objectives so everyone knows what to do and why; to hold people accountable for their performance; and, to align organizational behaviors toward a common set of visible objectives.

During the interview, we asked professor Kaplan about the growing use of machine learning to refine KPIs. Our own research was finding that more companies were using KPI outcome data to train machine learning algorithms to evaluate strategic and operational assumptions. How did his views on KPIs need to change, if at all, to accommodate this shift? In short, his response was ... not so much.

Professor Kaplan pointed out, that ML/AI tools were being used to better achieve KPIs set by management. His own work, he said, was focused at a higher conceptual level: helping executives to define and communicate KPIs and to align behaviors around these metrics. His message was clear: determining what to measure, which KPIs to focus on, was the critical leadership challenge. How you make progress toward these objectives is more of a lower-level management concern. An important one, to be sure, but one that wasn't his key area of focus.

This conversation was a pivotal moment in my own thinking about the role of measurement in strategy making and execution. Clearly, a company's system of strategic measurement is built to support objectives determined by leadership. Given that, how you measure is less important than what you measure. Of course!

But our research was identifying a new wrinkle: executives were using artificial intelligence and machine learning to discover new ways to drive growth, identifying and enabling new metrics and new behaviors.[2] These weren't efforts to create new products or new efficiencies with AI. Rather, we saw companies using multiple datasets and AI to expand the time horizon and characteristics of customer lifetime value. AI wasn't just helping managers to increase customer lifetime value, it was changing how they defined it. This is not a subtle shift.

And it's increasingly common. A television executive gave her data science team 50 years of KPI outcome data, and 50 years of consumer research, asking whether the KPIs she had for assessing a TV show's performance were still useful. Their answer was that other KPIs should be added to her list. The data scientists changed how executives assessed a show's performance. They weren't using AI to change the content of any show, they were helping to redefine what it meant for a show to perform well. Again, this is transformative and non-subtle.

A new trend is emerging: how you measure can be just as important as what you measure. We have observed many business leaders asking their teams: Do our metrics fully capture what drives value creation in our business? How can we use technology to improve our system of measurement — that is, how we create, assess, and use our metrics to better discern these drivers and identify better KPIs? These leaders are rethinking their approaches to measuring success, to developing metrics, and to building organizational alignment. Their data-driven companies employ predictive analytics such as machine learning, along with leadership acumen, to identify and refine key strategic measures. More finely-tuned measures lead to better alignment of behaviors with strategic objectives.

The upshot: it is no longer simply what you measure that determines what you manage. It's how you discover what to measure that determines how you manage.

The upshot: it is no longer simply what you measure that determines what you manage. It's how you discover what to measure that determines how you manage. In industry after industry, we see innovative analytics leading to innovative metrics and new organizational behaviors that drive superior performance outcomes.[3]

One example comes from the technology sector. For most of its long history, IBM relied on management intuition and HR data to assess attrition risks — until Diane Gherson, IBM's chief human resources officer at the time, recognized that predictive analytics could do a better job of supporting the company's retention efforts. Under her guidance, IBM created a machine learning algorithm that could better assess which employees were preparing to leave the organization, offering recommendations to managers about what to do to keep them.

The IBM algorithm analyzes dozens of variables and millions of data points to deliver an analysis that is far more accurate than pure management intuition. Managers use the algorithm to identify the individuals to target for development conversations about cultivating skills and careers within IBM. The algorithm delivers perspective to managers and workers alike about skills and career development opportunities that connect with strategic needs across the IBM portfolio, in areas like cloud computing and AI. What's more, the tool helped change the content, tenor, and effectiveness of manager-worker communications.

In short, predictive analytics changed not only how the company measures and manages attrition; it also improved how it aligned behaviors (such as conducting development conversations) with IBM's strategic objectives to improve skills and increase retention. IBM would not have improved its retention outcomes had it relied on the old way of measuring and managing attrition, via management intuition and HR data.

Our research shows that companies are developing, connecting, and pursuing a blend of analytically sourced and executive-determined KPIs. This hybrid approach to determining strategic metrics — in which KPIs are both determined by senior leaders and emerge from advanced analytics after strategy is set — has several implications for strategy development and strategic execution.

1. Using AI to source new indicators of success blurs the line between strategy development and strategy execution. Strategies make assumptions about how best to achieve organizational goals. Strategies tell you where to invest and what not to do. But, leaders can use AI to reassess strategy-related assumptions about the performance that matters most. AI can help redefine, not just improve, performance.

2. Leaders need to be accountable not only for their performance on a given set of metrics, but also for how well their strategic measurement system can test existing strategic assumptions and formulate new strategic hypotheses. They need to be accountable for accountability. Leaders need to hold themselves accountable for developing strategic measurement systems that can deepen their understanding of factors driving KPI outcomes, generate new KPIs, and adapt to new KPIs. Developing an analytics capability that can test and learn is itself an important objective, and it's critical to support that with sufficient investment.

AI can help redefine, not just improve, performance.

3. KPIs help align organizational behaviors toward strategic objectives. AI supports these alignment efforts in at least three ways: One, leaders can use AI to source new indicators of success, new KPIs. Two, leaders can use AI to align organizational behaviors with new KPIs. At IBM, managers use AI to inform employee development discussions that advance corporate objectives around building skills and capabilities in strategic business areas. Three, leaders can use AI to find new relationships among KPIs. That is, instead of merely maximizing performance on individual KPIs, AI can be used to optimize performance across KPIs. In a research project jointly conducted by MIT SMR and BCG, we show that organizations that achieve substantial financial benefits from AI are ten times more likely to change their KPIs compared to other orgs.

4. Using AI can also help align behaviors with strategic outcomes by improving culture, as well as KPIs.[4] Our research shows that deploying AI solutions that improve decision quality and efficiency also improve several aspects of team culture, including morale, collaboration and learning. At the airline KLM, for example, managers use AI to identify passengers who are most at-risk to miss their flight after they had checked in their bags. Removing stowed luggage is a common but time-consuming process that can delay departures and frustrate passengers and airline crews alike. With its AI solution, KLM loads at-risk passengers' luggage last: making it easier and faster for baggage handlers to remove; reducing the need for flight attendants to pacify passengers waiting on the tarmac; and, improving on-time departures — an important metric within the industry. With AI, baggage handlers, flight crews, and gate attendants work together more effectively: their actions are better aligned toward on-time departures.

Deploying AI solutions that improve decision quality and efficiency also improve several aspects of team culture, including morale, collaboration and learning.

Companies too often focus on creating a strategy for AI, and not enough on how to conduct strategy with AI. If you use AI only to improve performance, you are missing something important. Our research strongly suggests that the companies that win with AI are, and will be, those that effectively develop strategy for and with AI.

Using AI to align the organization is a process I call predictive alignment. It's a fundamentally new organizing principle for aligning organizational behaviors with strategic objectives. And it represents an untapped potential for organizations that focus on using AI to lower costs and improve efficiencies.

These observations complement other perspectives discussed in this report. Using AI effectively can have a significant effect on organizational alignment, team performance and culture; it can also improve the outcomes that firms produce for shareholders and other stakeholders.

David Kiron *is the editorial director of* MIT Sloan Management Review*. Previously he was a senior researcher at Harvard Business School and a research associate at the Global Development and Environment Institute at Tufts University.*

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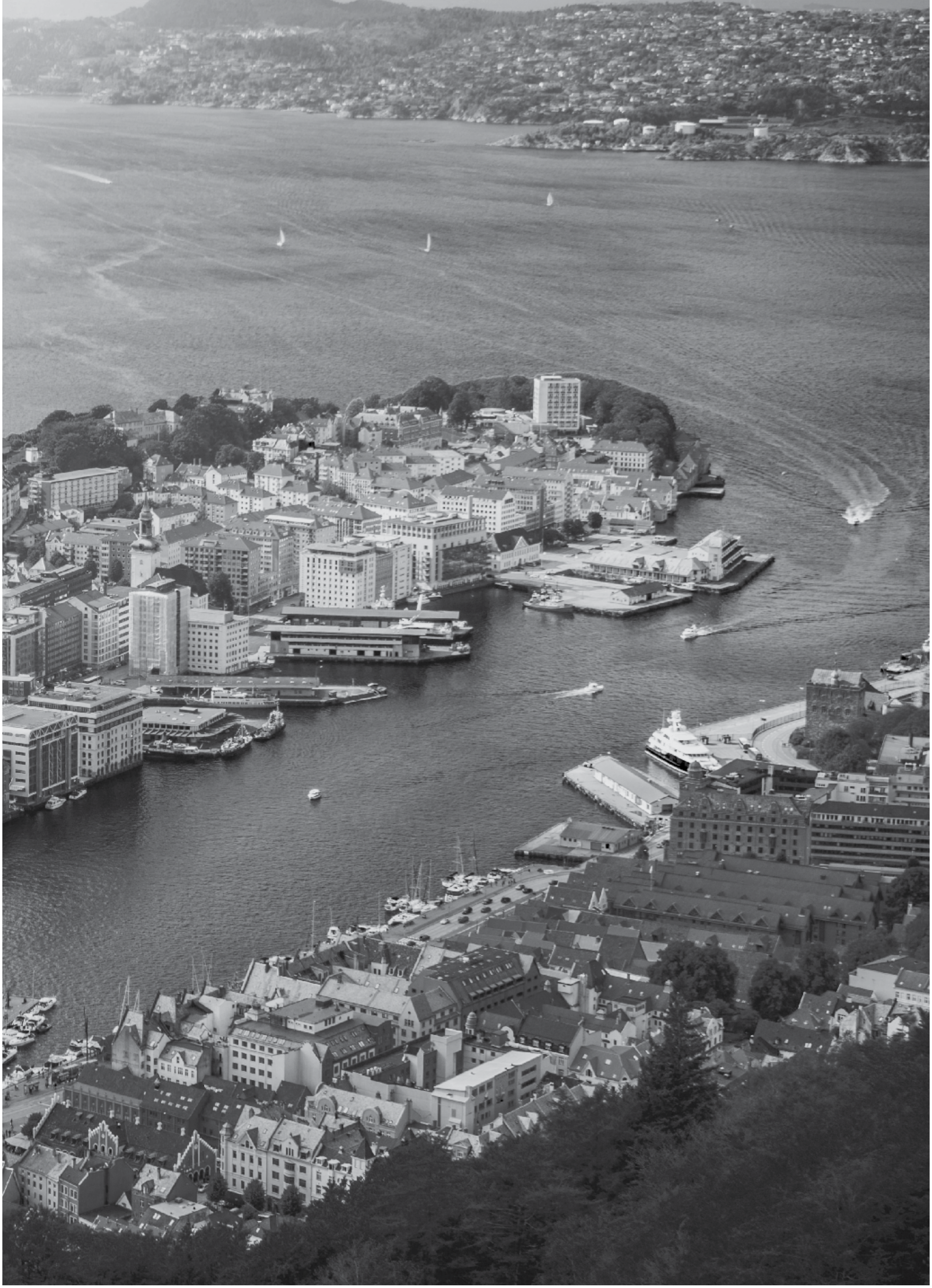

The Academy

An Interview with Professor Karin Thorburn

Karin Thorburn

Q: In 2003, Norway became the first country to set a quota (40%) for the number of women firms must appoint to board roles. Can you share a bit about that history and what drove that policy priority?

A: The quota was a social policy measure. Norwegian politicians were pushing for gender equality in many different settings, and in the early 2000s, the limelight fell on corporate boards. At the time, about five percent of the directors of publicly listed companies were women. The Norwegian Parliament adopted the quota in 2003, but with a sunset provision. If shareholders voluntarily gender-balanced the boards over the next two years, the quota would not be mandated. However, by December 2005, the fraction of female directors had only reached about 15 percent. So, the government wrote the quota into corporate law and gave firms two years to comply.

Q: You have studied the impact of this quota on subsequent company valuations. What have you found?

A: There are reports documenting a positive correlation between female directors and corporate performance. However, this correlation does not imply causality. It is possible that profitable firms are more prone to appoint female directors or that women are more willing to accept board positions in well-run firms. But, with a quota, the causal direction is clear. The forced change in the board prompts a potential change in performance. This causal relationship is what makes it so interesting to study the effects of a quota.

Economists typically view boards as the optimal outcome of shareholders' free choice. The concern with a gender quota is that it restricts this free choice of directors; hence, reducing board effectiveness. If female directors generally lack the necessary qualifications, forcing the appointment of female directors can reduce the board's ability to monitor and give advice. Therefore, a board quota may lead to poorer corporate decisions and ultimately reduce firm value.

The counterargument is that director searches traditionally have been limited to closed male networks, overlooking potential candidates that could broaden the board's skillset and experience. Under this view, a quota may force firms to cast a broader net when recruiting directors, improving board independence and effectiveness, and increasing firm value.

Of course, a third possibility is that there is a sufficiently deep pool of qualified board-ready women that a quota won't matter for firm performance.

We were interested in this debate, partly because an earlier study claimed that the Norwegian quota destroyed up to 20 percent of the value of listed firms with all-male boards. But take a step back and think about it. The average board had five shareholder-appointed members, two of which must be female under the quota. So, is it plausible that two new female directors could be so incompetent and influential that they could convince the board majority to make such bad decisions that they destroy 20 percent of the firm value? Also, if the loss of the two male board members causes the value decline, shareholders could retain their experience and skills by simply adding three new female directors to the current board. As it turns out, the average board size did not change after the quota. Hence, shareholders must have considered the new female directors sufficiently qualified to replace the departing males rather than expanding board size.

The forced appointment of female directors to the all-male boards had no valuation impact.

We examined the stock market's reactions to different legislative events that increased the likelihood of quota adoption. Importantly, the stock-price response to all these events was close to zero, also for firms with all-male boards, so there was no indication that investors viewed the quota as costly. As a side note, we discovered that the earlier study had failed to control for the cross-correlation in stock returns, i.e., that stock prices tend to move together on the same day. Therefore, after making the appropriate econometric adjustments to the earlier study, there was no support for their claim that the quota had destroyed value.

We also formed portfolios of firms with all-male boards vs. boards with female directors before the quota and found no difference in their long-run returns. So, the forced appointment of female directors to the all-male boards had no valuation impact. We also couldn't find any effect on the operating profitability of listed firms compared to firms not regulated by the quota. Overall, the evidence indicates that investors viewed the Norwegian board gender quota as value neutral.

Overall, the evidence indicates that investors viewed the Norwegian board gender quota as value neutral.

We also studied how corporate boards changed in response to the quota. One concern was that the new female directors would have less CEO experience. While this turned out to be true, firms maintained the overall board-level CEO experience by replacing the less experienced male directors. Another concern was that a shortage of qualified female board candidates would lead to a concentration of board seats among a small group of women and that these "golden skirts" would be too busy to perform their board duties well. However, looking at the data, there was no increase in board seat concentration following quota compliance. Hence, the evidence suggests that the pool of qualified female directors was sufficiently deep, corroborating our finding of a value-neutral effect of the quota.

The financial press has repeatedly reported that Norwegian firms fled the stock market to avoid the quota. However, these reports are wrong to attribute the delistings to the quota. The companies that delisted were acquired or filed for bankruptcy. Given the complexity and cost of such transactions, it is highly implausible that firms would undertake them to avoid appointing a few women to the board. Moreover, the influx of firms listing on the stock exchange exceeded delistings, so the total number of listed firms kept growing through 2007, as the quota was phased in.

Q: Norges Bank Investment Management (NBIM), which manages the Norwegian sovereign wealth fund, stated last year that it wants to see the companies in which it invests — globally — boost the number of women on their boards, and to consider setting targets if fewer than 30% of their directors are female. What is your view on this?

A: NBIM's investment mandate is to maximize the fund's expected returns at an acceptable risk level and to be a responsible owner. As part of its shareholder engagement strategy, NBIM issues position papers that describe what it expects from the portfolio companies, which form the basis for voting. These policies typically address generally accepted principles for good corporate governance, such as board independence, separation of chairperson and CEO, management compensation, and directors' time commitments. As discussed before, board gender diversity has no valuation impact. It is a social policy issue and not a corporate governance measure. Based on NBIM's mandate, I don't think it should use its voting power to push social policy issues worldwide, including the gender balancing of corporate boards. That notwithstanding, I cannot imagine NBIM would ever divest itself of a company just because it has an all-male board. So, while the position paper on board gender balancing is toothless, it may make some Norwegian politicians feel better about the fund.

Q: Joining NBIM and many other institutional investors, Goldman Sachs Asset Management has announced that it will vote against board nominating committees at companies without a minimum number of women and minority board members. In the US, moreover, it will vote against all board members if the company has no female directors. What's your view here?

A: To attract capital, institutional investors must respond to the changing preferences of the individuals whose money they manage. Investors in the western world increasingly demand that their wealth is invested responsibly and in a manner that is consistent with their personal values. I think the growing institutional investor focus on board gender balance reflects a broader trend in society towards embracing diversity. On a personal level, I am in favor of more diversity in the corporate world. White men have traditionally held the high-powered positions in the private sector. The institutional investors are now stepping up to promote changes where the government has failed to act. I cherish their engagement in this issue. However, it is important to remember that it is not about investment performance but, rather, social policy. In other words, it is a means to attract clients by representing their values.

The argument that diversity is good corporate governance has no support in the research.

Q: In December 2020, NASDAQ filed a proposal with the Securities and Exchange Commission (SEC) to adopt new listing rules requiring its listed companies to have (or explain why they do not have) at least two 'diverse' directors, including one who self-identifies as female and another who identifies as an underrepresented minority or LGBTQ. The SEC approved NASDAQ's plan in August 2021 and this has since triggered at least one challenge in the federal courts. Specifically in terms of shareholder returns, what do you see at issue here?

A: I don't see any issue with adding board diversity to the listing rules. First of all, we know that board gender balancing does not affect firm value. Since the board is a team where directors complement each other, many minority candidates can add value to a board with their different skills and experiences. It is just a question of wanting to find them. But more importantly, the new Nasdaq rules only require the company to comply or explain. So, any company considering their potential female and minority board candidates to be less qualified can say so and make no change. If the opponents to the new rule consider this explanation legitimate, they would have no issue with the requirement.

Thus, the protests suggest that they are afraid of the market's interpretation of such an explanation, reading it as a sign of other underlying problems. For example, a failure to appoint female or minority board members can leave investors with an impression that management is unwilling to embrace change, harming investors' trust in the current leadership. Hence, the explaining part may reveal other less flattering fundamentals. I see no harm in this. Companies must stand for their actions, including a lack of diversity on the board. So, I take my hat off to Nasdaq for being progressive and adopting the new diversity rules.

Q: Arguments for increased diversity reflect public values held by many, but policy-makers and regulators tend towards justifying related initiatives in terms of producing improved corporate governance, with an uptick in firm performance and a decrease in anticipated conduct risks. What is your view on diversity as a governance matter?

A: As I have said before, the argument that diversity is good corporate governance has no support in the research. Instead, it is a social policy measure that reflects the changing values in society. I think policymakers and regulators should be honest about the rationale behind diversity initiatives, so voters can hold them responsible for their decisions. The changes may still be welcomed by many.

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The ESG Dilemma: The Many Meanings of 'Structure' in Machine-Readable Regulation

By ROBERT WARDROP

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Technology has the potential to deliver better regulation and compliance outcomes. To unlock this, regulators and firms need to converge around a consensus structure for representing both the relevant rules and firms' internal data. In this article, Bob Wardrop, Management Practice Professor of Finance at the University of Cambridge Judge Business School and Director of the Cambridge Centre for Alternative Finance, explains why this seems to be so difficult in the highly dynamic domain of Environmental, Social and Governance (ESG) reporting.

Feeding the machine: the case for structured regulatory data

A mix of technology change, geopolitical tension and sustainability challenges suggests that the world may be entering a period of unprecedented regulatory uncertainty. This uncertainty is making compliance with regulatory obligations more complex.

A growing number of organisations have concluded that there are diminishing returns from throwing more human resources at this complexity and are migrating to more machine-based compliance processes.

However, applications running on machines cannot 'read' the form of regulatory content that is published for human consumption by regulatory authorities. This needs to be translated into a machine-readable form using technologies like natural language processing (NLP) and machine learning (ML). This 'translation' consists of classification and information extraction tasks that impose structure onto the content. Structure, in this case, means applying an organising framework to content that sets out what data elements might (or must) exist within it, how they relate to one another, and how they should manifest. Structure, in short, is what makes content meaningful for the purposes of an application and its end users. And it follows from this that different use cases, or different user expectations and practices, call for different structures, even when the underlying data are the same.

Since the middle of the last decade, regulators too have joined the machine-readable movement with initiatives aimed at translating their entire rulebooks into a structured, machine-readable form — and imposing local, proprietary structures in the process. While this translation work is straightforward for obligations in relatively stable and internationalised regulatory domains like AML/KYC, it is extremely challenging in the emerging 'turbulent' themes like Environmental, Social and Governance (ESG) risk management and reporting, where practices are likely to vary greatly across the globe.

What characterises ESG obligations that makes this so difficult? And how can consensus structures play a critically important role in overcoming the obstacles?

The penny drops: origins of the demand for mandated structure

At the Cambridge Centre for Alternative Finance (CCAF) in the Cambridge Judge Business School, we sensed policymakers' growing interest in ESG long before it reached its current fever-pitch state. Our 'pulse meter' in this regard is our Cambridge Fintech and Regulatory Innovation online programme which, since 2019, has trained more than 1,400 financial services regulators and policy makers from 130+ countries, helping to guide them in designing and managing innovation initiatives responding to market innovation. As policymakers grapple with the digital transformation of the financial industry — the winners and losers, emerging risks and coordination challenges — we've learned to identify opportunities to deploy our research and technologies in order to create public-goods: tools that can help policymakers to help overcome these complexities and obstacles.

> A regulatory problem becomes machine-readable only by first developing a consensus structure for the relevant data.

ESG issues often come up in our work, informing our thoughts on the design of regulatory reporting frameworks, organisational reforms and supervisory tools. For instance, in the Spring of 2021, an official from a G7 finance ministry reached out to the CCAF to discuss their government's approach to regulating green finance and investment, and to explore how this could be implemented in a digital format. They posed a question that really struck a chord — 'how can we make our proposed legislation and rules as machine processable as possible?'.

Fundamentally, addressing this question revolves around the various methods of factoring traditionally non-quantifiable metrics into both the regulator's rulebook and the industry's go-to tools for managing compliance — for example, including culture and conduct metrics in traditional financial sector assessments and finding a place for them in the Governance, Risk and Compliance (GRC) systems used by firms.

The official was not alone in asking this question. Developments at the time were suggesting that both regulators and industry were aligning on recognising that a regulatory problem becomes machine-readable only by first developing a consensus structure for the relevant data.

Back in spring 2021, the policy world in many countries was going through an ESG frenzy, with governments and regulators scrambling to build taxonomies of green or socially responsible exposures, write disclosure and risk management rules for ESG-linked products, and align corporate reporting with the expectations of various international standard-setters. The compliance industry had also sprung into action, on the premise that ESG was, in principle, very much suited to being read and implemented by machines. One directory[1] alone lists almost 100 ESG-related compliance automation (RegTech) solutions and even that estimate is unlikely to capture the full population.

Within our research centre at the University of Cambridge, work was already underway on the Regulatory Genome Project. The RGP is an ambitious programme of work to create an open structure for representing the world's financial regulation. In fact, the first edition of the regulatory obligation taxonomy for ESG reporting and risk management was very nearly complete.

Understanding consensus structures

This was not a bad starting point. As already discussed, machines need to be given the references with which to see what is in front of them, or a way of assigning meaning to things. That's what structure does. The notion of a 'consensus structure' builds further on this concept — it is a shared framework of references within a peer group (say of firms, or policymakers, or ideally both), that can be used to ensure counterparties structure the same data in the same or in mutually reconcilable ways. A consensus structure, in other words, is one that preserves meaning across organisations and functions.

A 'consensus structure' is a shared framework of references within a peer group (say of firms, or policymakers, or ideally both).

This is perhaps a more dynamic meaning of 'consensus' than some readers will expect. It is not sufficient for all parties to agree that a particular representation of their data is useful or comprehensive or accurate; they must also adopt it in their operations — mapping their data and processes to it — and invest in and enforce harmonisation. It is relatively easy to observe domains where such a consensus structure is either missing or too static to make a difference. Some tell-tale signs are:

- **duplication of effort**, both within firms and industry-wide, as firms each produce exhaustive mappings of rules and data to their own internal information structures, oblivious to the huge overlaps between them and their peers.

- **organisational silos and lack of interoperability**, as different business functions and different software vendors insist on their own preferred structure, making it hard for information to flow correctly between peer groups.

- **vendor lock-in**, as it becomes prohibitively expensive for many potentially good vendors to compete with incumbents who have already produced mappings to their clients' information structures, thus restricting innovation and improvement.

Why is consensus more elusive in ESG?

From the playground to policymaking to bitcoin mining, to pursue consensus is to solve collective action problems. It takes near-total alignment to realise most of the benefits, up to which point individual parties' incentives will always be more salient and easier to realise. In the ESG space, it has often taken the full force of the law and furious backstage horse-trading, as with Europe's ESG taxonomy, to develop consensus structures. One reason is because the stakes are high. Technical-sounding discussions about whether a given 4-digit Standard Industry Classification code is 'Green' or not could translate into billions in lost investment, thereby affecting some national economies more than others. A convenor that does not have a government's power to compensate 'losers' is therefore at a grave disadvantage.

From the playground to policymaking to bitcoin mining, to pursue consensus is to solve collective action problems.

In more mature areas of regulation, the combination of an authoritative non-state convenor and a large economic prize can fulfil the same function. For example, the International Swaps and Derivatives Association's (ISDA) Common Domain Model (CDM) has achieved a large measure of success in digitising the regulatory and contractual treatment of derivatives. In the case of ESG, however, the regulatory and legislative framework, the consensus structure, and even the commercial practices around ESG labelling are being built and harmonised simultaneously. Horse-trading is harder when you can't see the horses clearly.

For this reason, ESG suffers more acutely than other domains from a common regulatory problem: mutually reinforcing risk-aversion. Regulated firms crave certainty and safety in numbers; and they are never keen to converge on standards without a good sense of the regulator's approval: why should they invest in structures that could be superseded by new rules, or even legislation? But regulators also know that they can rarely afford to promulgate, let alone maintain and enforce, standards at the level of detail that industry would find directly executable. They cannot provide their explicit or implicit seal of approval until they see how the standard performs under pressure, and unless they are assured of a sustainable governance structure. Indeed, where standards have worked in favour of compliance automation there is typically a relay between the regulator's relatively high-level rules (and guidance) and the more practical (and flexible) guidance provided by industry subject matter experts.

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Building the consensus structure for ESG

In broad terms, building a consensus structure for ESG has to date involved three work streams. First, it involved the adoption of an ontology of entities, concepts and functions. Then, the standardisation of data formats, identifiers and definitions so that all parties speak the same language and name all counterparties consistently. Finally, it involved the adoption of standard disclosures and metrics so that consumers and product distributors could make informed choices.

The latter of these three elements, the standardising of disclosures and metrics, has always been the work of regulation. But ESG is a good case study for how regulators are becoming increasingly willing to cover more of the former two elements than they have traditionally done. This is a journey that all digitally transformed regulatory domains have already embarked upon, from anti-money laundering to market infrastructure to data protection. Traditionally, regulators have been reluctant to influence or own industry standards at this operational level. In the RegTech era this needs to change, because the closer rules get to machine-executability the less open they are to interpretation. For detailed instructions to be trusted, they must either owned by regulators or delegated to industry. There is a risk that a small number of proprietary solutions from industry emerge as de-facto standards which dominate the market and stifle innovation, thereby artificially restricting the range of compliance outcomes beyond what regulators intended.

There are other challenges that need to be addressed. We convened an asset management Special Interest Group meeting in late 2021, as part of the Regulatory Genome Project, and the participants highlighted three noteworthy issues.

- Firstly, key ESG issues, such as greenwashing, represent both business and reputational risks that go far beyond compliance; firms may be at risk of obsessing over the reporting elements that are most readily machine-executable to the detriment of the business itself.

- Secondly, the proliferation of ontologies and standards is challenging for firms working across borders, which must ensure that requirements are not simply tracked and complied with, but are also reconciled across jurisdictions.

- Thirdly, data standardisation is crucial, but once complete it simply shifts the business and regulatory pressure on to deeper processes related to data use; such as data sourcing, quality assurance and governance.

Fundamentally, if the aim is to develop a consensus structure for relevant data, then we must overcome the problems created by having more than one type of structure being applied, and more than one interpretation of what data are relevant in the context of that structure.

Regulation-as-code and regulation-as-content

To put these challenges into context, it is useful to compare the two primary approaches for making regulation machine-readable (or even executable) in the first place.

Regulation-as-code aims to rewrite rules and the law as unambiguous statements invoking standardised data. Structure is built into the system by design. Get this right and software (sometimes referred to as 'rules engines') can then look up the relevant data and produce a compliant outcome — be it a decision, a report, a calculation, etc. — that is auditable end-to-end.

But many risks related to ESG products and disclosures, and certainly high impact ones at their heart are conduct risks.

If ESG regulations were to work well and achieve their goals one would not, in most cases, look for early evidence in changed portfolio allocations or consumer outcomes but in the governance and management of risks in the organisation.

Regulation-as-content accepts the current legal and regulatory language, with all its flaws and ambiguities, and aims to extract from it the types of entities and obligations it is discussing, the likely business functions and processes affected, and perhaps even some standardised action points (e.g., this obligation requires the creation of a policy; or the review of a document; or the signing of an attestation). Structure is thus imposed on the system, typically through applications of AI. The outcome of regulation-as-content is not typically an action, or report, but a pre-populated draft policy, impact assessment or gap analysis.

Regulation-as-code is the default mode of attack for reporting- and disclosure-related obligations, and so too for much of the drive towards ESG regulation. To some extent, this is because the regulators and compliance teams that first began to grapple with the implications of ESG were drawn from domains in which this mindset prevails. A lack of standardisation was the most overwhelming risk driver at the time, and this introduced a bias towards a structure driven by reported data fields.

But many risks related to ESG products and disclosures, and certainly high impact ones such as greenwashing, at their heart are conduct risks — they're about people doing and choosing the right thing (or failing to). Even operational matters, such as the over-reliance on noisy data, have deep roots in conduct — in what gets one promoted, which products are easiest to get approved, what arguments senior managers respond to favourably. More importantly, ESG rules are not aimed at the conduct of incompetent or rogue employees, but at their bosses and the tone and examples they set for the business.

If ESG regulations were to work well and achieve their goals one would not, in most cases, look for early evidence in changed portfolio allocations or consumer outcomes but in the governance and management of risks in the organisation. One would expect to see cultural change resulting from the changing tone at the top (and even observe the early "echo from the bottom"), long before any of the metrics currently tracked have moved the needle at all.

What should a risk-based, consensus structure for ESG look like? Regulators, firms and technologists will need to work together in coming years to answer this question.

Have we got ESG regulation backwards?

Attempting to regulate (and comply) for such outcomes thus brings regulators and firms into the regulation-as-content space, where the machine can never do more than help to augment human judgment. It also forces them to lean heavily on new and imperfect metrics of behaviour, culture and how these are changing. Without a consensus structure to guide both data collection and business practice, the opportunity for duplication, and for inconsistent aims and measurements between firms, is enormous.

In such areas one would ideally build a consensus structure that is part theory of change — tracing how, realistically, ESG rules might bring about their intended outcomes and identifying which persons, functions and policies the path runs through, from the Board downwards — and then tie visible outcomes to each path. The result would be a consensus structure built 'outwards' from the key risks and outcomes to be avoided, and then allowed to cascade into governance structures and senior management accountability, policies and controls, product features, the calculation and management of exposures, and the like.

This approach has the added advantage of applying symmetrically to all three elements of ESG. In current practice, artifacts such as exposure taxonomies have focused on 'E'; elements of ESG regulation inserted into corporate law or codes of practice have focused on 'G'. But an approach that works backwards from risk and how it is owned need not prioritise one element over the others.

The approach set out above is, to be clear, the exact reverse of what current ESG rules appear to emphasise. But firms are familiar with this way of working — from anti-money laundering to cyber-security, working backwards from the ownership of risks to the operation of controls is quite common, and especially so where the stakes are high. It might also be practically easier to achieve consensus in this way, without forcing industry to agree on thousands of variables at a time.

Which way now for digitising ESG compliance?

The approach advocated above will offer small comfort to policymakers who just want to make sure that popular ethical and green labels are not misused or arbitraged, and that firms cannot wiggle out of their obligations as good corporate citizens simply by renaming their exposures. There is no need for policymakers to de-prioritise these. However, when considering how to equip themselves to automate compliance, firms should think beyond the datapoint-driven approach that policymakers have taken to date, and seek solutions optimised for understanding real risk.

How will we know we're moving closer to achieving this? Well, risk models are an instrument of governance, not compliance. Well-understood risks lend themselves to consistent measurement or at the very least ranking that decision-makers can trust. They can be priced, however approximately; and their dependencies and correlations with regulatory requirements can be discussed with some certainty. Firms that understand their risks well do not need to keep guessing whether noisy data is bad data or simply data mapped to fuzzy, poorly-defined concepts.

What should a risk-based, consensus structure for ESG look like? Regulators, firms and technologists will need to work together in coming years to answer this question comprehensively, practically, and at scale. But one thing we do know even now: compliance- or data science- or tech expertise alone will not produce the answer for them. It will also take leadership, among the regulated and the regulators — and those who ultimately own these risks must avoid the temptation to free-ride on the efforts of others to realise a consensus structure and step up.

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ENDNOTES

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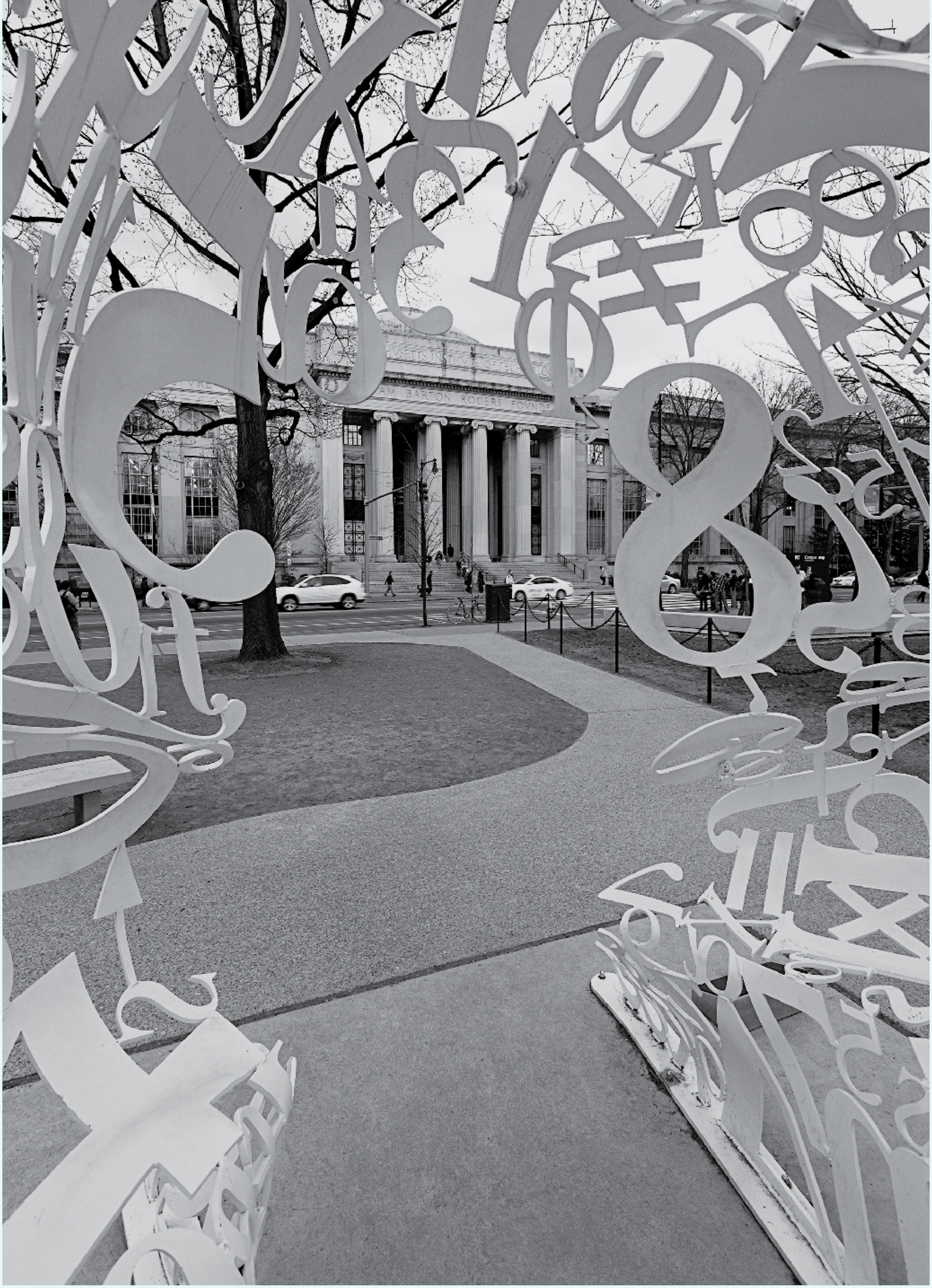
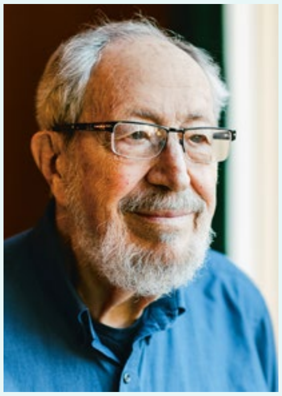


The Cultural Issues in Banking Safety and Effectiveness

By EDGAR H. SCHEIN



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Perhaps surprising to many, a detailed analysis of how to reduce risk and improve organizational safety is, in fact, also the best way to achieve the conditions necessary for long range excellent performance. A recent article offered a related analysis, with regard to how those in the banking industry might better protect themselves from conduct related scandals, risk management failures, and other events that increase risk and undermine productivity and excellence.[1] ▸PAGE 441

Here, I wish to elaborate on that article, offering a number of additional points and detailed discussion of risk management in industries or organizations where work is becoming more complex, and where excellence in performance is more and more essential.[2, 3] These remarks are based on my long experience in consulting on safety, risk, and performance improvement in a variety of different industries, and my work of the last six years on organizational improvement processes with my son, Peter Schein.

Point 1. Know the particular risk factors in your particular industry

It is tempting to assume that risk and safety issues are basically the same in all industries, but this turns out not to be the case. You need to figure out your risk factors and what to do about them based on where your industry fits along a broad dimensions of different types of risks in different industries identified by René Amalberti, a French safety expert.[4] He presents his comparative dimension in a metaphorical manner by asking: "In your industry do you feel more like a small fishing boat captain or the director of a blood bank?"

His point is to make you aware that the management of your risks depends very much on: 1) the nature of the tasks that you are trying to perform, 2) the degree to which the technology of that performance is well understood and manageable, 3) the degree to which you can predict changes in your various environments, and 4) the degree to which your processes are supervised and monitored by outsiders, government agencies, laws and the courts.

The degree to which you can control or be controlled in each of these areas then tells you how much your industry or organization must train its leaders to be skillful in controlling and managing the things that are not well controlled. In the fishing boat industry you can control very little and therefore you are dependent on the fishing boat captains being talented and well trained in maintaining safe operations. If you are in the blood bank industry your technology and regulations cover much of your operations so your focus can be on those few elements in the supply chain, testing, and administration that are highly visible and predictable, but also quite limited.

You can ask yourself where your kind of banking fits on this dimension and, therefore, what your particular risk elements are. Are you more like a high hazard industry such as fishing boats, nuclear plants, airlines, pharmaceuticals, mining and extraction, or are you more like consumer goods, restaurants, various kinds of services such as a blood bank where some of the uncontrolled factors are known and less depends on the skill and training of the operators. If your organization has some form of safety committee, locating yourself along this dimension and identifying the areas of high risk becomes essential.

By high risk we should mean what kind of accident or deviation from normal operating procedure would not just hurt you but would put you out of business. For example, in working with an Audubon organization that had parks and trails and ponds and summer camps, we surmised that people hurting themselves on the trails and suing the organization would be far less damaging than if it was discovered that in one of the summer camps a counselor who had been hired by the organization had sexually harassed some of the young female campers. Recognizing this risk focused their safety concerns on how they staffed their summer camps.

Senior executives and board members need to be highly aware of this risk dimension above and beyond how it relates to what regulators are holding board members accountable for.

Point 2. Learn how your industry is influenced by the "macro culture" in which it operates, and the occupational cultures that influence executives and employees.

By macro culture we mean the cultural elements that derive from your country's culture and the cultures of your executives and employees. What is considered to be safe or unsafe, what is considered to be ethically legitimate or not legitimate, and what is considered to be legal or illegal will vary by country and by the training of the employees in the bank. Words like "corruption" or "ethics" or "bribery" may not only have very different meanings in different countries, but what kinds of behavior fall within the scope of those terms may be different may be different as well. Context will undoubtedly influence how a given bank and it's employees define these terms for themselves, quite independent of what the bank's headquarters policy, located in another country, may promulgate as formal principles or rules.

This issue not only influences what the risk factors are but even basic operations. I once helped a Swiss bank executive in figuring out how best to manage a dilemma. Orders from the parent company, which was in the UK, were vague and therefore very difficult to implement. When the executive raised this issue and asked for clarification, he was told that the orders were quite clear and he was expected to do what was appropriate. Not only was he unsure of what to do, however, he was quite worried that he was expected to do "the right thing" without really knowing what the parent company considered to be "right."

On the matter of employee occupational culture norms, it is quite possible that different educational programs in finance and accounting present different boundaries to the students as to what it is OK to do or not OK to do. Bank managers who have come up through the system in their particular country may have learned ways of doing things that they take for granted to be OK, only to find out that they are now in a bank that has somewhere different standards. These new standards may be so taken for granted that no one bothered to explain them to the new manager until after that manager had unwittingly created a scandal. It is also possible that what are considered to be the norms of behavior might differ if the promotion system favored primarily executives conservatively trained in finance and accounting or executives who were entrepreneurial and daring.

Every bank needs to have not only a “safety culture” task forces to think through what kinds of risks are created by country and occupational cultures, but to check for variations in what are considered to be appropriate limits of behavior in different parts of the banking system.

Is it possible that the ship that ran aground and bottled up the Suez Canal last year did so because the captain of the ship refused to pay the “normally accepted bribe” to the guide boat captain?

I would think that banking has many areas, especially around the rules for lending money, foreclosing on loans, covering up accounting errors, etc. that should be written up as a booklet of ethical dilemmas and what to do or not to do that is distributed to new employees and discussed regularly. Employees at all levels of management should be encouraged to bring forth questions around behavior that they are confused about. ▸PAGE 199

Point 3. Create an industry self-monitoring and training function

I spent five years on the advisory committee of INPO (Institute for Nuclear Power Operations)—an independent organization funded by the 100 or so nuclear plants in the U.S. nuclear power industry. INPO has as its mission to evaluate each plant on a regular basis to ensure that it meets the licensing requirements of the Nuclear Regulatory Commission and to provide feedback, remedial suggestions, and education and training in areas where a plant’s standards have slipped.

INPO also does research and analysis to build what they consider to be a requisite “safety culture” for all members of the industry and creates educational and training programs to promulgate these. INPO connects closely with a similar organization in Europe called WANO and with the IAEA in Vienna. In this industry, as should be the case in all industries, there is a positive emphasis on what is a well-run nuclear plant, not just what is a safe one. It is in this industry that we see the clearest example of high levels of open communication and trust up and down the line as being the core process of what they call their safety culture.

It is the absence of trust and open communication up and down the line that is usually associated in other industries with poor quality work and marginal safety. By concentrating only on fixing things after something is going wrong, too many firms fail to concentrate on enhancing the things that are going well and that produce high-quality performance, innovation, and adaptiveness that is increasingly needed.

Is there any kind of consortium or group of banks that is already doing something like this or should the banking industry begin to evolve a program that would help the whole industry to maintain high standards of excellence and safety? In the manufacturing world and also in Health Care the emphasis on “improvement,” derived from US fascination with the Toyota production system and the whole “quality” movement that came out of our engineering culture. In many healthcare organizations that we have worked with the quality and improvement emphasis gets much more attention than the safety issue because it creates a broader perspective for thinking about organizational effectiveness. This issue connects closely with the need to develop better community relationships and to explore ways of banks collaborating with each other rather than competing.[5]

As an aside it should be mentioned that INPO is very successful in its monitoring and training, but has been remarkably lax or unsuccessful in convincing the public and the community that nuclear energy is today quite safe. The U.S. public continues to be scared of nuclear energy in spite of the fact that most scientists agree that it will have to be used in place of fossil fuels along with solar, wind and other sources if we are to slow down global warming.

Does banking have a similar public relations problem in some communities in that we cannot assume that a community automatically trusts a bank in the light of past scandals? Is there an Industry equivalent of INPO that collects information about effectiveness and safety and circulates that to banks?

Point 4. Involve the board and the executive suite in risk and safety management

My active interest in safety surfaced early in my career when I learned on a trip to South Africa in 1969 that supervisors in the gold mines believed that the native employees were not only disrespectful and untrustworthy because "they never looked at you in the eye, they were "shifty eyed." The supervisors had to be given special cultural training to learn that: "In the native culture it was in fact disrespectful to look directly at a superior!"

Once this had been cleared up, a second cultural issue arose with direct safety implications. The normal blasting operations sometimes left unexploded sticks of dynamite deep in holes. Management decided that the best way to prevent employees from poking into these holes and unwittingly setting off new explosions would be to put up posters of snakes coming out of these holes on the theory that the employees would be frightened and stay away from the holes. The accident rate went up and it was only discovered after many conversations with employees that precisely because they were frightened of unseen snakes, they would deliberately try to get them out by poking sticks into the holes!

When asked what should be done to prevent this, the employees were very clear in saying that the management should simply put up a poster saying "Dynamite--do not poke into holes"" and the word will get around quickly that everyone understood why not. Management had unwittingly perceive the employees to be far less intelligent and responsible than they actually were by showing snakes instead of sticks of dynamite in the posters.

The point of the story is to highlight how senior management tends to operate from its own and often misguided beliefs and assumptions about how risk and safety should be handled, or, even more dangerous, the task of safety management is entirely given over to some other function. Yet it has been shown over and again that employees see things and do things with major implications for safety, and that management either deliberately or unwittingly sets barriers to such critical information circulating up in the organization. Management tends to tell, to make up rules and announce them without really investigating whether those rules will actually make the place safer, or as in the South African mines, actually make it less safe because they never asked the necessary questions until after the accident happened.

> It is the absence of trust and open communication up and down the line that is usually associated in other industries with poor quality as well as marginal safety.

In my management classes I often asked the students what it meant to them when they were first promoted to supervisor or manager. With high regularity the answer was almost always "Now I can tell others what to do." While this might have worked in the days of the assembly line and industry viewed as a giant machine, it is less and less valid as a definition of management today and is gradually being replaced by what we are calling "Humble Leadership" where "humility" is not defined as a personal trait, but as the leader's ability to situationally recognize her or his lack of information and dependency on others to figure out what to do.[6]

Point 5. Replace the dictum "Everyone should learn to speak up" with "We need to promote a climate that makes everyone feel psychologically safe."

The issue of what exactly is management's responsibility for the creation of trust and open communication bears directly on the often heard proposal to "encourage a speak up culture." Paradoxically, it puts the burden on the employee who feels that it is actually not safe to speak up because he or she has seen the bad things that happen to whistle blowers who identify things that are not done correctly, or have had personal experiences of not being listened to. How to fix this is complicated as the following examples from my consulting with New York's Con Edison utility will highlight.[7]

An electrical worker underground sees a set of corroded circuits that may generate an outage or explosion. He reports it to his boss who says "thanks" we'll report it upstairs. The boss puts it into a package with all the other reports he has gotten that day and sends it to the vice president for safety who now does two things: he gives a list of danger areas to his technical staff for triaging and he looks over the data to see which departments are having the most trouble based on the number of reports from different departments.

When he has identified those departments he talks to their line managers who then call up the supervisors and ask the following question: "We noticed that your crews have an unusually large number of timeouts and reports of problems; can you look into that and let me know what might be going on there."

The supervisor is annoyed at having been singled out and lets his crew know that they are calling too many timeouts and are seeing too many problems. The supervisor may even challenge some of the safety concerns by given crew members by implying that they are "wimpy." From that point on anything that is even a little ambiguous fails to get reported, and what the employee has learned is that it is not in fact safe or even worthwhile to speak up, even if a program has been launched by senior management on the importance of speaking up.

In the meantime senior management is blissfully unaware that they have unwittingly created increasing safety risks for the sake of productivity and scheduling by their request to find out which crews are having the most problems because they don't want customers complaining about their outages.

Banking is not vulnerable to such life-threatening safety issues, but is it possible that a supervisor observes questionable loans being authorized and has had a similar question from his branch manager about not being productive enough or failing to meet scheduled sales targets, and that this same supervisor ends up wittingly or unwittingly encouraging such questionable loans in the future? Is it possible that senior management at headquarters is actually unaware that it is their desire for productivity that is creating both the questionable behavior and the hiding of it?

The CEO has heard the talk about encouraging speaking up, announces to the entire bank the need to encourage speaking up but remains unaware that the normal productivity pressure create behavior that is unsafe yet remains invisible. An even worse possibility is that a level or two below senior executives middle managers are caught up in this lack of psychological safety and may be unwilling to tell the CEO what is actually happening until there is a major exposure and a scandal. For example, we may cynically believe that the CEO of Wells Fargo must have known what was happening and should be held accountable, but it is actually possible that key information about unsafe practices was hidden and perpetuated because of productivity and schedule pressures?

Is your bank relying too much on exhortation to speak up and failing in creating a more psychologically safe environment? How would one do that?

Point 6. Build more openness and trust throughout the organization by: 1) Reducing professional distance and impersonal transactional relationships, and 2) Increasing more personal relationships at every level.

Both excellent performance and safe practices depend upon the free and open flow of information up and down the hierarchy that creates the high level of trust that problems will be identified and dealt with. Those high levels of openness and trust must begin at the very top and gradually be cascaded down through the hierarchy by each managerial level building more personal relationships with their direct reports, their peers and their own bosses.

This sounds utopian but you will find in your most excellent banks that this is precisely how they operate from the board on down, and you will find executives who not only understand that it is their own behavior that must change first to avoid the unwitting creation of an unsafe climate, and have learned how to do that.

When organizations function as transactional hierarchies, based on clear roles and tightly enforced rules, they function well if the tasks they perform can be routinized and stabilized. One might assume that banking lends itself to such a machine model of organization and management. The growing concern about the safety of some banks, following the collapse of some others, suggests that the task of banking itself has become more complex and more vulnerable to rapid changes in the technical and social environment.

As tasks become more complex, adaptation to changes in the environment begin to require adaptive not only capacity in the operation at the front line. Such capacity will only be acquired through information on what is possible and what is desirable, and that has to become more widely distributed among all levels and, therefore, makes the organization as a whole more dependent on such information 1) flowing freely up the organization and 2) information about what is to be done and what is appropriate to be done flowing freely down the organization and laterally.

Only if senior management and even the board recognizes the need for more personal relationships even across hierarchical lines as a prerequisite for building openness and trust, and creates a reward system that encourages every level to become more personal open and trusting, will the organization become adaptive enough to maintain excellent performance in a rapidly changing technology and social environment. There are no silver bullet solutions to getting there, but the organizations that are trying to do that are focusing more on the nature of relationships in the organization, more on the use of humble leadership and other relation building concepts such as humble inquiry.[8, 9]

One approach that is seen increasingly so in the health care industry is to use more "Humble Inquiry," learning to create more personal relationships by getting to know each other better in the work context, collapsing professional distance, learning to work in interdependent teams, and, in summary, seeing leadership as a "team sport," rather than acts of individual heroism.[10, 11]

Point 7. "Practical Drift" as a particular safety problem in the nature of the work itself

The work of an organization can be technically designed but ultimately is done by humans and brings with it various human characteristics. No matter how carefully a job is designed and no matter how carefully we train people in how to do it, it is human to begin to see variations of how the job can be done. These variations have been labeled "practical drift" and can be either improvements and how the work can be done or deviations which create safety problems.[12] It has also been observed that such variations can become normalized and forgotten until an accident reminds us that those variations became routine and accepted, though they were never sanctioned.[13]

An early example was the "banking" of work by employees in the Hawthorne studies of Western Electric. Crews were trained to wire units in a certain way and the industrial engineers set a target of how many such units were to be produced in a given work day. It was called "straight line output" and seemed to be working very well as "a fair day's work for a fair day's pay." However, what the observers saw was that on some days the crews felt energetic and produced more units than the expected number and hid the extra units to be available for those days when the crew was tired and was producing less than the target. "Over production" was also carefully hidden because the workers believed that the levels achieved on the good days would become the new required norm in the pay for piecework system.

Is your bank relying too much on exhortation to speak up and failing in creating a more psychologically safe environment?

The Con Edison top level Environmental, Health, and Safety Committee which included the CEO and all unit heads met weekly and acknowledged that they saw examples of practical drift in all the work. But they had not focused enough on the need to observe and monitor such behavior to determine whether it was improvement or dangerous. It was decided that the coaches and trainers who initially trained new or promoted employees in their new jobs had the additional responsibility to visit and observe the trainees after they were on the job for some months or even years to determine whether practical drift had occurred and with what possible consequences. Innovations could then be added to the training, while deviations could lead to sanctions and retraining.

Is the work of banking susceptible to this kind of practical drift and are there mechanisms in place to discover it, evaluate it, and either institutionalize it or eliminate it?

Point 8. The problem of compliance with rules

The issue here is complicated because there is no one answer to why employees ignore or actually disregard and disobey things that are clearly stated in the rules and enforced by supervisors. I collected examples and put them together in the following chart to illustrate reasons and what the organization may do about various of these reasons. See Table 1.

WHY PEOPLE DON'T COMPLY WITH SAFETY RULES, FOLLOW SAFETY PROCEDURES OR REPORT UNSAFE CONDITIONS

Type	In the Field Manifestations	Remedy
Lack of knowledge, skill, know-how or experience	"I didn't know this was a hazard" "I didn't know what to do because the reality was different from what I learned in training"	Formal education and training Practice, on the job training, coaching by more experienced workers
Overconfidence	"Nothing bad ever happened to me before doing it this way, so why worry now?" "I've been in the field long enough to know how things really work and what shortcuts are ok and make work easier"	Credible stories from close calls or actual incidents Personal accounts of lessons learned from credible sources, trusted coworkers
Macho Self-image	"I can do this job in spite of the hazards" "I can be a hero and others will respect me for it" "Only sissies or novices do it the standard way"	Personal counseling and coaching Employees examining and redefining the norm of what is heroic
"Practical Drift"	Confidence in short-cuts that have been invented, have been found to be ok, make work easier, and have been passed on by old timers to newcomers	Regular review by trained staff of how work is actually being done Adoption of methods that are better Retraining in correct procedures Appropriate discipline for compliance failure after retraining
Social Norms	"We all do it, no one ever said anything about it, why make a big deal about it all of a sudden" "I know its not by the procedure in the book, but that's how we do it around here. Do you want to fit in and do it our way or do you want to cause trouble for all of us"	Norms only change when the employees who hold them get involved in the change process and decide on a new norm Acceptable risky behavior has to be defined as highly risky and unacceptable
Mistrust of Authority	"They lied to us before about what was safe or unsafe so how do I know they are telling us the truth now?" "I tried to tell them about what was not safe but they did not listen (or did not act or respond)"	Training of supervisors in listening, responding and conflict resolution Training supervisors to communicate clearly with managers
Mixed or Unclear Incentives	"My boss tells me to comply with all the safety procedures but he still wants the job done and let's me skip steps" "My boss (or co-workers) don't like it when I slow the job down because of some safety issue"	Re-examine middle management incentives and discipline to determine whether productivity pressures outweigh safety concerns Change incentives and back up with extensive training

Type	In the Field Manifestations	Remedy
Work Group or Work Peers Self-esteem	Not wanting to embarrass one's own group or work peers. To protect collective "face" Reluctance to "rat out" a fellow worker who is not complying with a rule	Clear and consistent messages from all levels of management that safety and open communication is a top priority, reinforced by close monitoring of immediate subordinates to insure that incentives are appropriate
The Ultimate Reason	"If I comply with the procedures I can't get the job done"	Ask the employees with genuine humble inquiry why they are not following procedure, listen, and then either retrain or change the procedure

It is the last item, what I have called "the ultimate reason," that is the most troublesome because it is not clear when the deviation is "breaking the rule," and when it is "positive practical drift," as the following true example will illustrate. In the underground electrical work the wearing of shields to protect the eyes was an absolute rule, violation of which led to instant dismissal. In one such case of immediate firing of one of their best splicers, the supervisor and the next level manager could not believe that this person with such a good record had failed to wear his shield so they brought him in to get the whole story.

The employee reported that he was in the middle of a splicing operation when the high humidity totally fogged up his shield and produced a high risk that he would mess up the splice because he suddenly could not see what he was doing, so he lifted his shield just when the supervisor arrived and caught him. The manager then learned that this could happen frequently in the summer months and that they had never responded to previous reports of this problem. In fact they remembered instances where employees had been praised highly for their dedication to the work even if it involves some personal risk.

What triggered this current incident was that safety concerns suddenly became a higher priority which meant tighter enforcement of the rules which were already in place but not always enforced. This particular employee was so valued that he was not only reinstated but also was then asked to be on a task force to find a company that would produce eye shields that would be less susceptible to fogging up. They found such a company which led eventually to everyone using the new shields!

The tension between getting the job done to support the productivity needs of the organization and to do the job safely and exactly by the rules is very real and not always easily resolved. I would guess that this tension is high in the banking industry because employees at the front line have a fair amount of discretion in how they handle various financial transactions and how they interpret the rules pertaining to those transactions. The important thing for management to recognize is that safety and productivity can lead to conflicting principles pertaining to some of those rules, but the over arching principle is open communications and the development of trust.

Concluding Thoughts

As must be obvious by now, there are no simple answers to minimizing all possible risks that can hurt an organization or even put it out of business. I have learned, however, that the preoccupation with identifying risks and evolving mechanisms to minimize them is a perpetual problem rather than one that can be fixed by working on all the above points. In other words, just as the maintenance of organizational excellence is a perpetual problem, so the issues of risk and safety are perpetual problems, and must therefore be a primary concern not only of senior management but the organization as a whole all the time.

It would make sense to have regular weekly or monthly meetings devoted to an exploration of how to increase excellence and reduce risk, and to include in those meetings diagonal slices of employees at all levels of rank, seniority, and technical skills. It also makes sense to make improvement and risk analysis a part of every day conversation, perhaps to open every meeting with a discussion of risks, safety and improvement ideas as Paul O'Neill was famous for doing when he was chairman of ALCOA.

During my years of consulting at Con Edison I once asked my friend Ellen Langer, who was a Professor of Psychology at Harvard and had been writing about mindfulness, what she would ask a work crew that was about to go out to do a job that could be risky.[14, 15] She provided an answer that I found very useful in everyday life and would propose as a good question for the beginning of any task: "What is different today?"

And if things go wrong, and we are busy trying to understand why something went wrong, she had another question that is the essence of becoming more mindful about all these matters: "What else is happening?" or "What else happened?"

We tend to be far more concerned with identifying root causes, identifying who did something wrong, seeking certainty so that we would know what to fix, and, in the process of seeking causes we become mindless, narrow our perspective and our peripheral vision, and then are likely to miss more than we had realized — other things that also went on that may be more relevant both to improvement and to risk management.

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ENDNOTES

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PEER PERSPECTIVES

"Man's most human characteristic is not his ability to learn, which he shares with many other species, but his ability to teach and store what others have developed and taught him."

MARGARET MEAD

CULTURE & COMMITMENT [1970]

Peer Perspectives

Reimagining Ethics, Risks & Compliance with Behavioral Science at Novartis

By ANTOINE FERRÈRE

Antoine Ferrère

NOVARTIS

It's fair to say that when we started our journey, in September 2019, there was no established "best practice" — some easy 5-point plans or magic-quadrant-endorsed vendors — to help us in bringing behavioural science to the task of improving and transforming how we drive and embed a more reliably ethical culture, manage behavioural risks, and ensure greater compliance. There still isn't.

> The way you start matters less than getting started.

However, we did have strong evidence to suggest that adopting behavioural science in this connection would make sense and, beyond this, we had a clear-eyed desire and intent to explore the opportunity.

The Code of Ethics as a Trigger

Ask any behavioral scientists working in large organizations for tips on how best to start embedding behavioral science in day-to-day operations, while demonstrating the value in so doing, and it's likely they'll urge you to start with small, quick-win experiments — and they'll be right. It's unlikely that any of them will say "use this as an opportunity to roll-out a totally new policy across 150,000 collaborators around the world to put this new approach on the map".

Nevertheless, that is precisely what we did.

But why? The first reason is simply that the way you start matters less than getting started. So, why not build on existing momentum rather than row against the current? We often hear that using behavioural science helps us to "go with the grain" of human behavior, but we then sometimes fail to apply this advice to ourselves.

Second, there are a handful of fundamental, simple and robust insights that we know we needed to obtain, without needing to try and convince the organization to run randomized-controlled trials. So, our approach this was: if we want to roll-out a new Code of Ethics, we asked, what are the things we need to be sure to do so that we don't just wind up shooting ourselves in the foot? For example, if we're about to roll-out a new performance management and incentive management system — and both at the same time — then how do we ensure this is coherent and consistent with the values we proclaim?

Third, within any such large transformation are opportunities to experiment. And that's what we did. Doubling down on the agile, design-thinking, co-creation aspect of our initiative, we engaged more than two thousand employees from across the globe. That provided us a large-enough "sample set," from a social science perspective.

What did we do and how?

Here it's helpful to come back to two things we recognized at start of our journey. First, we knew very well that a policy — in itself — does little to drive what people actually do on a day-to-day basis. We understood that the actual impact of some company policy document, no matter how well written, would likely be limited to helping us open ourselves to other routes and opportunities for behavior change, rather than driving that change. So, we tried to articulate how our Code of Ethics, in combination with other interventions, could help to drive demonstrable operational impact.

We knew very well that a policy — in itself — does little to drive what people actually do on a day-to-day basis.

This has intrinsic value. The Code helps insofar as it clarifies what we expect people to do (or not) and how they should conduct themselves at Novartis. And we doubled down on this by making sure that, beyond the Code itself and clarity around our values, we also detailed what this means in practice — our "Commitments." They express our intrinsic values and help to simplify decision-making around the Code. Beyond what appears on the page, the Code and our Commitments signal to the rest of the organization that ethics matters, and that we care enough about it to mobilize a significant amount of the organization's attention, time and effort in order to co-create meaningful capabilities.

The signal this sent, and the momentum it created, allowed us to ride an internal wave of attention. We worked to articulate our behavior-change strategy through both the 'visible' parts involved in driving ethical conduct (our Code, Commitments, decision-making tools and support) and the 'invisible' yet critical aspects involved (the environment in which we operate, our day-to-day implicit expectations, and leading by management example). That was how we achieved more instrumental value.

Early on it became very clear that, if our goal was to drive ethical behaviors, we would need to go beyond the Code and investigate the ways in which we could remove 'what gets in the way' of our associates being their best ethical selves.

Early on it became very clear that, if our goal was to drive ethical behaviors, we would need to go beyond the Code.

It's important to pause there for a couple of seconds. There are a few reasons why, at times, it may seem unnatural for a large organization to focus on 'removing blockers.' Indeed, the default strategy, which includes compliance processes and systems, aims to motivate employees and change mindsets through the deterrent effect of negative sanctions. We add oversight.

The value of subtracting, of 'removing blockers,' doesn't make for an immediately attractive proposal: "Here's what we will not do" has a hard time competing with "Here's what we will do". Yes, good culture, clarity of expectations and motivating employees to do what's right in service of some deep sense of purpose is all critical. But it's not sufficient. It's not going to drive desired behaviours and outcomes if there are competing cues in the environment — be they incentives, behavioral norms, implicit expectations, etc. — that make 'doing the ethical thing seem an irrational choice. We'll come back to this point later.

Lastly, we also felt that, if we were engaged in a company-wide effort to co-create and launch a new and practically-applied Code, 'consuming' a substantial amount of the company's attentional bandwidth in the process, then we had a duty to do all we could to start by measuring where we stood on

Day-One, so we could then measure how successful we were in driving improvement over time. We turned to behavioural science to devise a strategy to do this.

Making Tangible the Intangible

How do you 'measure' ethics, or ethical culture? Can you measure it at all? It sounds like a very philosophical question ill-suited to the corporate world of KPIs and metrics. However, there are ways to do so.

> Culture, clarity of expectations and motivating employees to do what's right in service of some deep sense of purpose is all critical. But it's not sufficient.

The team of behavioral scientists at Novartis, working in Ethics, Risk and Compliance, reviewed decades of experimental evidence regarding the things that tend to make it more likely that someone will decide to do the wrong thing, 'all else being equal' — cheating, keeping quiet when the right thing is to speak-up, following the wrong example, caving to pressure, etc.

Importantly, our measurement strategy resides on the established fact that most corporate misconduct happens not because of one or two bad apples. They may exist, but how the barrel allows apples to rot is more important: good people end up doing the wrong thing.

> We are seeking innovative, technology-driven ways of putting these insights in the hands of local and market decision-makers.

Thus, we moved away from the standard and ubiquitous approach — measuring personality traits through 'personal style inventories' — and instead dug deeper into elements of the work environment in which our people operated. We designed a 50+ question survey in-house, based on decades of social science, and launched it across the organization — to more than 150,000 people across over a hundred countries. By February 2021 we had collected more than 38,000 completed surveys. We ran the survey again, this year, and across those two years we now have over 71,000 complete response sets providing us over 3 million unique and robust data points detailing the relevant perceptions of our associates.

The survey breaks down into three broad sections: 1) measures of psychological constructs and perceptions that have been found to influence certain behaviours, for good or ill; 2) a deep dive into our perceived internal behaviours, ethical and unethical — such as speak-up behaviors, psychological safety, trust in managers, etc.; and 3) a simple set of questions to capture key demographics while maintaining survey response anonymity. These insights allow us to understand better what levers we can pull to help build an ethical climate.

And this isn't just about ethics, per se. It's more so about how we work to create and maintain an environment that employees feel to be fair, one that provides them a sense of 'organizational justice' and leaves them feeling accountable for the things they do (agency) without feeling any conflict about what is seen to be right conduct (e.g., goal conflict, clarity of expectations). ▸PAGE 147

Our next phase involves acting on these insights. First, we are working to make sure that our leaders, at large across the organization, understand these important levers and how to talk about ethics in a way that drives impact. Second, we are seeking innovative, technology-driven ways of putting these insights in the hands of local and market decision-makers in a matter that is readily 'consumable.' Thirdly and importantly, we are acting across functions to partner with HR and other global departments so as to 'embed' the right ethics into day-to-day operations, whether in connection with hiring, promoting, managing, etc.

Informed by our survey insights around the operational mechanisms of ethical and unethical behaviors, we are now running large scale and truly randomized-controlled-trials to establish how best to work these levers and to make it more likely that our colleagues, at all levels, will do the right thing even — especially — when competing pressures get in the way.

By embracing a science-driven approach, we can identify tangible means of reducing the risk of misconduct posed by poor ethical cultures.

An important aspect of such research is our effort to make our findings public. If we truly want to embrace behavioural science for the benefit of our organizations and for society more broadly, then we need to share with others the insights we have learned, and help to advance relevant research in the academic community. Promoting good ethical cultures must be viewed as a shared commitment, among industry peers and others, rather than an exercise in achieving competitive advantage.

Data-Driven Cultural Insights

While we believe our approach is robust, comprehensive and recognized as such, we can't stop there. Going forward, we do need to go beyond reacting to the next problematic conduct issue by punishing the individuals involved. ▶PAGE 143 Instead, we must take steps to proactively shape the work environment so it makes it less likely for misconduct to occur in the first place. Or, at least, make sure we have nurtured organizational resiliency and inherent cultural guardrails to deal with misconduct appropriately and prevent it from spreading unnoticed and unchallenged. By embracing a science-driven approach, we can identify tangible means of reducing the risk of misconduct posed by poor ethical cultures.

There is a limit to how many times we can ask our associates to answer a 50+ question survey before it starts to lose some meaning. And there's a limit to what we can learn from a perception survey at all. How are we to move beyond simply asking people what they think and, instead, leverage the data sets at our disposal?

Looking to the future, we believe we must complement our survey-based approach with one that is more data-driven. Having better identified factors that drive ethical behaviour, how might we find proxies in our data that correlate to those levers?

A future in which we can connect our data to our intended ethics, culture, and performance is coming in to view.

Don't get us wrong, there will always be value in asking for people's perceptions: because, when it comes to ethical or unethical behaviours, it is those perceptions rather than some objective 'reality' that matters most. But a future in which we can connect our data to our intended ethics, culture, and performance is coming in to view, and we are on our way to doing just that.

Conclusion

Working to assure that our employees, across the world, are able to bring their best ethical selves to work is not limited to a yearly survey and data-gathering. Our efforts are in service to more effective organizational design, better governance, leadership decisions, policies and risk governance infrastructure.

But ethical culture can and should be measured, or we risk undercutting these change efforts. Driving ethical behaviors is like launching a rocket: it doesn't matter how much fuel and motivation you put into the system if you don't reduce the friction that gets in the way of lift-off.

Antoine Ferrère *is the Global Head of Behavioral & Data Science at Novartis.*

Peer Perspectives

Organizational Culture is Caught, not Taught

By MICHAEL ARENA & ROB CROSS

Michael Arena

Rob Cross

Shifting culture within organizations is challenging. In part, because it reflects people's values—their deeply held beliefs about what is good, desirable, and appropriate. Interactions can complicate matters further. When colleagues are embedded in informal networks with others who share and reinforce their values, they often become entrenched rather than open to new attitudes and behaviors. But it doesn't have to be this way.

By understanding the network dynamics of culture, we can better enable the shifting of culture. Culture and networks reinforce each other in organizations. Culture shapes the beliefs and values in networks. In turn, network interactions create and reinforce culture. This natural interplay between culture and networks isn't factored into most culture change initiatives but it is one of the best ways to make culture change actionable.

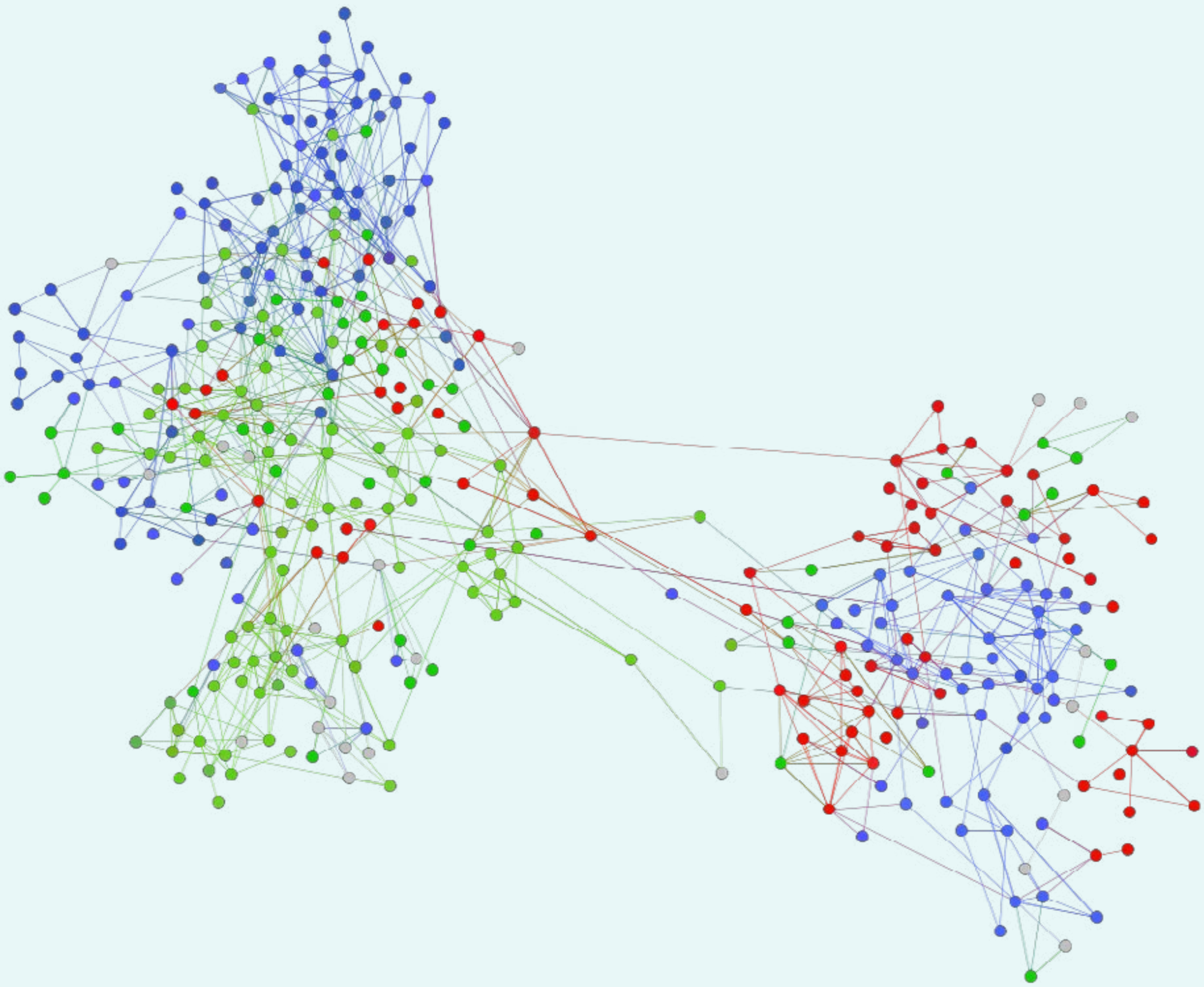
While most organizations think of the formal, hierarchical organization as the primary driver of organizational beliefs and behaviors, what we have discovered is a set of predictable network principles that are embedded in the informal organization. First off, culture and critical behaviors spread locally through the daily interaction of those closest to us — in network clusters. Secondly, local exemplars of behavior can have a multiplying effect on culture change — they are contagious. Finally, when it comes to shifting culture, context matters. More specifically, positive emotions amplify desirable behaviors, while negative emotions stifle them.

Clusters of cultural behaviors within the network

Most organizational change programs are based on the erroneous belief that culture is monolithic. We tend to believe that organizational culture is pushed down from the top of the organization through rigorous change programs, and is uniformly adopted across the organization. Reality is, these behaviors tend to cluster in various discernable pockets throughout the organization, based on their value to a given group.

Consider the organization below of just over 500 individuals. The larger group is a core sales team, while the slightly smaller group represents the marketing department. When we map the network with the individual strength behaviors from a 360 review (represented by the blue, red and green nodes), we can see distinct clusters of behaviors.

Indeed, more than 90% of the network is represented by three of six possible behaviors and these three behaviors are tightly clustered with one another. The



sales team to the left of the network diagram is highly customer driven, as indicated by the strong pockets of blue nodes. And it has a sense of urgency, as indicated by the green nodes. In contrast, the group on the right is a solutions team that has a solid mix of driving results, as indicated by the red nodes, and customer focus, as indicated by the blue nodes. Together, these clusters of behaviors generate healthy tension that results in better outcomes for the broader business.

By understanding the network dynamics of culture, we can better enable the shifting of culture.

When leaders regard a company's culture as monolithic, they tend to favor broad interventions that approach all employees the same way. But most organizations are not monocultures. They include numerous cultural subnetworks that continually interact, which is probably good for the enterprise. As in nature, where monocultures threaten biodiversity and increase existential risk, organizations benefit from having diverse sets of cultural norms and behaviors. This diversity makes it easier to adapt to change, to inspire new thinking, and to avoid blind spots that lead to ethical or strategic missteps.

For example, the organization represented above has developed intentional processes to ensure that the sales team and solutions team are leveraging their mutual strengths in solving problems for the customer. Additionally, they are elevating their independent strengths as a sales team that operates with urgency and a solutions team that stresses results for the business.

Contagious nature of cultural behaviors

Many efforts to influence cultural values in an organization rely heavily on the top few layers of the hierarchy. Senior executives might, for example, hold an off-site for the top 100 managers, assuming that new messages about cultural norms and priorities will naturally cascade through the hierarchy to others. But then, nothing very significant happens. Initiatives of this sort send a message, right or wrong, that top leaders have forgotten how their cultures actually work.

Employees deeper in the organization have a different experience of behavioral networks. They participate in the everyday conversations that convey whom to take seriously, what to care about, and "how we do things around here." A bit of this insight trickles down through formal staff meetings and memos from senior leaders. The bulk of it, however, travels from one person to another, through behavior networks that have less to do with the organizational chart and more to do with the coffee machine, the smoker's break outside the building, and the one-on-one Zoom chats.

In fact, every organization has a set of cultural exemplars (who exhibit a strength behavior) who model given behaviors, but they are not always part of the leadership team. They tend to be noticeably well connected and respected, however. Indeed, they are individuals that have earned the respect of their peers because they have earned local trust by informally engaging others with honesty, integrity, and thoughtfulness. As a result, they are highly contagious to others. ▸PAGE 445

Consider the example of a larger industrial organization. When we evaluated the effects of an 1,100-person division, we found that 50 well-positioned cultural exemplars had much broader reach across the network than the 50 senior leaders. The exemplars had a total reach of 60% of the division, almost twice as great as that of the senior leaders (31%), with a much higher impact on actual day-to-day change. Accordingly, when a culture is stuck, these informal cultural exemplars can become the nuclei of broad-based, contagious movements when top-down approaches fail.

Perhaps even more important is the fact that these exemplars are contagious beyond their immediate interactions. When an exemplar routinely interacts with a principal person (1 step away from exemplar), that person is 45% more likely to display the exemplars strength behavior as their own strength, one year later. In other words, the exemplar's behavior is contagious to his primary interactions. Furthermore, those primary individuals affect their own direct interactions (2 steps away from the exemplar) at an 11% more likely rate. Finally, that person affects their direct interactions (3 steps away from the exemplar) at a 4% more likely rate. The result being, these exemplars are not only more influential with their immediate interactions, but they are contagious three steps away within an annual cycle.

The role of leaders is to help influence specific interactions. Therefore, understanding that cultural behaviors are more likely to be caught than taught is essential to enabling local cultural shifts. For example, at one global bank that struggled with developing new customer-focused technology platforms, top leaders identified 80 customer-focused exemplars who were well positioned in the network to spearhead a cultural shift. These individuals represented four

Understanding that cultural behaviors are more likely to be caught than taught is essential to enabling local cultural shifts.

functions: a technology infrastructure group, a software development group, a marketing group, and a customer service group.

Rather than push for culture change from the top down, leaders instead sought to bring these exemplars together to ask them each to share a positive story with one another on modeling customer focus. At the conclusion of the session, leadership challenged each of these exemplars to find authentic ways to model their beliefs within their everyday interactions. They also created a very lightweight bi-monthly forum for these exemplars to gather with one another to share successes. The result was a gradual shift across each of the four functions toward a more customer focused culture.

By understanding the nature of how behaviors manifest across the network, organizations can better enable culture change activities.

Context matters for shifting culture

While behaviors cluster within the network and individuals can be contagious, context still matters. The sentiment of the organization can turn behavioral clusters negative and the spread of behaviors from person to person can be dampened by unconstructive organizational pockets.

Traditional approaches to culture change often assume that the process is rational, whereby leaders will communicate a vision with compelling logic that will persuade employees to commit to new ways of working. Our research, however, has shown that culture is more emotional than rational. Two employees are much more likely to share a cultural belief if the tie that connects them is energizing and emotionally engaging. Within the network, this means that clusters of positive emotions spread more rapidly than those with negative emotions.

In one study of first-level leaders in the R&D division of a large company, network analysis found that positive energy explained more than 40% of the variation in whether individuals absorbed the company's espoused cultural behaviors. These results led the company to leverage their energizers (people in the network with high energy connections) to act as cultural ambassadors. Nine months later, a survey showed improved consistency in cultural values across the division.

Negative emotions, such as fear or resentment, also have an effect. Local groups who embody these emotions create a stifling effect on the spread of desired behaviors. A business unit of a large technology firm conducted an analysis that focused on the question: "With whom would you be reluctant to share early-state ideas or differing points of view?" and the conclusion showed that the company had very strong pockets of fear. Despite having a very insightful group of employees across the organization, many were afraid to voice innovative ideas because they were likely to be shot down. The company's culture was knit together by its mutual sense of worry, and its creativity, risk tolerance, and market presence had suffered accordingly.

The analysis then focused on how both leaders and local experts had engendered this culture of fear and it revealed that while the negative energy was exerted by only a handful of individuals, its impact on others was significant. For example, fewer than 5% of top leaders generated fear. However, these individuals produced 62% of the negative sentiment within the firm. Furthermore, while only 8% of the local experts generated distress, they accounted for 81% of the negative energy around them. Therefore, while it may seem easy to dismiss these individuals as a few naysayers, they have a disproportionately high impact in setting the context for the broader business unit, resulting in a significant stifling of desired behaviors.

A deeper analysis in this case also revealed a common set of patterns for those who emitted positive energy verses those who produced fear. Energizers listened more, provided encouragement and sought out new possibilities, while de-energizers actively shut-down ideas, criticized others and insisted on their own approaches. Without identifying any individuals by these energy classifications, the organization sponsored a set of facilitated sessions to enable greater positive energy. These mixed sessions, comprised of both energizers and de-energizers. helped participants to build a climate of support rather than one that demanded compliance, with a focus on listening skills and possibility building. The result was the curbing of the gossip and negative rumor spreading that exacerbated people's anxieties, and a shifting of the context for culture change.

By understanding the nature of how behaviors manifest across the network, organizations can better enable culture change activities. They can tap into the local interactions within behavior clusters to amplify certain strengths, they can intentionally engage the local exemplars to create a contagious, multiplying effect for change, and they can actively shift the organizational context to seed positive sentiment. Once organizations recognize that most behaviors are caught, not taught, they can fully leverage the more organic, network patterns driven approach towards shifting culture.

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Peer Perspectives

An Interview with Dr. Charles F. McMillan, 10th Director of Los Alamos National Laboratory

Charles F. McMillan

Los Alamos NATIONAL LABORATORY

Q: At Los Alamos, you were responsible for maintaining the nation's nuclear wherewithal. Can you say a little bit about what that entailed? I'm sure risk and safety management were key concerns. How did you provide confidence that our nuclear capabilities were reliable and secure?

A: The phrase that we often use is "safe, secure, and reliable." It's a mantra. Maybe a little background would help clarify the related challenges.

The United States developed its nuclear stockpile during a period when we were doing active underground nuclear testing, as well as active development of new systems. All of that stopped, in terms of the way we had historically done things, with the last underground nuclear test — called Divider — being conducted in 1992. An outgrowth of this was asking ourselves, "How do we continue to care for the nation's nuclear deterrent, in a world where we aren't doing additional testing, and where those weapons systems are aging far beyond what we had anticipated when they entered into service?" Historically, such systems would have been in service for maybe a decade before a new system would have replaced them. But that hasn't been happening since 1992.

Our nuclear laboratories, together with the Department of Energy, Congress, and the administration, developed something that we call the "Stockpile Stewardship Program." This involves making much greater effort in computer modeling and in non-nuclear experiments. As part of that program, Congress put in place something that we call the "Annual Assessment Process," under the terms of which the Directors of Lawrence Livermore, Sandia and Los Alamos National Laboratories, together with the commander of US Strategic Command, must each write an annual letter in which they offer their candid evaluations regarding the state of the deterrent — the state of the Stockpile. Those letters go directly to the President.

Our letters have cover letters from the Secretaries of Defense and Energy, but the letters from these four leaders all go to the President unmodified and represent the best judgment of the leaders in each of these organizations regarding issues in the Stockpile that require attention, the tools that are used in evaluating these systems, et cetera. I wrote seven of those letters and I still remember my predecessor saying, "Charlie, you've been involved in this for a long time, but it's different when your signature is at the bottom of the letter!" He was right, it is different.

So, how did I prepare those letters? Well, the scientists and the engineers who have the day-to-day responsibilities for the systems prepared briefings for me, and we spent most of the summer working on these letters. Staff would brief me, and they would brief other teams. I had a 'Red Team'[1] that would look at what our scientists and engineers had done. And I personally looked at what they had done and asked a lot of questions.

This effort was informed by a process we refer to as "QMU" — Quantification of Margins and Uncertainties. We wanted to assure that our margins (for error, or failure) were much greater than the uncertainties with which we are confronted, so that the reliance that the country (and the world) places on the stability of these systems is well founded. At the end of the day, the essence of my letter to the President was about how our margins were kept much larger than the inevitable uncertainties.

Q: That's very interesting and highly relevant to a complaint heard often in the banking sector, and elsewhere, regarding the 'legacy systems' upon which those firms rely, and the difficulties of trying to keep up with and deploy more modern technologies and capabilities.

A: Well, at the nuclear labs, we face similar issues and simply have to manage them successfully. When we stopped putting new weapons systems into the Stockpile every decade or so, some initially thought that we could just carry-on building systems much as we'd always done. The problem is that this just doesn't work. Those of us in the technical world could see that pretty quickly from the front-end, but, for many in the policy community, this was perhaps not quite as obvious.

As an example, some of the systems that were developed in the Sixties and Seventies have vacuum tubes in them. Have you tried to buy vacuum tubes lately? These kinds of things are museum pieces! There are any number of materials that were readily available in the Sixties, Seventies and Eighties that are just not available today. In some cases, perhaps because production processes are no longer deemed safe for society, or because the materials have simply gone out of production.

So rather than try to replace things exactly as they were — which we can't do in the case of things like vacuum tubes — we instead developed what we call "Life Extension Programs" that use currently available materials. And here again we used the QMU concept.

We asked, "Okay, if we replace this with that, it introduces more uncertainty in the system. So how do we estimate how much uncertainty this introduces? What can we do to increase the margins in performance, in safety, in engineering reliability, etc.? How do we ensure we have enough margin to cover the added uncertainties?" Almost everything that's come into the shop for a life extension program has had to incorporate some change. We've had to look at many, many different margins in the context of making such changes.

> At the end of the day, the essence of my letter to the President was about how our margins were kept much larger than the inevitable uncertainties.

I'd emphasize that we were not just focused on 'margins for error' but, rather, 'margins to failure.' When is something not going to work? I've often used this analogy with high level visitors to the lab: Imagine you're driving down the road in front of me. The distance from my front bumper to your rear bumper is what I mean by margin. Then there are all kinds of uncertainties that go into whether or not I'm going to hit you — a failure — if you have to hit your brakes hard. Uncertainties might include how wet the road is, whether it's dark or daytime, how much sleep I got last night, the condition of my brakes, the condition of your brakes ...

In this example it's easy to make a long list of uncertainties. Then what you say is, "Okay, I want to take all those uncertainties and lump them together, and I want to make sure that I've left enough distance from the front of my bumper to the back of your bumper — margin — so that if you have to slam on your brakes, I'm not going to hit you." It's a pretty simple concept when you put it this way, but doing this in practice turns out to take an awful lot of work, particularly if you want to be quantitative about it and be prepared to defend your estimates of margin and uncertainty. A lot of work goes into that.

We take a similar approach to managing risk in the operation of a nuclear facility. You want to be very sure that you have sufficient margin from something that could cause a major accident.

Q: I'm sure... But this raises the question of human error. How do you think about misconduct versus 'poor conduct'?

A: Well, human beings make mistakes. One of my safety guys once said to me, "Charlie, if you expect perfection from human beings, you will be disappointed." So, we design our processes in these kinds of facilities to ensure there's enough margin to cover uncertainties. I don't want to suggest that the people who do this work are careless. I know the folks who work in these labs. They're very careful people. But even very careful people make mistakes.

Furthermore, when you think about uncertainties in facility operation, what happens when there is an earthquake? Or a fire? We have to take all of these kinds of uncertainties into account when we design our systems: then we engineer them and design our processes so that there's enough margin in the system to cover those uncertainties. Whether it's the weapons systems themselves or things like our operations, the same concept I think works reasonably well. Does that help?

Q: It does. Can I draw you out a little bit further on that? We have discussed a distinction between what one might call 'mechanical risk management' — that is, managing systems and processes, et cetera — and looking at how that intersects with 'behavioral risk management.' Can you say a bit about how mechanical risk intersects with behavioral risk in the context of what you've just shared?

A: What you described as 'mechanical' I think of in terms of 'engineered systems.' Whenever we can, we try to engineer our systems so that if something isn't right, the system physically prevents you from taking an action that could lead to something unsafe. Let me give you an example. Imagine I'm working with high explosives, I have a tank that will contain the high explosives, and that tank has a door. If I fire the explosive with the door open, it's a bad day for everyone. It's a very bad day. So, we put switches on the doors — and often multiple switches — so that in order to be able to even push the button that will fire the explosive, that tank door must be closed and locked. That's an engineered system. Whenever we can, we try to design systems that will prevent you from making such mistakes.

But now let's think about the process part of that. Let's say that, without breaking, the tank can hold up to a kilogram of high explosives. Now, I need a process sheet there that allows and prompts us to confirm that technicians measured the high explosives, and found it to be less than a kilogram, so we can safely conclude that we can take that amount of material into the tank. But — just to be extra safe — I also want strain gauges on the tank, so if we did the engineering wrong somehow, and the tank can't really hold a kilogram, or somebody made a mistake and put more than a kilogram into the tank, then we can measure how much the tank expanded and determine whether we damaged the tank under these potential scenarios. Those are "human controls," if you will — process controls. But whenever we can, we prefer engineered controls.

Q: May I come back to those letters you sent the President with regard to QMU? Presumably you needed to work with others on that — I mean, it wasn't just you, sitting up late one night dashing off thoughts. Can you say a bit about the process and people involved in this?

A: To be clear, I owned this. It was my voice and my signature on the bottom line. However, to make that work as valuable to the nation as possible, I drew on many different sources of input. As an example, my internal Red Team went into great detail examining different aspects of how our work had been done in the last year. They looked at things like our experimental facilities, to establish that they were adequate to the task of arriving at reliable conclusions about our work, and to provide me that input. I should also say that, on my Red Team, I intentionally included people from the other labs so that I would gain different points of view.

Part of the deal here, by the way, is kind of interesting. My charge to the Red Team was, "Here are the questions I want you to look at. You can talk to anybody about anything you need to try to help me answer these questions, and you can guarantee anonymity to the people you talk to."

One of my fears was that there was a problem, and an engineer or a physicist knew about the issue, but was afraid to bring it up for whatever reason.

One of my fears was that there was a problem out there, and an engineer or a physicist knew about the issue but was afraid to bring it up for whatever reason. I hope I'm not a terrorizing figure, but you never know! So, I provided a way for people to provide me with anonymous input. And I will tell you, the Red Teams always honored that commitment to anonymity. They have never told me who they talked to, or where they got their information because I needed to be sure that I got critical information in as unfiltered a way as I possibly could.

The lab directors do not see one another's letters before we submit them to the President, though we have sometimes exchanged letters after the fact. Our letters are intended to be genuinely independent assessments. The system is intentionally designed to provide independence among the laboratories and USSTRATCOM in providing those inputs. A friend once described the discipline to me this way: if I go to the doctor and he tells me that I have some dreaded disease, and I say, "Well, I'd like a second opinion." If the doctor then says, "Oh, well, why don't you just go down the hall to see my colleague?", then my answer needs to be, "I don't want the same opinion twice! I want a real second opinion."

It's also worth mentioning that we set up independent review teams at the other labs. Livermore and Los Alamos both work on nuclear systems, but we have responsibility for different systems. So, we send the information on the Los Alamos systems to a Livermore team. They then apply the tools at Livermore — particularly modeling and simulation tools — and then Livermore evaluates the Los Alamos systems independently. We do the same for them. The Livermore team would then come and brief me, and the Los Alamos team went and briefed the Livermore director. I did not see the briefing the Los Alamos team was giving to the Livermore director and the Livermore director did not see the briefing his team provided me.

These were ways of trying to assure that we had reliably independent points of view as to what was going on. And, because of the professionally competitive nature of the relationship between the labs, our hope was that the Away team would spot something that the Home team might have weighted differently, or maybe even have missed, because of the differences in the tools in use at each lab.

After all this exchange of views had taken place, the Livermore director and I would get together with our respective teams for joint briefings. And together we would try to think about issues that we might need to address jointly, in some way. But at the end of the day, each of us wrote our own individual letters and stood by them. Of course, we had support from our staffs — none of this is done in a vacuum. But at the end of the day, I had to decide what went into my letter, what didn't go into the letter, what was emphasized, what was not, what the exact wording should be. And I sweated all of those things...

Q: We've talked about the importance of people and "purpose" in connection with safety and accidents. This series of reports focuses on the role of organizational culture in the context of optimizing performance and mitigating risk. Was this something that had your attention at Los Alamos?

A: Yes. The people who work in the laboratory have good jobs. They can support their families. They can send their kids to college. But, in my interactions with them, as important as those financial considerations are, that's probably not why they went to work this morning. The majority of our people see themselves as contributing to the security of the nation and helping to stabilize the globe. That sense of purpose is what drew them to the laboratory environment.

Just recently, I was talking to somebody who said that they had had a good job somewhere else, but when 911 happened they said, "I want to be part of the security of the nation, and the laboratories are a place where I, as a technical person, can do that." This kind of thinking permeates the laboratory. The nation did not create the laboratories to provide good jobs for scientists and engineers. The laboratories were created because the nation needed security against threats that could affect the nation's existence.

We see ourselves as part of helping to provide that security. This is our purpose, if you will. And I find that sense of service, of duty, is strongly present at the labs. It's seen in our language. We talk about stockpile "stewardship." That is, we're caring for that capability for the nation. And I see people who also say that we're stewards of the taxpayer's dollar. We know that we're spending the government's money, and that this came from the taxpayer. Such awareness is, I think, very much part of the laboratory's culture.

Is it perfect? No. Do we see this in everybody? No. But the vast majority of people, I think, come to work with that sense of purpose.

I don't want to come across as saying there's anything wrong with people looking to earn a good living. As I just said, lab people earn a good living, but that's not why the laboratories exists. That's the distinction I'm trying to make.

We want to make sure we hire people who bring the right attitude — that is, one consistent with the right culture. We try to do that and then we check. Take someone working in the plutonium facility, for example. Not only do they have to get a security clearance that will let them see information that's highly protected, but they also go through a process that's called the "human reliability program." It involves things like drug testing and psychological exams. But, even more importantly, managers are taught to interact closely with the people on their teams. If it looks like maybe you didn't get enough sleep last night, because the baby was crying all night, a manager may well say, "Hey, it looks like today's a bad day for you, so we don't want you working on anything dangerous today. We'll gladly have you do something else today."

Managers watch very closely for things like someone showing up inebriated. I know managers who have said, "I need you to go with me to occupational medicine — we're going to do an alcohol test right now." And sometimes those tests are positive. I recently saw an example of a guy who works in the plutonium facility. His wife has back pain and so she put a little bit of CBD in her coffee. CBD is legal here in New Mexico. The guy said to his wife, "now, remember, I can't kiss you once you've drunk that." That's the level of seriousness people bring to this. Guys who are doing shots during a football game, aren't going to be in the facility the next morning.

In addition to that, we have to monitor the material itself very carefully. Going into the plutonium facility makes going into the airport look like a walk-in park. Gates, guns, and guards, whether you're going in or going out. And, by the way, you might ask, "What about high-level visitors?" Well, they get extra special treatment — the guards go into the facility with them, because they haven't been through the whole clearance process. In sum, we do our very best to hire people who are reliable and then we verify that whatever is actually going on is what we expect to see.

Q: How would you see these ideas playing out in the financial sector? Might you have any guidance to offer to leaders in that industry who are trying to manage operational risks like these?

A: This is well beyond my domain of expertise, but I think it would make sense to ask questions such as: "Where can we build engineered controls into the financial system?"

I trust you remember the distinction between process controls and engineered controls. With engineered controls, is it possible to defeat them? Yes. But it's pretty hard to defeat them by accident. You have to intentionally go out and defeat the switches, or whatever. How much of that could be done in the financial sector? Maybe we need to redesign some systems, or add new capabilities, to slot in these kinds of engineered controls. I don't know exactly how that would be done, but it may be something to think about. And I think that, on the people front, the culture front, just as the lab wasn't designed to provide jobs for scientists and engineers, the financial system wasn't designed to provide jobs either. We have a financial system because society needs it.

At some level, I think it would be a great thing if bank employees could go home and say to their kids, "I helped the US economy today. I helped make it a stronger place."

As I look at it from the outside, it seems that some of the things the financial system exists to do — its purpose, if you will — include things like: how we take people's savings and put them into productive enterprise, in ways that make production possible, with some level of return. Or how we deal with liquidity issues, so that funds are available when needed. Or managing risk: I have insurance on my house, for example. And I value things like having credit cards and checks that make it easy for me to pay for things. Finally, the financial system is an important implementer of both national and international policy — here think of the recent economic sanctions imposed on Russia. Those are all things the financial system does for society, as I see it from the outside.

A question I wonder about, but don't know how to answer, is whether bank tellers see themselves as helping to provide liquidity to customers? Do they see themselves as the conduits for shifting savings to productivity in the economy? I worked hard at the laboratory to help people in the construction trade to understand how what they did affected the nation's security. I remember a talk I gave to some of our construction guys. These were the people pouring concrete, and they had strengthened the roof on the plutonium building. And I said, "Look guys, I want you to go home and tell your kids tonight that what you did affected the thinking of the four-star general at US Strategic Command."

At some level, I think it would be a great thing if bank employees could go home and say to their kids, "I helped the US economy today. I helped make it a stronger place." I don't know, maybe that's idealistic, but that's something I did think a lot about at the lab. As leaders, we worked hard to communicate with people, because sometimes if you're down in the bowels of an organization, it's hard to see how what you do in the accounting or the procurement or the

HR world affects the mission of the laboratory. But I argued that every single person who was there was essential to the organization's success. I think it helps people to see how what they're doing contributes to the big picture. I think it helps the culture. And I think it helps them to do their jobs better — and not just better, but with "purpose."

Q: The Basel Committee on Banking Supervision discusses operational risk in terms of failures flowing from systems, processes, people and external events. Much emphasis goes to systems and processes, but the people piece is challenging. Can I draw you out on that, within the context of your experience at the lab?

A: I go back to my earlier comment: if you expect perfection from people, you'll be disappointed. I've talked a little bit about this from the perspective of purpose, but there's another element that's critical and it's a tough one to get right: leadership. We as leaders have a responsibility to set the tone in our organizations. And when there are unacceptable behaviors, we need to deal with them — and be very clear about dealing with them. People pay attention to expectations. They notice when a colleague is walked out the door because they didn't live up to those expectations.

At the same time, it's important, in my view, to make a distinction between mistakes and violations. Let me just give you an easy example. I might make a mistake in weighing high explosives. I hope that doesn't happen very often, but that would be a mistake. On the other hand, if I disable the interlock on the door for the explosive tank, that's not an accident, I see it as a violation. I had to go in there and disable that switch. I treat those two cases very differently. In one case I may be saying, well, maybe you shouldn't be handling high explosives, or maybe we need to revisit some basic training. But in the case of disabling a switch, it is far more likely that I'm going to say, "Sorry, you don't belong here. You need to work somewhere else."

Q: In closing, can I just ask how you see character in the context of everything we've just discussed? What's the role for character in all of this?

A: Integrity. I think there's a very important leadership role in saying what kind of an organization are we going to be. Within that, we need to make sure we treat people fairly, but we cannot condone behaviors that are antithetical either to the culture or purpose of the organization.

My experience as a leader in the laboratory system has taught me that people have exquisite inconsistency-detectors — people saying one thing but doing another — and they expect their leaders to act with integrity. When I talk to emerging lab leaders, this is one of the things I talk about. To be successful as a leader in the lab, there are several things you have to have. You have to be technically good enough to understand a very technical environment. You have to be able to understand people: some of the stuff that walks through your door is hard to deal with. And you have to be able to communicate.

But all three of those have to take place in an environment of integrity. If we as leaders fail in that regard, we're much more likely to have problems in our organizations. But when we model integrity as a character trait and make clear that it is expected of those around us, our organizations do a much better job of fulfilling the purpose for which they exist. And, if I'm right that the financial system exists for an important purpose, then society needs to be able to expect that integrity.

When we model integrity as a character trait and make clear it is expected of those around us, our organizations do a much better job of fulfilling the purpose for which they exist.

Dr. Charles F. McMillan *was the 10th Director of Los Alamos National Laboratory and President of Los Alamos National Security, LLC from June 2011 to December 2017.*

Author's disclaimer: These views are my own personal views. They're not the views of Los Alamos National Laboratory nor of the United States government, but rather they are thoughts and ideas that I have gleaned throughout a career in the weapons program.

ENDNOTES

1 "Red Teaming is a function executed by trained, educated, and practiced team members that provides commanders an independent capability to fully explore alternatives in plans, operations, concepts, organizations, and capabilities in the context of the operational environment and from the perspectives of our partners, adversaries, and others." (source)

Peer Perspectives

An Interview with Timothy O'Neill, Richard Spencer, and Owen West


Timothy O'Neill


Richard Spencer


Owen West

Q: The conflict in Russia-Ukraine recalls to mind something US National Security Advisor, Zbigniew Brzezinski, argued back in 1997: "War may have become a luxury that only the poor peoples of this world can afford." I wonder if you have any thoughts on that?

West: As with any prediction about the face of war, Brezinski's theory lasted four years before it was proven wrong. It's true that imbalance can lure policymakers into war. These perceived vulnerabilities range from monetary to military materiel to the lack of nuclear arsenals. But wars are as unpredictable as hurricanes. What we do know is that, after periods of coexistence, big wars fought among wealthy nations are hard to foresee.

O'Neill: When Brzezinski talked about a poor nation, he meant the absence of a nuclear capability. Such nations rely on conventional weapons and can use them without fear of 'mutually assured destruction.' The countries with nuclear arms tend to be the richer states. Brezinski was implying that we can still deploy conventional, non-nuclear weapons, but they have to be on battlegrounds well outside of the nuclear-armed states.

Spencer: Tim has framed it perfectly. I think that's exactly what Zbigniew was probably talking about. We have such an ability among wealthier countries to wage all-out destruction that, really, it is only the poorer countries where you can have what I call "a kinetic war" today.

And it's also true that you can't 'dominate' a country simply by bombardment, as Russia is seeing in Ukraine. You have to actually occupy territory, which involves a whole different cast of characters, and different set of arrows in the quiver. We haven't seen this play out among 'Great Powers' since the Second World War, so it's unclear which arrows the combatants will ultimately reach for.

Q: A recent article that appeared in the Economist discussed what the conflict might mean, economically, with reference to the age-old "guns-versus-butter" trade-off. The piece argued that we shouldn't think in these either-or terms, concluding, "A strong defence is, regrettably, a necessity for a strong economy." Do you agree? Why?

Spencer: I am always a proponent of a 'whole-of-government' solution. To quote General Jim Mattis, I'm a firm believer that the reason you have a strong Department of Defense is so that you can give the State Department one more day to negotiate. Over the last 20-plus years, we've often led with kinetics. We've led with the Department of Defense, while State may have operated in parallel, or a step behind in some cases. What we're now seeing is a whole-of-government solution being applied, with the Department of Treasury and the banking system standing out in front. That's something new for the world to see.

Let's go back to the beginning of the US Navy. The reason it was stood up was to protect the trading interests of the country. Look at that today — the trillions of dollars that trade on the ocean, the essential communications lines that run under the ocean. The United States Navy is one of the freedom forces keeping those avenues of commerce, transportation, and interchange safe and open. One of the observations I had during my time in the Navy is that we really have to start playing 3D chess — this isn't checkers anymore. It's guns and butter, and more.

Now let's also look at the history of Ukraine. Why did Stalin want it? Because it was the "breadbasket" of Europe. What are we going to see if the current conflict leads to crop shortages? Ukraine is a major feeder of countries south of them, in the Middle East and the Horn of Africa.[1] Remember, the trigger for the "Egyptian Spring" was the price of bread. The impact of what's going on now in Ukraine will produce what some have called a "re-sculpting" of geopolitical strategy. This is going to have immediate tactical effects around the globe as well.

So, we have to start thinking about the second, third, and fourth order of effects implied. If we need the "A-Team" in the State Department now — and we definitely do! — then we also need the "A-Team" in every single executive branch department if we are going to achieve a whole-of-government approach to thinking things through before taking action.

O'Neill: In my view, the concept of guns versus butter is an anachronism. It is only relevant to closed economies. Prior to globalization, when countries could trade only within their narrow geographic perimeter, defense-spending simply maintained and did not expand the trading envelope. The consequence was a trade-off between investing in guns versus butter. In the last 40 years, however, global trade has expanded dramatically because of the stability provided by United States as the sole superpower.

During the Cold War, there was no meaningful trade with the Communist Bloc lead by Russia and China Now trade has been globalized. As a result, everything that Richard talked about should be seen as the investment that nations need to make in order to protect that global trade. There is a clear ROI on that defense spending, because the expansion of trade has led to a significant growth in global GDP.

West: For fifty years, the United States has carried the load for liberal democracies. A strong defense is a necessary umbrella for free market economies. American warships have escorted oil and cargo tankers to keep commerce flowing. American troops have deployed to restive areas to keep wars from expanding. Our allies have not allocated similar percentages of GDP dollars to the common defense and have been able to "free ride" for decades, betting that in the event of war, the US will intervene. So far, they've been right. Look at Germany, which has outsourced defense to the US in recent history and relied on Russia for cheap energy. Regrettably, a strong defense is not required if you have a strong ally that is willing to accept disproportionate defense investment. That equilibrium is being tested now.

I'm a firm believer that the reason you have a strong Department of Defense is so that you can give the State Department one more day to negotiate.

Spencer: Tim's historical march down the timeline of using finance as a control mechanism reflects a strategy. What we're seeing now is the tactical application of these tools in a very different way. The magnitude of it is unsurpassed and I think that's a key difference.

O'Neill: Banks serve as the spigot through which money flows and the sanctions have turned off the spigot for identified parties on a very big scale —

including Russia's central bank. But the problem is that money is like water: it's fluid and moves to wherever a leak permits. It remains to be seen how state-sponsored evasion schemes will dilute the impact of the sanctions.

There's another important context here, discussed by Graham Allison in *The Thucydides Trap*.[2] When the US was the only superpower the geopolitical environment was relatively more stable. At the end of the Cold War, it was natural to bring Russia and China back into the global economy. e.g., Russia trading with the West and China entering the WTO. One consequence, however, is both Russia and China are now more emboldened to flex their economic leverage and military muscle. The 'Thucydides Trap' that Allison refers to is the inevitability of conflict between a sole superpower and rising superpowers. That is an important backdrop to current circumstances because it might reverse the trend of globalization and send us back to the Cold War economic isolation of Russia and possibly China.

Q: US Treasury Secretary Janet Yellen recently said, "Russia's military forces have committed heinous atrocities in Ukraine and the global community must hold them to account." The banking sector has been expected to play an essential role in that regard and, perhaps inevitably, that's been discussed in terms of the "weaponization of finance." What has that meant for firms? What's next?

O'Neill: The 'weaponization of finance', in practical terms, means that the US government has put more countries and individuals on the OFAC list. (Office of Foreign Assets Control) Money movements are controlled by banks and those accounts can be frozen, including official accounts such as the Russian central bank.

As people are beginning to appreciate, in finance there is inside and outside money. Inside money is somebody else's liability. Euros, Yen, Dollars, Sterling, and all fiat currencies reside within financial institutions, and can be legally withheld. Outside money is gold, or money sewn into your mattress, held outside of banks. Outside money is not a liability of someone else, so there is no 'counterparty risk,'. The weaponization of finance will accelerate the interest in forms of outside money with no counterparty risk.

A recent book by Nick Mulder, entitled *The Economic Weapon,*[3] reviews the history of economic sanctions after the end of World War I. Woodrow Wilson and other leaders believed another great conflict could be avoided by using sanctions instead of direct military intervention. The subsequent history has shown that economic sanctions are very effective — but only against smaller states. Economic sanctions were not effective against Japan and did not prevent World War II. It is difficult to contain large nations with just sanctions. Russia is a large, resource-rich country with a nuclear-powered military, so we should manage expectations about what economic sanctions can do. They should be used, but they're not decisive.

Spencer: Let me pick up on that. The US has marshaled one of the most unprecedented amalgamations of friends and allies to go after a geopolitical event — but there's still 'porosity' in the system. There are always going to be leaks, and some adversaries have developed a core competency in exploiting this, Iran perhaps leading that list. They'll benefit by the sanctions regime. This is the sort of second, third, and fourth order of effects I was referring to earlier.

Simply turning off the spigot of inside money, to use Tim's term, doesn't address the inevitable leaks in the pipe that will need patching. Some may call what's being done the 'weaponization of capital,' but capital can be used as an arrow in the quiver of any country seeking to protect its interests. That's seen in different ways among different actors amidst different circumstances.

West: That's right. The banks will follow the law (in terms of OFAC) and will follow the President if he chooses to make use of the bully pulpit more broadly. The Russians long ago figured out how to shore up their balance sheet, so the freeze on their central bank hasn't had the desired effect. The Ruble is now higher than it was at pre-invasion levels. Meanwhile, NATO can't agree on very many entities and oligarchs to sanction. German and Swiss companies have been paying the Russians in Rubles — and we have not commented. So Western banks have been unwilling to take on a leadership role in the sanctions context akin to the way they've led on social change issues and best practices in corporate governance.

So, I think 'weaponization" is the wrong term. Banks are bureaucracies, inclined to deal unless a counterparty appears on a Bad-Boy list or might pose reputational costs that will be determined by some Congressional sub-committee. After invading Crimea in 2014, Russia was hit with (weak) sanctions and an oil price that fell by 50%. But their Western business dealings soon rose, and their capital reserves were multiples stronger by 2022, when they decided to attack again. By 2016, it was apparent that China posed the greatest threat to the West. But the banking sector is far away from being 'weaponized' against China. In fact, it's appeared eager to do more business with China each year.

Some may call what's being done the 'weaponization of capital,' but capital can be used as an arrow in the quiver of any country seeking to protect its interests.

Spencer: Right. We have to be careful about being fooled by the power of this so-called weapon. In the last 40 years, as interest rates have gone down and the world markets have globalized, monetary policy and, for that matter, fiscal policy have been very powerful, both as stimulants and remedies when we've gotten ourselves into trouble. Whether it was '87, '08 or 2020, we could turn them on and off, giving us tools with which to manage a global economy that's dematerialized, as Tim put it.

I think what people are missing in this moment is that covid, the supply chain disruptions, and now a commodity rich nation like Russia turning off critical commodity supplies, all of this confronts us with problems that can't be solved by throwing money at them. The Fed can print money, but not barrels of oil. It can print dollars, but it can't print wheat. Since the financial crisis we've grown used to seeing the Fed and DC come to the rescue. That was the case in '08 and again in '20. What happens if we try for a third time, and it doesn't work? What are the consequences of that? I think that's something to worry about.

Q: The banking sector has suffered innumerable misconduct scandals, resulting in what some estimate to be $700 billion in punitive fines since the financial crisis — despite the billions in annual spend on governance, risk and compliance infrastructures. Is that spend delivering the expected ROI? And are those fines simply 'priced in' as a cost of doing business?

West: That's a very good question. I'm not informed enough to know whether the compliance framework emplaced in 2009/2010 has delivered a preventative ROI, whereas we know that more IRS agents will pay for themselves. I do know that, if you shrink fraud risks to near zero, it will impinge the bank's role in the capital markets that fuel our great democracies. Each case of misconduct looks obvious in hindsight. But fraudster clients and unethical bankers invent new ways of trickery to fool the system, mimicking the 99% of clients who seek capital for legitimate businesses.

O'Neill: After the dot com bust in '00, we had Sarbanes Oxley. After '08, we had Dodd-Frank. Now in the middle of Russian aggression in Ukraine, we have these sanctions. That means new, hidden operational liabilities for banks to worry about.

Q: Given the role it plays in current geopolitics, one could argue that the potential for misconduct in the banking industry is now a national security concern. Do you agree?

West: The patterns of bank misconduct have so far not reached a threat level among our top national security concerns. Hacking our financial networks, on the other hand, is a major threat.

O'Neill: Yes, but the cleverest frauds are all analog. They involve human beings interacting with one another. In business and in life, there's no amount of prevention that can keep you from being a victim of a very clever fraud. Such people understand your rules and processes and are constantly figuring out ways to attack and defraud.

Of course, there are potential fines: unintentional mistakes might be made. Banks do not operate in a zero-defect environment because of error and incomplete information. But the mistakes should only have reputational risk and not national security concerns.

Incremental regulation can be beneficial in many contexts, particularly in terms of KYC (Know Your Customer) rules. It is best practice to know your customer in as much detail as possible. Transparency, drilling all the way down to find the ultimate owner of an account, is something that should be done in normal course.

Spencer: I might turn this around a little. I think we need to ask how we can become more proactive towards risk, rather than reactive. There are new technology tools nowadays that work to forecast where risk might lie, so you can apply additive controls proactively, before the regulator has to come in.

We try to be highly predictive managing risk in the financial context. The mantra on the Street is that "risk is your friend." That's how we make money. With the right machine learning or AI tools we can say, "here is my financial model and it is going to generate X worth of profit." Why aren't we applying those sorts of tools more commonly to our internal and operational risks?

The Fed can print money, but not barrels of oil. It can print dollars, but it can't print wheat.

No, we can't afford to bring non-financial risk down to zero. But we can get ahead of the curve when it comes to regulation and supervision around such risks, especially if we want to avoid seeing more regulation imposed upon us. This is going to be a fascinating front going forward.

Q: This report focuses on evolving views regarding the importance of culture in the industry, how culture is believed to shape conduct, and what that means in terms of governance and supervision of issues that haven't lent themselves to quantitative risk analysis heretofore. There's some debate as to who ultimately 'owns' these issues in a firm. Your thoughts?

West: If the culture is strong enough there is no ownership debate. Everybody owns it. This requires a core set of business principles that are reinforced from the C-suite, down through the ranks, and back up again. At Goldman, we attached a number to even the most poetic problems, which I appreciated. A top-flight, independent risk analysis group helps enormously and must be supported at the top. More important is the way culture is communicated and reinforced. After all, culture eats strategy for breakfast. Firms with fuzzier cultures place undue responsibility on

More important is the way culture is communicated and reinforced. After all, culture eats strategy for breakfast.

risk or compliance groups without empowering them. With that structure, you'll face a risk decision-making breakdown every five years or so.

O'Neill: Culture is much more important than strategy. It needs to be embedded and understood throughout an organization. Reputational issues happen within a company because of culture not strategy.

Reputational issues happen within a company because of culture not strategy.

In the finance business, you do not have to worry about the bad ideas. They will stall and not get traction. You have to worry about the good ideas, because they will achieve liftoff and go too far. That is when you get into trouble. One hallmark of a good culture is the ability to say, "No, we're not doing that transaction."

Spencer: Just after I arrived at the Navy, we had the horrific McCain and Fitzgerald accidents. After we paid our respects, we brought in a whole bunch of people — from both the civilian side and the military side — to analyze what had gone wrong. They pointed to something called "the Normalization of Deviance." If you have only 98% of the people you need, the bough of the tree bends a little to accommodate. When you only have 95% of the people you need, the bough gets bent further. And that continues until it snaps.

One hallmark of a good culture is the ability to say, "No, we're not doing that transaction."

If we're going to avoid this, we have to have a cultural infrastructure that prompts us not to deviate from the North Star. ▸PAGE 409 That old comment, that culture eats strategy for breakfast, is just so true. Culture, when applied and supported correctly, is the strongest bone in the enterprise. That's needs to be protected and monitored. It requires constant caretaking.

O'Neill: The C-suite needs to own this responsibility. The best cultures are not rule based. It starts with the quality of leadership and the people they hire, people with a sense of mission and responsibility, which is oftentimes missing in the finance business. Risk management has to be hands on. You have to be constantly receiving information and able to tell what's important and what's not.

It sounds counterintuitive, but you need to worry more when people are making money rather than losing money. When someone is losing money, the control and remediation is underway. When people are making a lot of money, the hubris can set in and controls might be ignored. Performance in the top 1% is just not sustainable unless the law of mean reversion is repealed. A period of underperformance is inevitable. The problems develop when the money is being made and that is when you need to be vigilant.

Spencer: Just taking this one step further, I think the current focus on ESG is a good thing in this context. We have to start looking at culture. The regulators are. The shareholders among the up-coming generations are. So, we have to get our houses in order and set the right culture governance standards.

O'Neill: As we get more data on causality rather than correlation, ESG may be the ultimate value factor in stock selection. A stock can be valued on classic factors of price-to-book or price-to-earnings. But ESG metrics can provide a measure of companies with genuinely long-term, sustainable value.

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Owen West *was an energy trader for Goldman Sachs for twenty years before retiring as a partner to become Assistant Secretary of Defense for Special Operations from 2017-2019. He took two leaves-of-absence to fight with the Marines in Iraq while at Goldman.*

ENDNOTES

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OUR VIEW

"Nothing is so complex as relations when considered with regard to a society, and nothing is so difficult as to discover truth, when involved and blended with these relations."

SIR JAMES STEUART

AN INQUIRY INTO THE PRINCIPLES OF POLITICAL OECONOMY [1767]

Our View

An Interview with Gary Cohn, Keith Noreika, and Barbara Novick


Gary Cohn


Keith Noreika


Barbara Novick

Q: Barbara, Environmental, Social, and Governance (ESG) interests have become part of the mainstream thinking among institutional investors. You've said that "G is Key" but most of the airtime goes to the E and the S bits. Would you expand on that for us? And how does it relate to concern for firm culture?

Novick: Whether it's the media, the shareholder proposals, the data requests — any way you cut it — I think we can all agree that the lion's share focuses on E and S. And that's unfortunate, because G is the most important. When we ask, "what's good governance?", the answer usually echoes Justice Potter Stewart: "I know it when I see it." It's important that we recognize that each company is different, that different industries have different risks.

So, there's no one formula that gets you 'good governance' versus 'bad governance.' There are some basic obvious things like independent board members and the like but, at the end of the day, you have to ask yourself: do I have the right people? Are they considering the right information? Is management providing the right information to the board? And are the right incentives in place to align compensation with the values of the company and its shareholders?

Let me tie that in with firm culture through a few recent examples where governance was involved.

Consider Boeing — a company long known for quality and safety. Somehow, that was turned on its head and the company became so bottom-line oriented that it tried to pretend there were no fundamental problems despite repeated airplane crashes. To pretend there's not a problem suggests that there's something very, very wrong with the culture. And, in the end, that's a governance issue, and the outcome was enormous fines and settlements as well as turnover at the C-suite and board level.

And we can find similar examples in many other industries. Just think of Volkswagen's "Dieselgate" scandal, for instance. Some people argue that German corporate governance mechanisms are improved by having workers on the board, and I know some of our politicians think that engaging employees in this way is the solution to good governance outcomes. Well, Dieselgate was a problem for an 'old-economy' German industrial firm. Wirecard, and the fraud there, showed that 'new economy' digital firms are not immune from risk governance issues. Despite having employees on the board of those firms. Again, there's just no magic bullet.

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By the way, a significant percentage of Volkswagen's equity is owned either by the Porsche and Piëch families, family foundations, or the Lower Saxony government. They don't really have independent board members. So, if you want to fix the problems at Volkswagen, you'd have to seriously look at the ownership, the weighting of voting rights, and related governance issues.

The Vale mine disaster in Brazil in 2019 offers yet another example in a different industry and a different jurisdiction. A dam collapse sent millions of tons of toxic waste flooding the surrounding area in what was Brazil's worst industrial accident. Meanwhile, the alarm system Vale had installed to warn local residents of this kind of risk did not go off. Some two or three hundred people were killed — we're still not sure of the exact number. And it turns out that, a few years before the disaster, a smaller mine run by Vale experienced the same problem.

Where was the board in terms of the oversight of these risks? Who was asking the hard questions after the first disaster: "do we have other dams that have similar problems?" After the big one, they got shut down for a while and they had to go and do an engineering study of all their mines. Ideally, that study should have been done after the first incident.

And that's a governance problem. Vale has since agreed to compensation for "socio-economic" and "socio-environmental" harm. So, that's the S and the E in ESG. But what was really at play here was an underlying governance issue: whether or not the board was overseeing risk properly by challenging management's risk assessment.

Lastly, let's look at a financial services example. What went on at Wells Fargo to cause such a high turnover of staff? Why were so many employees leaving? Where were all those reported whistleblower complaints going, since the board claimed that it knew nothing about the mis-selling and false account scandal that landed the firm in hot water back in 2016? That's typically an audit committee function, but it could be handled by another committee, such as a risk committee. One question to consider: is management giving the board the information it needs to fulfill its role?

Is management giving the board the information it needs to fulfill its role?

Q: Thanks, Barbara, but let me be a little bit provocative. Some would argue institutional investors should provide a check on oversight of these governance issues, as part of their 'stewardship' function. Of course, investors point to the board, the board points to the C-suite, the C-suite points to front line leaders, who point to their staff. In the end, nobody seems to bear ultimate responsibility. Should that responsibility sit with large institutional investors in any significant measure?

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Novick: Well, the first thing to consider is the legal obligation, right? The board has a legal fiduciary obligation to all shareholders. Typically, no single shareholder has a majority ownership — not even 20%, right? You could say the Big Three asset managers have grown and that, in the aggregate, they may have 25%. But, at the end of the day, each institutional shareholder is a minority shareholder and acts independently. In the United States, there's some very clear language in terms of antitrust: you essentially can't work together to coordinate your votes on proxy issues. So, I don't see in practice how one could make individual firm governance a responsibility of its institutional shareholders. That said, investors have a role in understanding companies and making informed votes on proxy issues.

Q: Gary, let me bring you in here. You are the Vice Chair at IBM, you sit on a number of other boards, you've also been in management of a systemically significant bank, and you have had a role in shaping related government policy. Do you agree with Barbara that governance around these risk issues is the board's responsibility? Or are these risks effectively "priced in" as a cost of doing business?

Senior management is only as good as the data it works with.

How do we take the reality of human behavior and put some data behind our ability to inquire into it?

Cohn: I think it's hard to argue that it's priced in, but it's hard to argue that it's not priced in. That's not a great answer, of course. But it's also hard to pinpoint ownership of these issues in the way you're talking about this. Barbara brought out a very interesting point on the different compositions of boards. If you take Deutsche Bank that has employees on its board, for example, on one hand, and compare risk governance there against some other banks that have completely independent boards or banks that are family owned, and then look at how they each performed in the financial crisis, I'd bet you that Deutsche Bank did not outperform.

I'm not picking on anyone, but the point here is that there's a lot of distinct and different forms of risk governance infrastructure within these organizations. A board can't be expected to run the day-to-day governance, or culture and conduct of these large organizations, whatever industry you may be in. I don't care if you're in the automobile industry, the aircraft manufacturing business, or in the pharmaceutical businesses — just to list some where we've seen recent crises. So, we've got to look to senior management.

That said — and though people will find this difficult to believe — the truth of the matter is that the senior management are often unaware of what's going on in the core of their organizations. Despite best efforts, they're often operating in the dark. Senior management is only as good as the data it works with, the information it receives through their reporting systems, and the layers of reporting that aggregates up to them.

The board sits on top of all that. You've got layer upon layer, with the board being the highest layer up. But the bottom of the hierarchy probably has the most vital information, because that's where the incidents are happening most often. However, as that information moves up to the top, it gets filtered and watered-down at every level. That's the reality of human nature, and we're not going to change thousands of years of human nature. So, in many respects, we have to live with that reality. I think that's why the NY Federal Reserve Bank and so many other regulatory organizations have started to talk about this issue of culture and conduct, and asking how do you change culture, and how do you change conduct?

It's admirable that they've taken on this challenge. But it's a challenge! The question is, how do we take the reality of human behavior and put some data behind our ability to inquire into it? Is there a way to put science behind the G in ESG? We put science behind financial risk management. We can give you standard deviations, probability analyses, reams of financial and transactions data. The SEC recently came out with views on how to report on environmental data. You have to publish what your carbon footprint is or will be under future scenarios. We can report data on the social makeup of a firm and its customers. But to a large extent, the G piece of ESG has never really been addressed through data in the same way as the E and the S. Is there a way to get to a data set that allows you to put the G on equal footing? Is there a way to bring the day-to-day operational insights in the core of the organization up to those at the top who are trying to drive it in the right direction?

Q: Thanks Gary. But now let me now try to be a bit provocative with you as well. Put your Goldman Sachs hat back on for a moment and imagine you have some system that successfully brings the data from the bottom up to the top of the organization without filtering it beyond all recognition. Does the top of the house really want that information? As discussed elsewhere in this report, the standard industry approach is to look to surveillance and monitoring to detect when something goes wrong, and to take corrective measures thereafter. In many other industries, that doesn't fly — we insist that leaders can predict and prevent disaster. Do banking sector leaders share that aim?

Cohn: Yes. And I think there's a lot more effort geared towards "predict and prevent" in banking than people really appreciate. Once an event happens in one of these organizations, it is easy to model for that exact event and prevent it. For example, after the '08 crisis the regulatory environment shifted towards stress tests, and we saw a lot of change in reporting requirements, more documentation required to help us to predict and prevent another similar financial crisis. It is unquestionable that bank leaders want to get off the back foot around non-financial risk in a similar fashion to how we've done so for financial risk. The question is, how?

Bank leaders want to get off the back foot around non-financial risk in a similar fashion to how we've done so for financial risk.

Novick: Can I jump in here? Look at the size of these post-disaster settlements. I'd question the idea that any company can put aside adequate reserves and treat this as business-as-usual. Just to put some numbers to it, from what I can tell, Boeing paid $2.5 billion in fines and settlements with families. Volkswagen paid $15 billion just to settle with the US regulators, and then there were so many other countries where they faced fines that, when you add it all up, there's over $30 billion in settlement costs. At Vale, it was $7 billion just for compensation of the victims. It's hard to figure out all the numbers at Wells Fargo but, again, we're well into the billions. So, this idea that you can set aside reserves and just consider it a cost of doing business, I don't think so.

And this is where I would disagree with Gary. Where there's smoke, there's fire. If a mine fails, or an airplane falls out of the sky, and if the board doesn't act, and senior management doesn't do something to assume they have a problem but, instead, goes into the mode of doing some emergency PR management exercise, that's a problem.

And, to me, that's where the accountability and the responsibility are clear. This is no longer something in the trenches, that got filtered and watered down as the information worked its way up. I agree with Gary that, in many cases, the boss only wants to hear the good news, so things just keep getting worse and worse and moving further away from reality on the ground. But when something happens that's so obvious, like people quitting Wells Fargo in droves, and you've got whistleblower complaints that the board was ignorant of, then I say there is a governance problem.

Q: Keith, let me draw you out on this. Barbara says it's the board's responsibility to make sure management is doing the right thing. Gary says management is doing its best to get good information and welcomes more. But there's still a little bit of this finger pointing in different directions: the third line looks to the second line, the second line points to the first line, and the first line directs us back up to the second and third lines. Where does the buck stop, looking at this from a regulatory perspective?

Noreika: As it happens, I'm now at a banking conference where we had a lot of these discussions earlier today. We talked about the three lines of defense model of risk governance, and how it works in practice. The results may not always be what the model originally intended.

Ultimately, from a regulatory standpoint and from a market standpoint, I think the board and management collectively have their reputation and the company's reputation on the line. Especially in a publicly traded company. I think these issues make the regulatory aspect of governance all the more important.

Barbara was just talking about antitrust issues with institutional investors voting. In the banking context, there are rules that prevent shareholders from acquiring controlling interest. On the one hand, we make sure that bad people don't get to buy too much of a banking institution where they could do harm to the financial system, to the safety net, to consumers. But on the other hand, we don't have robust enough market discipline. So, this effectively protects everyone, including management and boards.

That's where there could be an additional agency problem, in terms of what's in the best interest of stakeholders. Governance has evolved a lot over the last 20 years. When you think about the way companies were governed in the '80s and '90s, there were real agency problems there, and we've come a long way since. But one of the things that came up today in our conference discussions is that these issues are not static. What you're doing today as best practices is not necessarily what's good tomorrow, because technology advances, thinking advances.

There are times where you may be doing something today that works in the current environment for you — say compliance in a money-making aspect of the firm — and you don't change things because that would mean an investment of money that you might rather pay out to shareholders, or in bonus payments to management. We see this especially where an institution is growing or changing, and maybe a senior figure is thinking about retiring and does not want to worry about problems that may erupt down the road. A lot of the reforms since the financial crisis tried to address these kinds of incentive issues from a regulatory standpoint or a good governance standpoint.

We're seeing technologies come to market that can help to bring more information from the bottom of the pyramid up to the main decision makers.

I would define governance, basically, as managing complexity and credibility. That's what I tell my clients. I mean, you only can go into a regulator and say, "we're complying with the laws," if in fact you have a governance structure that does that. And you can only go to a shareholder's meeting and say, "our product/business is safe, reliable, etc.," if you have a governance program that ensures that. But in a competitive market, over time, you may need to build better guardrails. And I think technology is really where we'll see the revolution in terms of this governance aspect.

Gary was talking about limitations to human nature. True, but we're seeing technologies come to market that can perhaps overcome some of those limitations — tools that can help to bring more information from the bottom of the pyramid up to the main decision makers. I'll straddle between Barbara and Gary: I think both management and the board need to have these tools.

There are limitations to what a board can do. They don't manage the company. But the more information you can get to them in discrete increments that allows the firm to develop a reputation for good governance and compliance, then the less the board will probably have to do. They can ask questions, and better see the "smoke" that Barbara talks about, so they don't suffer the "fire." But obviously, there are issues and need for greater board involvement, where those systems aren't in place, or have been left to languish over time and need to be updated.

Q: So, the board has a responsibility to question management and to develop clear awareness around risk governance capabilities and lapses, as Barbara notes. But Gary raises the point that management may not be able to answer such questions adequately, due to struggles in getting reliable information up from the bottom to the top. And Keith would agree that it's for the regulator to assess whether or not a firm is doing a good enough job in that regard. But I'm sure you'd all agree that a firm will always know more than its regulators. So, given these limits to what investors, boards, management and regulators can achieve, is this perhaps a matter that requires legislative action?

Noreika: I'm not really sure. Once Congress gets involved, things will get more complex, and legislation doesn't necessarily bear a great relation to the way things are actually done, or should be done, in the marketplace. Look, I think there are limitations inherent for regulators. Basically, they can only double check the checkers, right?

At some point, we just have to have transparency in the market that is sufficient enough to allow us to rely on the free market system. There are special rules in place for industries like financial services, where externalized risks could have large ramifications and create systemic risk between institutions. But I don't think, in general, that regulators are going to be able to do the job of management or the board. The most they can do is identify where there are deficiencies. And, to a large extent, that leaves regulators to rely on the information that the board and management are able to provide. If the board or management isn't getting the information it needs, neither will the regulators.

If the board or management isn't getting the information it needs, neither will the regulators.

Cohn: The idea that boards can do all these miraculous things is unrealistic. For new board members it takes time to actually figure out what's going on in a company. Plus, a lot of board members sit on the boards of two or more companies or are CEOs themselves. How long does it take to get up the learning curve, and then at what point have you been on the board so long that you have to defend the prior decisions of the board?

Unfortunately, I've seen this happen. There's a very short period where you know enough to question effectively without having become too friendly with management, many of whom you may actually have put in their jobs, or you at least approved them for the role. So, to me, I think this idea of the board being the savior just won't work. I think that we need to be realistic about what the board can and can't do, what the board has an ability to fully understand, or not.

So, it's tough. When you ask, "who owns this responsibility?", I understand why you wind up being pointed to the first line, second line, third line, you're pointed to risk, compliance, legal, or HR. But I can make this discussion very simple. The CEO, the president, the chief operating officer, the named executive officers of the firm own the risk. I think that's their job. And when you sign up for that job, whether you like it or not, you own the risk.

Diversity is definitely a governance concern.

Novick: I agree with Gary that the C-suite is responsible for managing the risk of the company. And that a board should not become management. But a board has responsibility for risk oversight, and that's why I used the Boeing example. When the first plane falls out of the sky, the board should be saying, "okay, I'd like an independent review of what just happened." Instead, the board seemed to accept the argument that the problem was one pilot who didn't know what he was doing, and the plane's fine. And then the second plane falls out of the sky. In between, the board has a role to ask management those tough questions, right?

Or at Vale, a small mine fails, and the board should say, "let's get an independent assessment of our other mines." And not the company's own engineers, but a truly independent engineering assessment. That's an oversight role, as opposed to a day-to-day management role. As a board member coming in four times or six times a year, you can never have that level of operational engagement nor should you in normal times. However, where there's a warning sign, you certainly should ask probing questions.

Now, the capture question is very interesting. I'll tell you a real story. In the United States, there's a rule that, if you're an executive of a company and you leave that company or retire, they can put you on the board, but there's a minimum number of years before you're considered independent. So, we were working on a response to a request for information for a UK regulator, and I got an early draft. It says, if you've been on the board more than 12 years, I think that was the number, then you're not considered independent. And I said, no, no, no, that's not how it works! And they said, no, no, no, it is! As we talked about it, we realized that the US and European views on capture are quite different. In the US you have to have this amount of time keeping away, but in Europe, they consider it a problem if you're on the board too long.

As with many issues, I don't think there is one correct answer. Having watched various board members who have had a longer tenure, they actually know the company better than those who haven't been there long. A good board member does seek to keep a little bit of distance. It's hard, but they can still be friendly with management and develop real relationships. But they also have to maintain a healthy skepticism. It's the shorter tenured board members that, I think, are the most tentative. They don't know if they know enough. They don't know if they should be asking these tough questions, so maybe they look to others to initiate. Maybe they'll follow, but they don't feel that they are in a position to raise difficult questions themselves, to be the squeaky wheel. And I just think that's human nature.

I'll tell you, I'm not exactly known for being the quietest person, and as a new board member, I've asked people "did I engage too much or too little?" I want to know where to calibrate, as a new member, because I'm getting into their culture and their dynamics. And that's a sensitive spot to be in. I can imagine someone who is maybe a little less willing to jump right into things feeling even more reserved and holding back. So, I don't think that just because you're long tenured you should be considered captured. And I don't think just because you're short tenured, you should be considered independent. I think there are good board members and there are not good board members.

Q: Barbara, diversity, equity and inclusion has come to be viewed as a governance matter, as is discussed by a number of our contributors this year. What is your view?

Novick: Diversity is definitely a governance concern, because it's about the composition of your board. Do you have the right people in the room? The biggest change in governance in the course of our careers is that it used to be all white men, all CEOs of one another's companies, setting each other's compensation. Really? It might not have been the Japanese *keiretsu* or Korean *chaebol* system, but it was pretty close in terms of the results.

Someone like me would never have been asked to sit on a board. And forget the female part! I wasn't the CEO at BlackRock. I wasn't even technically a C-suite executive. I'm a founder of the company, I helped build the company and ran lots of parts of it, with billions of dollars of revenue and thousands of employees. But I didn't have the CEO title, or CFO, or COO title. Obviously, relevant experience should be what matters most.

I think the sea-change has been that companies now are willing to open the aperture, and say, "Well, I can't get a sitting CEO, because boards will allow most sitting CEOs to sit on one outside board, at most, and there's not enough sitting CEOs to go around. So, I've got to look more broadly. How about someone who's running a business? How about someone who's retired that wasn't from the C-suite? And I might need some different skills sets related to new technology or cybersecurity. I've got to look more broadly." I think that's healthy and has led to a better mix of board members with usefully diverse experience sets.

Now, I'm liable to sound schizophrenic on this. On one hand, you look at the numbers and you say to yourself, "Really? You can't find more women or black or Latino or Asian — pick a category — and you really can't find more qualified people representing this group?" People often say that there's 'no pipeline'. I think that's just an excuse. Tell me what category you want, I'll find you someone highly qualified.

Diversity of thought and diversity of experience is what you're really looking for.

So, on that front, it's clear that unless it gets through to people that diversity is a benefit to the company, that needle would never move. On the other hand — and I feel strongly about this — I think that quotas are a bad idea. I think what Goldman or NASDAQ have done regarding IPOs and listings is too prescriptive, and I'm not keen on voting policies that establish de facto quotas instead of evaluating the true diversity of the board.

I think diversity of thought and diversity of experience is what you're really looking for. And creating these skin-deep variations — "I need one of these and two of these and three of those." I don't think that's the best approach. I don't want to be that board member who was chosen based on some physical characteristic that may be easy to see, but is irrelevant to my qualifications and should not be a consideration. Why would that be the characteristic that they care about? And I think many other people feel similarly.

Step back for a moment and imagine a company that's doing business in, say 10 countries, and they came in with a board that has 10 white men — but they were from 10 different countries, spoke different languages, and so clearly had a different form of diversity. Should we be against that? I don't think we should.

That's a valid form of diversity, if they've made a decision about their business that prioritizes a deeper understanding of different countries and insights into their respective cultures.

I'd rather see a company explain how they're getting dissenting voices, or accessing different kinds of ideas in the boardroom, than have a quota system where a third party mandates that you have to have X number of Y. When this stuff first started, it started with gender. But if you say you need X number of women, then you've effectively excluded people in other categories. That just doesn't seem right. And, not surprisingly, we are now seeing requests to set aside seats for other categories.

Q: Keith, I'm sure you read the report that Paul Weiss did for the board at Credit Suisse, after its Archegos-related losses, trying to dive into what caused that. Brad Karp at Paul Weiss wrote a pretty hard-hitting report, which he discusses here. ▶PAGE 137 An interesting question is whether those findings were at all unusual. Or was the reaction at other firms, "There, but for the Grace of God, go I"?

Noreika: I think any time there's potential wrongdoing, it means you have to take a look at culture and environment. It can have a lot to do with the issues that Barbara was talking about with diversity of viewpoints, and Gary's point about asking the right questions. Ultimately getting a variety of different viewpoints, both internally and externally, allows you to better evaluate and improve your governance structure holistically—from the board all the way down.

Novick: Many companies nowadays do employee opinion surveys. The responses are anonymous. And most employees understand that the results are going to be compiled and that their name will not be associated with it. The more you can get employees comfortable with that, the better. But you don't get the good information from questions where employees just a check the box. The good information is had when you give people the opportunity to include comments. And again, if it's done with anonymity and if employees believe someone in senior leadership is going to read the responses, you'd be amazed at what information people are willing to share. If you want information that jumps over all the mid-levels of management, that's one way to do it.

Noreika: I was just speaking with someone who had worked at the old Norwest, who said that she and the CEO would have lunch, maybe once a quarter, with a customer-facing staff person, with no management in between. And, in that circumstance, of course they were more likely to pick up on sales practice problems or other issues — knowledge which would likely be beneficial to compliance and good management of the firm. Maybe today it's a luxury to be able to solicit good information in that way, as opposed to using a survey. But I absolutely believe technology can create a means of picking up on things that might otherwise get filtered out as it moves up the ladder, with huge potential impacts on the firm's franchise value.

Q: Gary, whether at Goldman or elsewhere, you must have seen whistleblower reports. What was the reaction to that? Is relying on whistleblowers the right approach? Is that effective?

Cohn: It's clearly a line of defense, and I think it's an effective one. But if someone is then spending time trying to figure out who a whistleblower is, that's a horrible use of time and reflects a bad culture. Did I ever spend one second trying to figure out who the whistleblower was? No. I was trying to figure out if there was a problem. Was this a single isolated incident? Or was this a real systemic problem? That's what you ought to be doing with a whistleblower report.

> We have to make sure our people are comfortable reporting the truth, reporting the bad news.

We had an external hotline, to an outside firm that took our whistleblower complaints, to make sure everyone felt they had real privacy, that they weren't just calling someone in the firm. And that predated Sarbanes-Oxley. I've always operated in cultures of psychological safety, where people were happy telling others what they thought. Probably a little too happy at times! But we're talking about the tip of the iceberg here. The problematic issues are in the middle to the bottom of the iceberg. We can talk about the executive officers and we can talk about the board, but they're only as good as all the people down below them, and how ready they are to escalate critical information. We have to make sure our people are comfortable reporting the truth, reporting the bad news.

That to me, is the key to a good culture, to success, to everything. And the organizations that tend to thrive are organizations where escalation of problems is more seamless. I don't know if it's truly seamless anywhere in the world — as I said before, there's the human nature element in all this.

Why are Goldman and Nasdaq more interested in mandating diversity than in mandating one-share/one-vote?

Q: In this context, what might be relevant disclosure requirements? If these culture and conduct issues, diversity issues, and speak-up issues are governance issues, then what disclosures should we expect? What I've heard from the three of you is that it's pretty hard to answer that question, because we're not sure who's to be doing the disclosing, nor what it is to be disclosed. Can I ask you to react to that?

Novick: I don't think there is a checklist of disclosure issues with regards to governance beyond your board makeup. That's what I was talking about in terms of how firms approach diversity, how they're getting to hear from other voices in the boardroom.

If you had some kind of metrics — like those gained through employee opinion surveys, or from whistleblower complaints and how they were dealt with — there might be some disclosure you could do around those kinds of things. But I don't think a lot of these things are formulaic, which is why I started with the, "I know when I see it" line: you know it when you see it when it's bad, you know it when you see it when it's good, and it's different for different kinds of companies.

Imagine if you had an engineering company, for instance, and you had no one with a scientific background on your board. That would be bad. At the other extreme, if you had a completely retail-facing company, and all you had was a bunch of technologists who knew nothing about consumer preferences, you'd say that wasn't really the right answer either. Or if you had a company whose products are tailored to, let's say the Latino market, and they have no one with that background or insights about that community. Chances are the company is going to inadvertently do something harmful to their reputation in their primary market. That's what I mean when I say that good governance isn't formulaic.

Cohn: I don't think you can disclose away bad governance, and you can't disclose your way into good governance. I agree with Barbara, you know it when you see it, both ways.

Noreika: I take a little bit of the opposite view. I would think there's more established good and bad in the G part of ESG than there is for the E or the S parts. That ought to lend itself to something more robust than gut-feel, without becoming formulaic.

Q: Barbara, I think you wanted to say something about dual class shares in this connection?

Novick: You asked earlier about the role of institutional shareholders, and I find it fascinating that there is so much focus on E and S of ESG. Even within governance discussions, a huge amount of the focus is on diversity.

From my vantage point, the single biggest issue is the need for one-share/one-vote. This is a core corporate governance idea. Yet there are a growing number of companies coming to market as dual class share companies. Look at Facebook — everybody's favorite flogging stone nowadays. If you have a shareholder proposal, even if 100% of your institutional shareholders vote for it, it doesn't change anything where the institutional shares are less than a majority. And this structure is spreading like wildfire. Companies are staying private longer. We have all these 'unicorns' which, when they do go public, they do so with dual share classes.

Why are Goldman and Nasdaq more interested in mandating diversity than in mandating one-share/one-vote? Unfortunately, this creates a downwards spiral for corporate governance globally. Every exchange is competitive with other exchanges, and by allowing dual share class companies in one jurisdiction, then the next guy's going to say, "well, to stay competitive, we need to offer companies this flexibility too." So Hong Kong does it. And to stay competitive with Hong Kong, the London Exchange does it as well. I went around the world, talking to different exchanges, asking them to not follow in this. And each one said, "but how can we not do it if others are doing it?" Even jurisdictions where they disliked the structure felt they had to offer companies the option.

And when you look at Europe, you realize that weighted voting rights and affiliated voting are quite common. In fact, a significant percentage of its listed firms have a family foundation, a public sector owner — something that is not an institutional investor — which controls a third of the votes. And in a lot of these places, the block vote may be conflicted as they're unlikely to vote against their family member. Clearly, institutional investors have less of a say in these companies. And it's a huge percentage of them: 61% of the companies in the MSCI Europe, so over 400 companies, have some issue of non-institutional or unidentified shareholders.

So, to come back to your earlier question: what is the role of institutional investors in effecting good governance? Dual share classes and weighted voting rights further dilute the potential influence of institutional shareholders. In short, this is why I'd like to see more focus on one-share/one-vote which is a key governance issue.

Noreika: I think the issues that Barbara raises could very well be a potential cause of future instability and risk in the market.

Novick: I agree with Keith. It's a little like the rating agency's pre-mortgage debacle, right? You keep lowering your standards because you can't lower your price. And the only way you can compete for more business is by giving people a better deal. So, you hold your nose and you lower your standards until something goes wrong, and then Congress brings in Sarbanes-Oxley 2.0. I'd like to head that off with a shift towards one-share/one-vote, either upon IPO, or through a 'sunset clause' that gets you there in a reasonable period of time.

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Barbara G. Novick *was a co-founder of BlackRock in 1988. She transitioned from Vice Chairman to Senior Advisor as of February 2021.*

INTRODUCING DEEPER DIVE SUPPLEMENTS

The Era of Accountability

A prioritization of environmental, social and governance (ESG) interests has been in growing evidence in recent years. But while climate change concerns and social injustices dominate the news headlines, a majority of investors say governance, and governance related lapses, are the more important element. “G is Key.”

Firms and their leaders are being held to account for governance failures that result in stakeholder harms. Investors are voicing new expectations of boards. Supervisors look to C-suite and business leaders for evidence of reliable non-financial risk management.

And employees are increasingly prepared to “speak out” as whistleblowers and activists when management fails to assure that a psychologically safe workplace enables and encourages “speak up” behaviors.

With executive compensation being tied to good governance outcomes, what’s next in the Era of Accountability?

Learn more in a Deeper Dive supplement to this report, available later this year on Starling Insights, a membership-based platform that will feature all of our *Compendium*, thought leadership, video, podcast, and event-driven content.

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Our View

Culture & Conduct Risk in Banking: Achieving a Better Standard of Care

by TOM READER & STEPHEN SCOTT

Tom Reader

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Behavioral risk management in banking is most typically an exercise in applied hindsight: we investigate misconduct only after it is discovered to have taken place, and then revise rules and procedures to aim at known past problems, rather than targeting potential future troubles.

This 'detect & correct' mindset has resulted in of billions of dollars in punitive fines across the industry worldwide over the last decade. Estimates put the figure at some $700 billion—and this, despite the tens of billions that firms have invested annually in their governance, risk, and compliance control infrastructures during that same time frame. What is to be done?

We suggest that regulators and bankers look to the nuclear power, aviation and healthcare sectors for instruction: industries where operational risk management failures are simply intolerable. In the wake of catastrophic loss events and significant public harm, these industries have adopted a 'predict & prevent' standard of care. Their subsequent success is illuminating.

With the exception of the Fukushima Daiichi nuclear disaster of 2011, triggered in large part by a tsunami, we must look back to the 1986 Chernobyl disaster to find a nuclear accident of any similar magnitude. In 1970, 2,226 people lost their lives amidst 298 air-traffic incidents. So far, this year has seen 175 fatalities across 43 accidents—a drop-off made all the more remarkable when we consider that the volume of air traffic has increased by some 60% since just 2004. A 1999 report, *To Err is human: Building a Safer Health System*, found in-hospital medical errors to be a leading cause of preventable deaths. Today, a robust "patient safety movement" has promoted dramatically improved safety practices that have been adopted worldwide.

Resident pathogens

James Reason is a pioneer in the study of organizational accidents. After researching numerous catastrophic accidents in healthcare, aviation, and nuclear power, he found that these risk and safety management failures rarely followed from isolated bad acts or individual error. Rather, they were most often the product of "*resident pathogens*"; unacknowledged latent conditions that compromised organizational defenses during some acute triggering event. "People at the human-system interface—the 'sharp end'—were not so much the instigators of the accident," Reason concluded, "rather, they were the inheritors of 'accidents-in-waiting'."

Reason sees risk management failures as spilling from three "buckets": the individual, context, and task. Much risk management takes aim at the individual actor—the disgruntled employee, insider threat, rogue trader, or incompetent boob.

But Reason decries this "human-as-hazard" mindset. Instead, he emphasizes the context in which a task is carried out. This includes risk management systems and processes, of course, but culture is of far greater significance, because it reflects the underlying priorities of organizational members and directs behavior.

There is a distinction between acting *badly* and acting *poorly*. Risk and compliance managers in banking emphasize reliance on surveillance and monitoring tools to spot bad acts—intentional misconduct. But it is the unintended error—acting poorly—that poses the greater concern for most firms. In many instances, unrecognized cultural norms drive poor behavior, through a "normalization of deviance" that leads to eventual catastrophic failure.

Risk management systems that fail to take culture as a starting point are compromised at the outset. Worse, as learned anew in the wake of BP's Deepwater Horizon accident, they invite a false sense of security which resident pathogens will ultimately exploit.

Today's covid necessitated work-from-home protocols have forced many firms to confront the latent conditions that shape their daily operations and organizational performance. This should be seized as an opportunity to root out resident pathogens. In that direction, bankers and their supervisors would benefit by studying four lessons learned by peers in other critical industries.

- **Encourage a speak-up culture.** Studying accidents in the healthcare sector, Harvard's Amy Edmondson found that a psychologically safe working environment was essential to effective organizational learning from past failures—that is, a culture characterized by interpersonal trust, obligatory candor, and a willingness to admit error openly.

- **Establish public-private partnerships.** The admirable aviation safety record seen in recent years first necessitated a revolution in thinking among regulators, executives and pilots' unions. This was advanced when a White House blue-ribbon commission called for an industry-government partnership to "replace confrontation with cooperation."

- **Cooperate with competitors.** Firms do better to increase resiliency through shared learnings rather than by going it alone. Chernobyl led to an industry-wide safety mindset that reflected, "a collective commitment by leaders and individuals to emphasize safety over competing goals to ensure protection of people and the environment."

- **Deploy a forward defense.** In the industries that Reason studied, risk management was improved through a mix of non-technical skills training and re-orienting risk systems and processes to promote a culture of safety which, in time, facilitated "a gradual transition from reactive to proactive methods of managing and controlling hazards."

A better standard of care

Experience in the healthcare, aviation and nuclear sectors demonstrates that we can do better than merely to record and react to past accidents. Instead, we can adopt a standard of care that emphasizes anticipation of accident and the proactive mitigation of known and potential risks. But if we are to manage from a proactive posture, we need to take a dynamic view of risk and to recognize that risk unfolds into accident within an evolving social context: future accidents will likely stem from subtly different causes than those that led to past accidents.

Predicting and preventing disastrous outcomes implies that firms have learned what signs of future trouble they should be watching out for. These are often non-obvious and discovered by looking to the experience of peers. But we can also look inward: we have shown that artefacts of an organization's culture may be distilled from unobtrusive data, and that this can provide reliably leading indicators of risk management failures, thus permitting for proactive remedy.

Where organizations have developed metrics that illuminate latent conditions so as to identify *potential* threats to safety, these metrics not only provide insight into how well risk is being managed at the day-to-day operational level, but also reveal how future outcomes are likely to flow from institutional priorities and values as they are observed to operate *in practice*.

Catastrophic risk management failures in the healthcare, aviation and nuclear industries are dramatic: people die. By contrast, no one suffered immediate physical harm due to the false-account scandal at Wells Fargo, the 'fees-for-no service' practices at National Australia Bank, money-laundering at Natwest and Deutsche Bank, or the Archegos fiasco at Credit Suisse. ▸PAGE 137

The harm done to society through bank misconduct scandals is more insidious: they extend an already advanced erosion of trust in the industry and, because personal accountability is seen infrequently, this contributes to the perception that bankers operate under different rules than those that apply to "the little guy," courtesy of regulatory capture and cozy government ties.

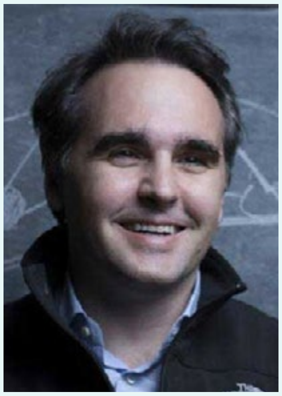
This has impaired the public's faith in market discipline, in capitalism, and even in democracy itself. Bankers should seek to mitigate these 'negative externalities' of their own accord or, experience in other high-risk industries suggests, society will demand that governments *impose* a higher standard of care on the industry. It is not enough to 'detect and correct' misconduct scandals and bank risk management failures. We need to 'predict and prevent' such outcomes.

A version of this piece was first published by Thomson Reuters Risk Intelligence on 14 October 2021.

Tom Reader *is an Associate Professor of Organizational Psychology at the London School of Economics & Political Science where he researches organizational safety, and practices important for averting accidents.*

Our View

An Interview with Damon Centola and Betsy Levy Paluck



Damon Centola

Betsy Levy Paluck

Annenberg School for Communication, University of Pennsylvania

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Q: Damon, in our report last year you described "complex contagions," making the observation that, while most people think the key to driving change lies in identifying influencers who can advocate for an initiative, in fact, change is less so about finding the "right people" and more so about having the right "contagion infrastructure." What does this mean and how is it relevant in a management context?

Centola: The rational choice model has come under heavy criticism, and the shift has been to say that, if people aren't rational, there must be something more generally cognitive going on that we can define as "behavioristic" and address through "nudges." There are unconscious biases and heuristics we can seek to understand which will then tell us how people will act. To me, that approach is as narrow-minded as the rational choice perspective. Because the assumption is that a person is an isolated actor: give them the right stimuli, they'll make the right choice. In the rational choice model, the important stimulus is usually taken to be information. In the behavioral model, it's triggering parts of the brain conditioned by evolution to respond in certain ways. But that's still methodologically individualist and overlooks the fact that a lot of the decisions people make are based on the people around them.

The orientation that Betsy and I bring to this discussion does not see people as so fixed. There's tremendous plasticity to behavior, conditioned on social factors that can be studied, understood, measured, and treated. They can be intervened upon. People don't like the term "social engineering." They don't like the idea of being manipulated. But it happens all the time. It's what governments do to produce desired social outcomes and, when they fail to do it successfully, everyone throws up their hands and says, "what's the point of government?" But these failures usually reflect bad policy. The idea is to figure out how to correct our policies based on our best science, and our best science has moved significantly beyond the individual.

For a long time now, a common intuition has been that, if we just give people access to the right information, they'll make smart decisions. And other than broadcast media, one of the ways of disseminating that information is through social networks. For three-quarters of a century, research has been instructing us that information-spreading is the key to a better-informed population and better decision-making. More recently, we've taken this idea and applied it in terms of "influence." Even if people don't have *all* the information, if you give them *certain* information, then that will influence their decision-making.

But this thinking basically views social networks merely as pipes: conduits of transmission. This is consistent with the way we think of a disease spreading: I come into contact with you; you transmit the disease to me; and then I transmit it to somebody else. Hence the idea of a 'super-spreader.' If we get someone who's highly connected, they'll come into contact with lots of people and they'll have a very high probability of transmitting the disease to all of them.

> The important change in thinking here is that, when it comes to behavior change, and belief change, our social networks serve as prisms.

Translated into the informational context, we think of someone like Beyoncé. With all her social followers, we believe that if she says something to those followers, or does something that's seen by them, then that information will spread out to lots and lots of people and alter their behavior.

The important change in thinking here is that, when Betsy or I look at social networks, they're not seen as pipes. When it comes to behavior change, and belief change, our social networks serve as prisms. They refract and shape the information we get.

Many people exhibit behaviors that aren't part of any information spreading process, but those behaviors nevertheless shape how we interpret information. The people around us affect whether we are ready to believe new information or reject it, or whether we think it's ultimately irrelevant to us. These networks of influence around us are not even noticed if we're only looking at pure information-diffusion. But it's those networks that do the majority of the work influencing our behavior, determining how information affects us once it does get to us, and influencing whether that information reinforces our existing belief in some idea, or helps to accelerate a change in opinion.

> If we're going to think about organizational culture, we have to think about how these networks govern our coordination in ways that are largely invisible to us.

The complex contagion perspective centers on the structure of those social influences around us that really shape, and control our receptivity to information — and invisibly governing our behavior. In organizations, of course, this happens more powerfully than in everyday life. In everyday life, we've got stronger influences and weaker influences all around us, people we interact with more, like our family. ▸PAGE 361 But within an organizational context, we are principally coordinating with small groups of people. That process of coordination governs many of our decisions, and it happens invisibly. Let me explain.

In an organizational context, it's common to describe the big challenge in terms of a *cooperation* problem. But the cooperation problem is something we're aware of. It's something we think about. We can see when there's a tension between our personal interests and the collective interest of the group. I think the *coordination* problem is more interesting because it appears trivial. It's less obvious, because we're coordinating all the time, without even noticing it. Things like 'implicit biases' are not typically part of cooperation problems, because we cogitate over those things. But, with problems of coordination, it's like the water a fish swims in; we don't even notice it. Think about the things that make us feel comfortable, the things that make our peers feel comfortable. That's what governs our behavior in implicit ways.

So, if we're going to think about organizational culture, we have to think about how these networks govern our coordination in ways that are largely invisible to us. That's what complex contagions are: forces of social influence that can shift the entire culture of an organization without anyone really knowing that they're changing their behavior. And — precisely because we're not aware of it — we need to refocus our attention towards it purposefully.

A scientific awareness about how that process works is quite powerful. It means you can change the culture of an organization without needing lots of motivational speeches and seminars to get people excited, nor does it require compliance and monitoring processes to police subsequent behavior. Instead, you can put people in a context specifically designed to shift their behavior in a desired direction. It's hard to understand that such interventions are happening all the time. It's hard to point to invisible structures and processes. But those structures and processes are there and, as scientists, we can measure them.

Q: Betsy, in this report, Amazon Web Service's Michael Arena describes a "natural interplay" between organizational culture and organizational social networks—one which isn't typically factored into culture change initiatives. ▸PAGE 403 Your research suggests change to culture and behavior can be advanced through such networks. Would you please explain this? What led to your research? What are some of the most important or surprising learnings to date?

Paluck: Well, first of all, let's take it back a step and recognize the importance of culture. When those who have to answer for the effects of some particular organizational culture think about trying to change that culture, they most often think about top-down processes. They think about institutional arrangements and rules — and I certainly think of that, too.

Maybe one reason people don't think about networks quite as much is that the networks that people like me highlight don't involve people doing top-down work. It's hard to imagine how people who aren't at the top of the organizational ladder can have much to do with culture. But there's a lot of research showing the importance of mapping those organizational networks if we want to understand how culture is produced, reproduced, and shifted over time — by people within the organization who are *not* associated traditionally with top-down cultural power.

There's a lot of research showing the importance of mapping those organizational networks if we want to understand how culture is produced, reproduced, and shifted over time

My research is focused on networks of attention. Within every organization and community, there's a certain amount of attention that's going up towards the top. We look towards traditional leaders — those with the offices, the roles, and the titles. But we also pay a lot of attention to our peers, horizontally, and even to people who may be ranked below us. Why?

Well, we look to those people because we enjoy them, but we also look to those people for information. We have a sense of their place in the hierarchy, their role and status. Depending on what we observe them doing, we get a lot of information about the culture of the place. Many of those at the top of the hierarchy find that their behavior is pretty constrained in many ways. So, if you want to know what kind of humor is *really* allowable at an institution, if you want to know what kinds of attitudes are representative of the place, then you might not look toward the top, where the language is very constrained. Instead, you look to your peers and the people below you in the organizational structure, who are seen as maybe more genuine.

These networks of attention are really important. They tell us about the kinds of information that people are taking-in most regularly, about the culture of a place, the perceptions of what's typical and what's desirable in terms of behavior. In my own research, that's what we look for. People who get a lot of attention have an outsized influence on our ideas about what's expected in any given organization. And, to me, that's what culture is really about.

A leader can *tell* you what's typical or desirable, but if you look around and that's not how you see people acting, then it doesn't matter what people are saying in a top-down direction. What matters is what's happening in that attention network. It's important to recognize that the people to whom you're like to refer, when seeking cultural information, are usually those found in identity-based groups. They're the people you trust, because you share an identity, or a role.

For anyone interested in culture change, it's important to know what networks of trust are at work in the organization.

Trust is really important in those instances, because you are trying to find out how to fit in, to learn how to excel, how not to violate the norms of a place. You want to be able to trust that the people to whom you're looking to for advice, or those whose behavior you want to observe and mimic, are in fact people who can give you good information. For anyone interested in culture change, it's important to know what networks of trust are at work in the organization. What are the networks of attention within the organization? You need to know that because that's where you want to target your efforts to drive change. You need to shift what people see within those networks if you want to change their impressions regarding the norms of a place.

Such a "reference group" could include the people with whom you sit within a particular wing of an institution — like the office or a school. But it's more likely that you'll skip over some of that geography. There are people to whom you are connected in ways besides proximity. They're the ones you have a drink with after work, those you email or text regularly throughout the day. It is those within these networks of trust from whom you'll seek information about how to behave, about what kinds of behavior will be rewarded in your day-to-day life at that place.

Q: Damon, in *How Behavior Spreads*, you write about the importance of trusted relationships and argue that managers can make use of organizational social dynamics, "to design organizational networks that improve institutional capacities for innovation and adaptation." Can you offer concrete examples and explain how trust is relevant here?

Centola: When you're talking about the infrastructure of an organization, the key question to ask is, "what is the connectedness between groups that are functionally very different?"

When you're talking about the infrastructure of an organization, the key question to ask is, "what is the connectedness between groups that are functionally very different?"

How much discourse is there between the marketing and the engineering groups, for instance. How much information flow? The classic idea of a network "bridge" is that there's a person, let's say in engineering, who talks to a person, let's say in marketing, and so we expect there to be information flow between them. But that's a very narrow bridge! It means that, if the engineers are trying to get the marketing people on board with a new program or new idea, one person has to convince a lot of other people to change their way of working.

This is probably not going to be very effective. But now imagine that there are more connections between those groups, that several people in engineering go to lunch with several people in marketing and talk informally with them and get to know them. There's opportunity for more trusted relationships to develop there. So, when the engineers talk about this innovative idea that they're trying to get marketing excited about, there are several people in marketing who can independently evaluate what the engineers are saying, and then go back and talk to each other and coordinate within the marketing group to try to get the other marketing people excited about it. By increasing the "width" of the bridge between these different groups within the organization, you increase the degree of exchange and the depth and quality of knowledge that can be shared across these groups.

And that comes as a result of trust. If one person is trying to convince people in a different group to take something up, it looks like they have a hidden agenda. And, oftentimes, if that person is a network "broker," they may well have an agenda, because the more ideas they can spread around the organization, the more credit they'll get as the broker for those ideas, and the more attention they attract, the more likely they'll be to get promotions. That broker also has an incentive to keep his or her social ties exclusive, because their power in the organization comes from the fact that they're the only engineer who talks to people in marketing.

The question then becomes, how does it affect that person if you suddenly develop more connections between engineering and marketing? It basically reduces that person's power in the organization, because it increases the organizational capacity for those two groups to talk to each other. This is where adaptation comes in. If someone who is a "narrow bridge" leaves an organization, the question then becomes, how does the structure of the organization change? How stable is it? If a broker who has status in an organization can attract offers from other organizations, part of their power is, if they leave, they also take away a ton of infrastructure with them.

This is where the redundancy of social ties, and the role of "wide bridges" becomes really interesting. With multiple redundant ties, and greater bridge width across different groups, individuals may come and go but the social infrastructure stays consistent. So, you can still have a flow of ideas and coordination and communication across these different groups, which means that as there's employee turnover, there's nevertheless a stable infrastructure that allows people to share knowledge, and this allows the organization as a whole to be much more adaptive than an organization with "narrow" bridges.

Q: Betsy, you wrote a recent paper on engineering social change by using social norms[1], calling them ongoing group processes rather than a set static beliefs. By developing an understanding of these processes, you suggest, we can devise interventions to promote (or discourage) specific norms with 'predictive' reliability. That sounds difficult to apply in a risk or compliance context. Is it?

Paluck: Any intervention that is going to have predictable effects on people's behavior are not going to be the lightest-touch interventions.

Many people have tried to run with this idea of "social proof."[2] One light touch way in which some have tried to really run with this idea is to 'message' people, rather than trying to provide them with real social proof. We've all been messaged this way. We're told that 80% of the people in our neighborhood are going to go out to vote today (hoping that this will prompt us to do likewise), or that 90% of the people in your age group in your zip code have been vaccinated, (so why haven't you done so yet?). What's challenging about this approach is that it doesn't always match up with your experience, what you see in your reference network, in your habitual environment. So, such messages can be safely disregarded, we conclude. So, these kinds of culture change initiatives have had very mixed effects.

Sometimes you get a big bang for your buck, and I think that is especially the case when we're talking about hidden behaviors. "Oh! I had no idea so many people in this area have gotten vaccinated. Wow!" Maybe that leaves you more open to getting the vaccine as well. But a lot of the behaviors that we want to change are not hidden. There, you need a different kind of social proof. You need to discover where in the network you should target your efforts so that a particular witnessed behavior provides a 'right-in-your-face' sort of social proof.

What does it take to change people's behavior? Well, first we need to understand who people trust. Consider people who care a lot about the adoption of new technologies. One of the most powerful things they'll do is to sit down with a friend who's using the Big New Thing and ask, "What's that?" And their friend says, "Oh yeah, let me show you this. This is what I love about it. This is so cool. This is how it's changing my life right now." That's a kind of adoption that we don't often think about when we're trying to spread more ephemeral things, like responsibility, or anti-corruption practices. But we need that kind of social proof for the more ephemeral kinds of culture change as well. It's not all going to be light touch.

What does it take to change people's behavior? Well, first we need to understand who people trust.

We're at the point in our science where we have an understanding of networks and of norms such that, if we're going to invest in culture change, we know where to look. We have really good ideas about where and how to intervene to drive change. And that's how we've used the word 'predictive' in my research.

In that paper we were looking at teachers, and one of the big lessons for us was that even those teachers who are observing the network closely every day don't see the same networks that the students experience. What we observed was that teachers couldn't pick out the same influential people that students could pick out. There was some overlap, but shockingly less than you might expect. And the people who teachers *did* point to as being influential were the kinds of people who appealed to teachers. They were influential *in the eyes of teachers*, though perhaps not so in the eyes of students. We all have our biases in terms of who we pick out as influential folks.

For anyone trying to apply these ideas in a risk or compliance context, my counsel would be to take a bottom-up approach in mapping out the network of folks who will be involved in this kind of exercise. Identify who among them are the most influential people, and then check out their behavior. As a social psychologist I would say that you know a new behavior has become rooted in the network when some nodes — those who've have adopted it — become more highly visible to everyone else. By metaphor, if the "teacher's pet" is doing it, that certainly doesn't mean that everyone else is going to adopt it. So, in your compliance context, who are the people you want to see adopt the relevant behaviors? I would take more unconventional methods in trying to identify where adoption of the new behaviors you want to see is most likely to take hold.

For anyone trying to apply these ideas in a risk or compliance context, my counsel would be to take a bottom-up approach. Who are the people you want to see adopt the relevant behaviors?

There are a lot of different behavioral traces that we drop all around in an organization that give us a clue about where our attention is going. Sometimes we use surveys. We look to see who people report spending their time with or asking questions of. And you can do an analysis of emails to see who people are paying attention to. Who do they consult regularly? Who are they calling, texting, or Slacking?

Q: Damon, in *Change: How to Make Big Things Happen*[3], you make the provocative argument that we are more influenced by the *percentage* of people we know who opt into a particular behavioral norm, rather than the raw number of people seen doing so. Can you explain this, in the workplace context?

Centola: Think about the validity of an "urban legend." If one person tells you an urban legend, you're probably going to say it's not true. But if you hear it from several people, you might start to think there's some credibility to it. The people who aren't repeating the story may not have heard it, so their silence doesn't signal anything in terms of disbelief or resistance to the idea. Social confirmation has a strong, positive effect, but silence doesn't have the same negative effect. Just a couple people can confirm the rumor and get you to repeat it.

But it's *very* different for any kind of visible change in behavior, because the people who are *not seen* to be engaging in it are implicitly against it. If some members of your office have started using a new technology, or are trying to advocate for a new project management strategy, and you see all the peers around you but for two are sticking with the old strategy, then those two adopters are not very convincing. The effort to initiate change is weighed against all the people who are seen still to be doing the same old thing. Essentially, the non-adopters are an implicitly countervailing influence against change.

Because people exist within these social networks, they pick up and apprehend behavioral messages.

This is one of the key insights of complex contagion: it's not just that we need multiple reinforcing signals to be convinced that something is a good idea, we also need to be convinced that the idea is 'legitimate,' and that involves looking at everyone, not just the adopters. To succeed in driving change, we need to think about getting enough social reinforcement so that the visible adopters outweigh the non-adopters — ultimately making the non-adopters feel like *they're* the 'illegitimate ones,' the ones who need to catch up with the curve of change.

Q: Betsy, much of your past research is focused on prejudice[4], how it shapes behavior and how this can be changed when bad outcomes result. You argue that perceptions of what is *believed* to be a desirable behavior within a group are more important than any actual *knowledge* about what behavior is in fact condoned. Perhaps that's that 'prism' effect that Damon was just describing? Can you say a bit about this? And I'd be interested to know how you see this playing out in the context of DE&I initiatives.

Paluck: Damon just illustrated beautifully the landscape of how we would approach these kinds of problems. And notice what he didn't say. He didn't argue that we need to go in and try to convince each and every individual to change their beliefs or their behaviors. He didn't describe working individual-to-individual to implement some sort of re-education programming. Because people exist within these social networks, they pick up and apprehend behavioral messages as a collective, rather than as individuals.

A critical bit of 'connective tissue' among us is our shared reality: our collective understanding of how we are to treat one another, our standards for acceptance, our shared practices for how to get work done and how to apportion responsibilities, how to strike a balance between rights and responsibilities within an organization. It's all about these collective understandings.

And, to reiterate from Damon again, that is something that we can measure, something we know how to target. A lot of DE&I efforts have focused on the education and persuasion of individuals. The kinds of interventions I've been interested in focus instead on these shared understandings, the shared realities that characterize the networks within an organization. That represents an opportunity for a different kind of management intervention, one less so about workplace training and more so about shaping collective experiences and practices.

Q: Damon, you've also written that, as a network becomes more conducive of simple contagions, complex contagions are likely to become less common among that group. I can't help but think that this is highly relevant in the context of new 'hybrid' work environments. Your thoughts?

Centola: The way to think about this is that there's an economy of ideas. There's only so much stuff we can ingest during the day. So, the stuff that's easier to talk about and that therefore spreads more quickly is going to have an advantage in terms of affecting people's beliefs and ways of doing things. If a change is initiated that requires social reinforcement, and if that faces countervailing influences, then the change initiative is competing for social network bandwidth. The more content that's flowing around, and the easier and more familiar that content is, the less bandwidth we have for digesting new and complicated ideas.

Another way to think about this is to note the difference between *information* transfer and *knowledge* transfer. Information transfer is simple: you tell people things, and they repeat it. There's lots of that flying around in any given the day. But if we're after knowledge transfer, where people will have to think differently about what they're doing, adjust their strategies, or adopt new practices, then the effort required to spread that kind of knowledge is in competition with all the other informational detritus that's floating around. The 'economy' of bandwidth preferences things that are easier to spread — that is, the things that are familiar, the ideas that reinforce our normal way of doing things.

So, if the communication channels in the hybrid workplace are narrowed by virtue of the fact that there aren't as many informal opportunities for *knowledge* exchange, if communications aren't as rich or detailed or personal as would be the case in a face-to-face environment, then that adds a further advantage for the simpler, easier things to propagate.

There are so many features of face-to-face communication that allow us to be more compelling in our articulations, that make people more emotionally receptive to things that may challenge their existing way of thinking. Narrowing down the communication channels, in the way covid has, limits bandwidth and gives further advantage to the things that are easy to talk about and easy to spread.

Q: Betsy, in another recent paper, about "network insiders and observers,"[5] you explore who can best identify those within organizations who can truly influence peer conduct, arguing that this is critical to successful behavioral interventions. What does that mean for conduct risk management? How might senior leaders use these ideas to shape risk governance outcomes?

It's very hard for teachers or administrators to change a student culture. Because their patterns of behavior, their perceptions of the norms of the place, are created by the students.

Paluck: We've mapped dozens and dozens of networks in schools. These are highly complex organizations, with well-established hierarchies. They do churn, to some extent, but we've been able to study these networks closely, looking at how students decide upon the cultures that prevail at their schools. Sometimes, those are cultures that their principals and teachers approve of. Sometimes, it's the kind of culture that the higher-ups are working to change.

But it's very hard for teachers or administrators to change a student culture. Because their patterns of behavior, their perceptions of the norms of the place, are created by the students themselves — and they're very sticky. Students perceive what will make or break them at school, what will reinforce their reputation, or cause them to lose face. So, teachers and principals instituting new rules just doesn't matter much — other than perhaps to identify who it is that's going to be punished more often.

A goal of our research was to reduce cultures of abuse in these schools, cultures of violence, or bullying, or harassment. What we find in mapping these school social networks is that there are certain nodes in the network — particular students — who receive a great deal of peer attention. And sometimes, the most effective way to change the culture of a place is to work with these people, the "trouble-makers" who are often part of the problem.

You would think that what you'd need would be someone in the network who can regulate those people. But, in fact, involving those troublemakers in culture change projects is what has proven most effective. It comes back to the fact that they are so highly observed by peers that everything they're seen to do is 'overweighted' amongst their social connections, shaping again what would make or break your reputation at that school.

It always surprises teachers and principals when we come back to them and say, "All right, this is what our network findings tell us. We want to involve this student in our culture change efforts, with respect to conflict, violence, abuse at your school." And they'd say, "No way! These are the people who get hauled into the office all the time!" And we'd say, "Yeah — precisely."

And we we're not targeting them because they need to be remade or reformed. Rather, they know intimately the rules of the place. If you can engage them in a way that would help them to adjust some of their public behavior, even in small ways, in ways that make the school an easier place to be, these people really do have an outsized effect. We're able to measure and compare the effect of their involvement in our campaigns. Their involvement has a much bigger effect than the involvement of other students selected from the network who were perhaps more motivated to help change their school's culture but who didn't have that outsized impact.

It is counter-intuitive: we're usually eager to work with the people who seem motivated to drive positive culture change. It's not that we shouldn't involve those people, but sometimes it's going to be the people who have the eyes of their peers on them — even if they're deeply involved in the problems themselves. We find that these people have a great influence.

Q: Damon, in *How Behavior Spreads,*[6] you write that by understanding the network structure of a population we can uncover novel ways of controlling the flow of behaviors across it. Bank regulators often emphasize setting an appropriate "tone from the top," in this connection, but Betsy's just questioned this approach to shaping organizational conduct. What does your own research suggest?

Centola: The intuition that, if a leader gives some advice, it will be followed by everyone, is not consistent with what we see when there is a conflict in the norms of an organization. If Unilever acquires Ben & Jerry's, Unilever has a certain company culture, and Ben & Jerry's has another. So, whoever has the highest authority can simply say, "we should all work together in the following way." That's a nice message, and everyone gets that it's a nice message, and it sounds good to the board and shareholders. But it's problematic when subsets of people within the merged companies have different ways of operating, of doing their jobs and feeling competent in their work.

Simply saying, "we should all try to get along and cooperate on these sorts of tasks," or "here's the new ethics of the organization," doesn't at all change the way of doing business day-to-day. ▸PAGE 397 From the perspective of how we coordinate and get along, there's a fundamental issue: we all want to feel like we know what we're doing at work, we want to feel competent, we want to feel authoritative in whatever we're talking about. But, that's really very difficult when someone comes along and tells us that the things we've been doing, and the way we've been doing them, need to change abruptly.

While it may sound good to say that changes are important, it's hard to make real changes individually, without seeing that everyone else around you is doing their work differently as well. Changing workplace routines is like learning a new language. You were fluent in the original language. You could communicate and move in nimble and effective ways. But now people are asking you to speak in another tongue. And you worry you're going to look stupid or incompetent. You worry you'll be seen as ineffective at your job and be fired. So, there's a very strong incentive to stick with the things you know how to do and the way you know how to do them, particularly when everyone else around you is doing likewise.

It's hard to make real changes individually, without seeing that everyone else around you is doing their work differently as well.

If you try to do something new that no one else is doing, because someone at the top told you to do it, you're just going to look less competent than everybody else. The processes of innovation and culture change are all about people trying to learn a language *together*, to learn how to speak it without worrying that they'll be called out individually for failing. If we're all trying to do a new thing, it removes the risk that we'll be punished for missteps or stumbles. Without such reinforcement from our peers on this new thing, there's a tremendous amount of risk that we face. So, unless we're all going through change together, individually none of us are going to accept it.

The top-down management approach fails in cases where people are being asked to innovate, or to shift norms in ways that are uncomfortable or different.

The top-down management approach fails in cases where people are being asked to innovate, or to shift norms in ways that are uncomfortable or different. And fundamentally, that's because it ignores the realities of day-to-day work in an office, where we are not only coordinating with peers, but we're also entrenched in ways of doing things that have been successful. Asking us to abandon a successful strategy for something that's unproven is a high-risk proposition, which requires social reinforcement to succeed.

Paluck: Can I just offer some jargon I learned from my students the other day: you've got the "grassroots" activity, and you've got the "grasstops" activity. I like that, because I think when there is a helpful tone-from-the-top, people within the network can draw upon it to reinforce whatever they're doing. They may be taking a risk with their reputations by deviating from the status quo, and those people who could be very influential. In terms of promoting the adoption of new practices, they may need just that little bit of a guarantee that their deviance isn't going to hurt their reputations too much.

So, tone-from-the-top can work in concert with more peer-oriented change. Where you get the perverse outcomes is when there's only a tone-from-the-top but no substance beyond that. Everyone can see that it's just the latest slogan, it's empty messaging. Having the right tone *and* seeing social proof around you is extremely powerful, but it's hard to do one without the other.

It's also a challenge to know how to sequence these things as well. Should you start from the bottom? There's a lot of very provocative research saying that it might be really helpful to see adoption around you start to happen, even before you see that taken up by leadership. Because that feels more authentic. It feels like there's a genuine interest, a growing movement towards change, that you're involved in convincing leadership that you want such and such to be more a part of your workplace, or country, or community.

That's also counterintuitive for people. Leadership might think, "I need to give permission," or, "I need to set such and such a tone." But the psychology of it says something else.

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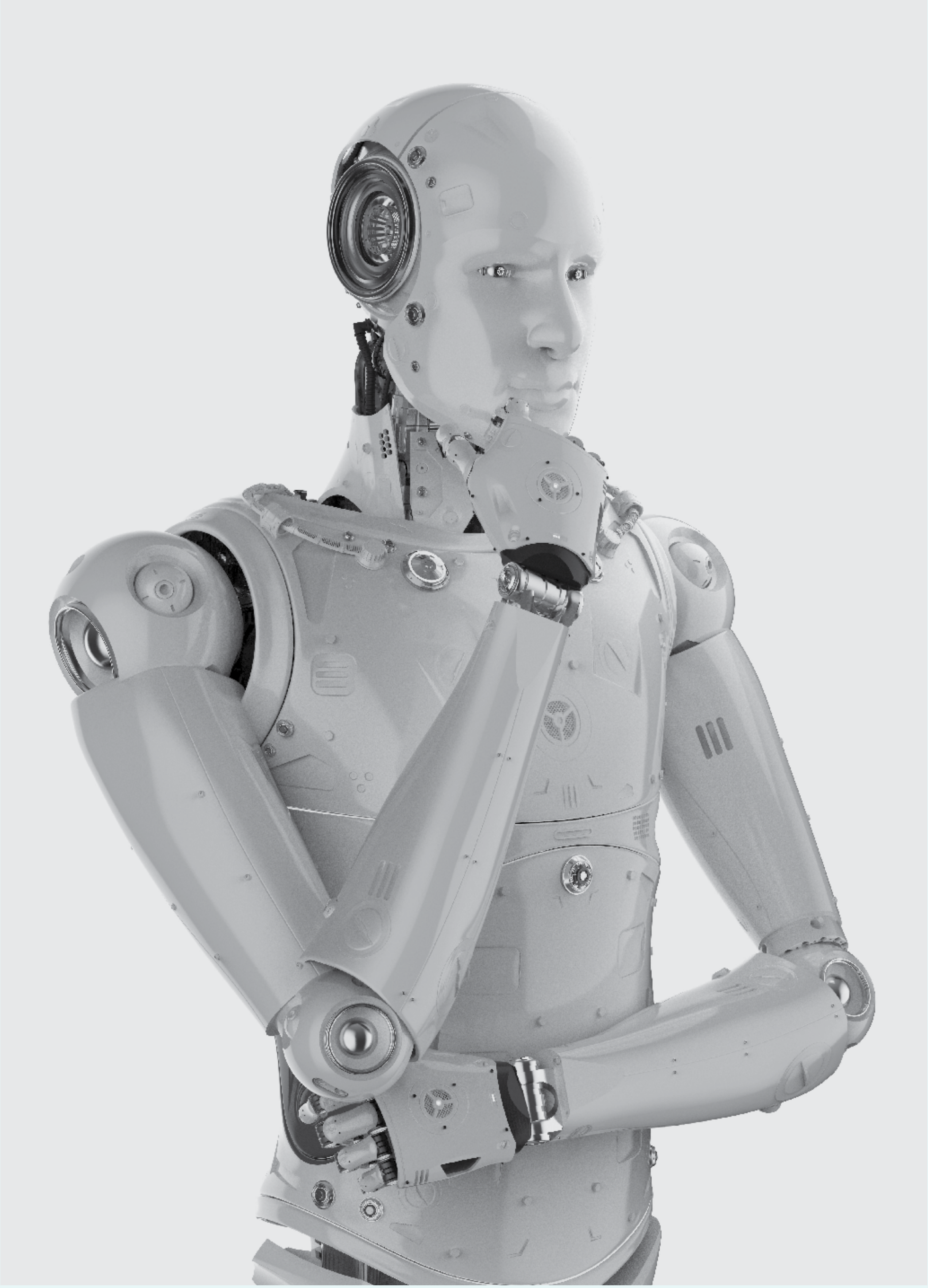

Our View

"Trustworthy AI": Let's End the Useless Shouting Match between Utopians & Luddites

by KAREN COOK, AMY EDMONDSON, THOMAS MALONE, & STEPHEN SCOTT

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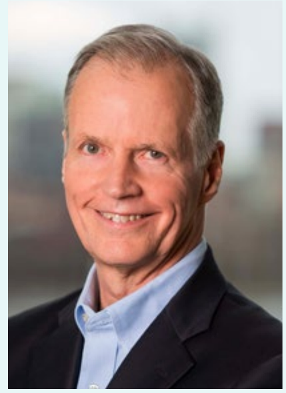

Tom Malone

AI is being adopted more and more broadly, for a range of business use cases, triggering much discussion and debate around attendant risks and opportunities.

A thoughtful discussion of any transformative technology is, of course, wholly desirable. But the current dialog has become a useless shouting-match between Utopians and Luddites. We'd like to reframe the discussion.

In its most recent Business and Finance Outlook, the OECD discusses the use of AI in business and finance, and the attendant opportunities, challenges and implications for policy-makers. These technologies, the report notes, are expected to yield advantages for firms by improving their efficiency through cost reduction and productivity enhancements. But the report cautions that use of AI in business and finance may create, or intensify, both financial and non-financial risks, giving rise to consumer and investor protection concerns. Thus, the OECD calls on member governments to give careful thought to a human-centric approach to "trustworthy AI." ▸PAGE 337

But what does this mean? Academic and scientific rigor demands that we begin any argument by defining its terms. And to start with the initial thorny question—what is AI?—we note that there is very little agreement on how best to define 'artificial intelligence.' Indeed, we think it better to refer to machine intelligence tools as 'augmented intelligence' since this captures the way in which such tools function most typically today—as an aid to human decision-making.

I KNOW WHAT YOU'RE THINKING...

It is more difficult still to define trustworthiness in the context of AI. But if we wish to ask, "how do we trust AI?" then perhaps it is best to start with first bit: "how do we trust"?

By evolutionary design, we are inclined to trust others whom we believe to be like ourselves, assuming them to work from the same background knowledge, beliefs and values as we do in the course of perceiving, describing and making decisions about the world. This belief, that we can accurately infer what someone else is thinking, is referred to as having a "theory of mind."

Melanie Mitchell, a professor of complexity and computer science, rightly observes that we have no similar theory of mind for AI. We don't know what the algorithms are "thinking," and we have no basis for inferring that machine intelligence systems "think" as we do at all. Indeed, we know that they do not. Yet AI is already central to many products and services that are in wide regular use: GPS navigation; spam filters; credit card fraud alerts; loan applications; book, music and movie recommendations; disease diagnoses; and countless more.

Most often, we are resigned to "trusting" these tools, simply because giving them up is either too inconvenient or too costly. But because we lack an explicit basis for that trust, we're left uncomfortably vulnerable to unknown risks. That discomfort is compounded by a barrage of competing claims from "experts," alternately proclaiming that magical AI capabilities will usher in a techno-utopia of sorts. Or conversely, warning that the relentless creep of AI into our lives will spell our ultimate undoing as a species.

REFRAMING THE DEBATE

Though it fills headlines, this shouting match between Utopians and Luddites produces much heat and little light. A cacophony of ill-informed media is unhelpful to those thinking through whether, when and how to make use of AI in the workplace. So, let's reframe the debate.

Trust is perhaps the most widely discussed topic in the social sciences, with one paper tallying up 121 definitions of trust compiled in the course of 50 years of research. Most of those feature a common element: vulnerability. In choosing to trust, we voluntarily expose ourselves to the risk that we may be disappointed in doing so, leaving us vulnerable to some subsequent harm. Yet humans evolved such that we regularly place our trust with complete strangers, and the collaboration this permits has been key to our success as a species. So, how do we trust?

Trust involves a mix of cognitive and affective components. Before making ourselves vulnerable—to a brain-surgeon, say—we want assurance that she is *competent*. But this is not enough: we also need to believe that she is *reliable*. Unreliable competence is not much better than reliable incompetence, after all. In order to make these cognitive judgement calls, we want information that allows us to *think* it is safe to trust someone in a specific given circumstance. But that's still not enough. We also want to *feel* that we can trust in this context, so we look for the additional assurance that this person is both *honest* and *benevolent* towards us—that they're genuinely working in our best interests. We trust from both the head and the heart.

Surveillance Creep

Because these same cognitive and affective components feature in decisions to trust some*thing* rather than some*one*, it is helpful to frame discussion of trustworthy AI along these dimensions.

A common complaint about the increased use of AI in the workplace is that it is invasive — a concern that has become more prominent amidst covid-driven work-from-home protocols. "The way my boss monitored me at home was creepy," reads the headline from a late 2021 BBC news article. "Data is the new frontline in workers' rights," argues the British trade union for professional workers in another article that ran in the *Financial Times*.

In the near term, expectations are that we will see a continued mix of in-office and at-home work arrangements. So, arguments regarding the creep of intrusive spyware in the workspace are only likely to become all the more shrill, even as employers maintain that they have no choice but to adopt greater surveillance and monitoring if they are to manage a remote workforce effectively.

Nowhere is this more likely than in the banking sector, where regulatory compliance requires that firms deploy robust surveillance and monitoring systems to safeguard against misconduct risk. These systems were designed to operate within the office, but now firms are expected to operate systems that can monitor employees while in their homes. Moreover, some regulators tasked with safeguarding the public feel it necessary that they do likewise.

For instance, the U.K. Financial Conduct Authority (FCA) raised hackles last year when it set forth its expectations for risk and compliance in the hybrid working environment: "It's important that firms are prepared and take responsibility to ensure employees understand that the FCA has powers to visit any location where work is performed, business is carried out and employees are based (including residential addresses) for any regulatory purposes." It is understandable that many employees object to this potential invasion of personal privacy.

Like bank risk and compliance officers, bank examiners and supervisors are well experienced with technologies used in surveillance and monitoring. They are thus well placed to judge the competence and reliability of such tools. But those subject to surveillance—employees—are not equally well positioned in this regard. And though bank managers and supervisors may feel certain that they act with honesty and benevolence, employees are more circumspect.

With limited ability to assure themselves that surveillance methods and monitoring tools are competent, reliable, honest or benevolent, is it any wonder when employees trust neither the tools nor those making use of them?

Trustworthy AI is a community-endeavor. If we want it to be welcomed gladly in the workplace, then employees, managers, regulators—and third-party AI vendors—must be able to satisfy the four key tests of trust:

- **Is it competent** — does this tool work properly in this context?
- **Is it reliable** — can we count on this tool to work when we need it to?
- **Is it honest** — is the functioning and the intent of tool transparent?
- **Is it benevolent** — is it designed and deployed to serve my best interests?

Panopticonfusing

"Regulatory technology (regtech) has assumed greater importance in response to the regulatory tightening and rising compliance costs following the 2008 global financial crisis," the IMF observes in a late 2021 report on the use of AI in finance. These technologies promise to help firms to achieve significant cost savings and efficiency gains, better risk management, and offer powerful tools for regulatory compliance and prudential oversight, the IMF adds.

One area of regtech innovation that has received much recent attention is the use of AI to identify culture and conduct related risks. "Conduct risk has only recently become recognized as a stand-alone risk category," McKinsey notes, "in the aftermath of a number of high-profile incidents of misconduct (and regulatory responses) in retail and commercial banking, capital markets, and wealth management." Effective culture and conduct risk management requires a new approach, McKinsey continues. "One that can 'connect the dots' across individual and team activities," in a manner akin to testing for the 'collective intelligence' of work groups.

This is the promise of regtech tools that identify patterns, hidden in data, that tie to specific conduct proclivities and performance outcomes with considerable predictive reliability. Critically, McKinsey observes, these tools, "go beyond the detection of past instances of misconduct—by which time the damage to an institution, if any, has already been done—to intercept the outlying patterns of activity that could lead to future losses."

This is a wholly new capability set that is not yet well understood, by the media perhaps least of all. Journalists frequently look to locate these tools within established cognitive categories, like surveillance. A recent Thomson Reuters article starts from this erroneous conflation. "Premising conduct risk management on systems and data analytics ties all conduct understanding to formal surveillance," the article complains, before going on to argue that this heightened level of surveillance will erode a critical atmosphere of 'psychological safety' in the workplace.

But predictive behavioral analytics tools are not surveillance mechanisms. Rather, they operate to provide management with a powerful diagnostic lens, like an MRI, allowing us to search out organizational health insights *without* invasive surgery. These capabilities offer a new means of connecting the dots between current circumstances and future outcomes in ways that may be non-obvious, and even counterintuitive. ▸PAGE 365

Such improved management capabilities may well help to *increase* psychological safety. This is all the more likely where regtech operates on the basis of readily available "unobtrusive data" that does not compromise privacy concerns, as some do.

A Better Standard of Care

"Reliance on data- and technology-led solutions may fail to deliver insights and controls," the Reuters piece above moans. That's certainly true. But the fact that marriage may end in divorce is not usually grounds for calling off the nuptials.

Predictive behavioral analytics tools must be trustworthy: fairly judged on their competence, reliability, honesty and benevolence. Where they pass these tests, such tools may permit for a much-improved standard of care: predicting and preventing adverse outcomes rather than merely detecting and correcting for them.

This will benefit firms and their leaders, shareholders, regulators, customers, and employees. Moreover, a reduction in misconduct may produce greater confidence that supervisors are able to maintain adequate oversight of financial institutions, bolstering the trustworthiness of the financial system more broadly. This is an opportunity that should be embraced.

We appreciate and share ethical concerns regarding the use of AI in the workplace. But what are the ethical considerations in deciding *not* to make use of such tools, where they work in a competent, reliable, honest and benevolent manner to the benefit of stakeholders?

We'd do better to reframe the debate around trustworthy AI in this direction.

Thomson Reuters Risk Intelligence ran an initial draft of this article on 11 November 2021.

Karen Cook *is a Professor of Sociology at Stanford, studying social networks, social exchange, and trust. She was founding Director of the Institute for Research in the Social Sciences.*

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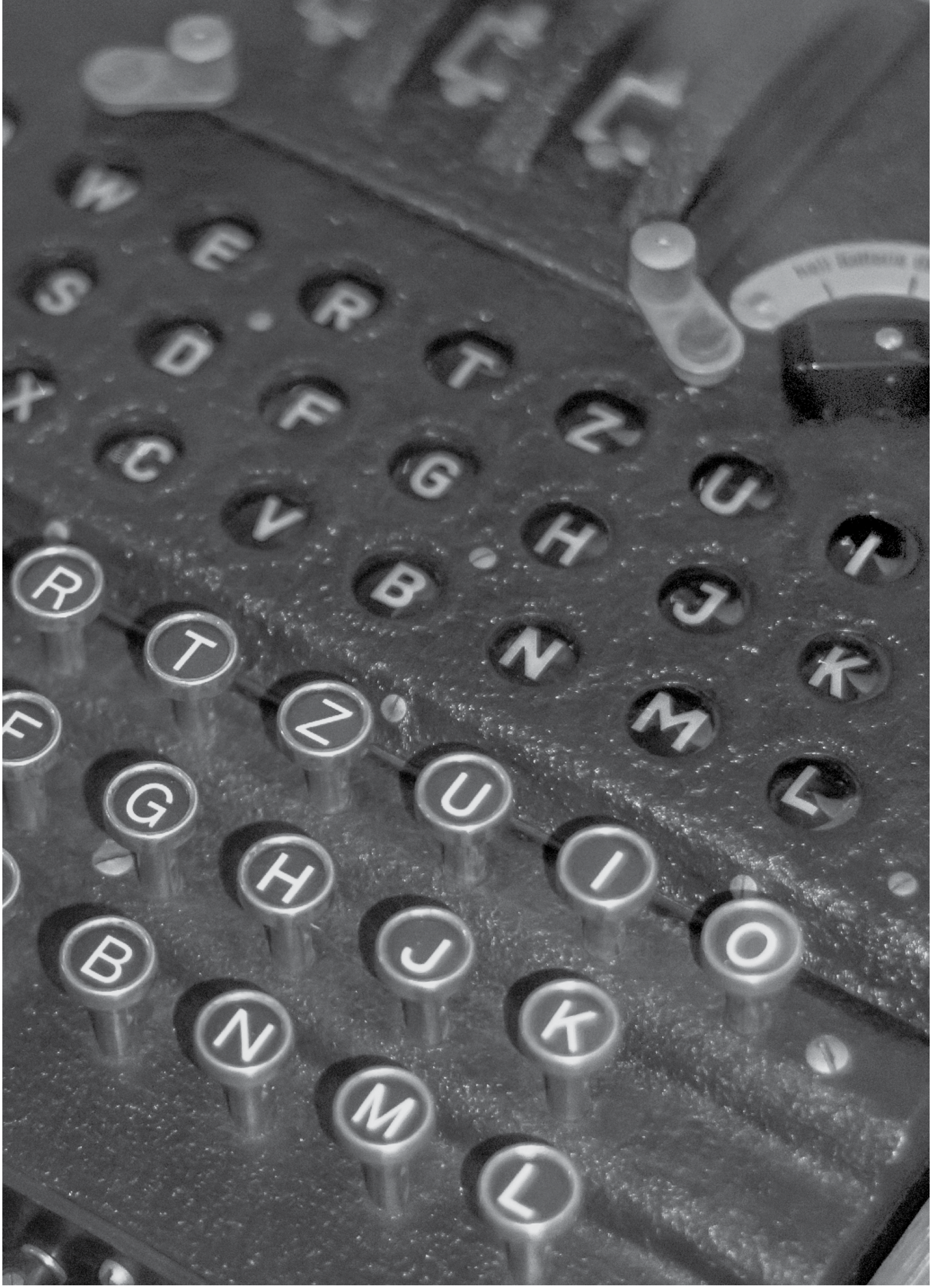

INTRODUCING DEEPER DIVE SUPPLEMENTS

Enigma Machines

In the wake of mishap, regulators and prosecutors are insisting that a firm's board and senior executives are able to identify the true 'root causes' of misconduct and risk governance failures, in order to take adequate corrective actions and facilitate proactive supervision going forward.

How is this to be accomplished? Survey instruments are more likely to reflect a firm's culture rather than reveal it. Staff is likely to convey what they think management wants to hear – or fails to respond to survey inquiries at all. Can we do better?

Drawing on behavioral science, complexity theory, and network analytics, 'computational social science' has enabled the creation of modern 'Enigma Machines' that can decode the human factors which shape operational outcomes, making them visible, malleable, and rendering them subject to effective management interventions.

Learn more in a Deeper Dive supplement to this report, available later this year on Starling Insights, a membership-based platform that will feature all of our *Compendium*, thought leadership, video, podcast, and event-driven content.

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Business ultimately needs to be seen as a vocation, an activity with high ethical standards, which in turn conveys certain responsibilities.

This begins with asking the right questions.

MARK CARNEY
VALUE(S): BUILDING A BETTER WORLD FOR ALL (2021)

You do not plan to ship goods across the ocean, or to assemble merchandise for sale, or to borrow money without first trying to determine what the future may hold in store.

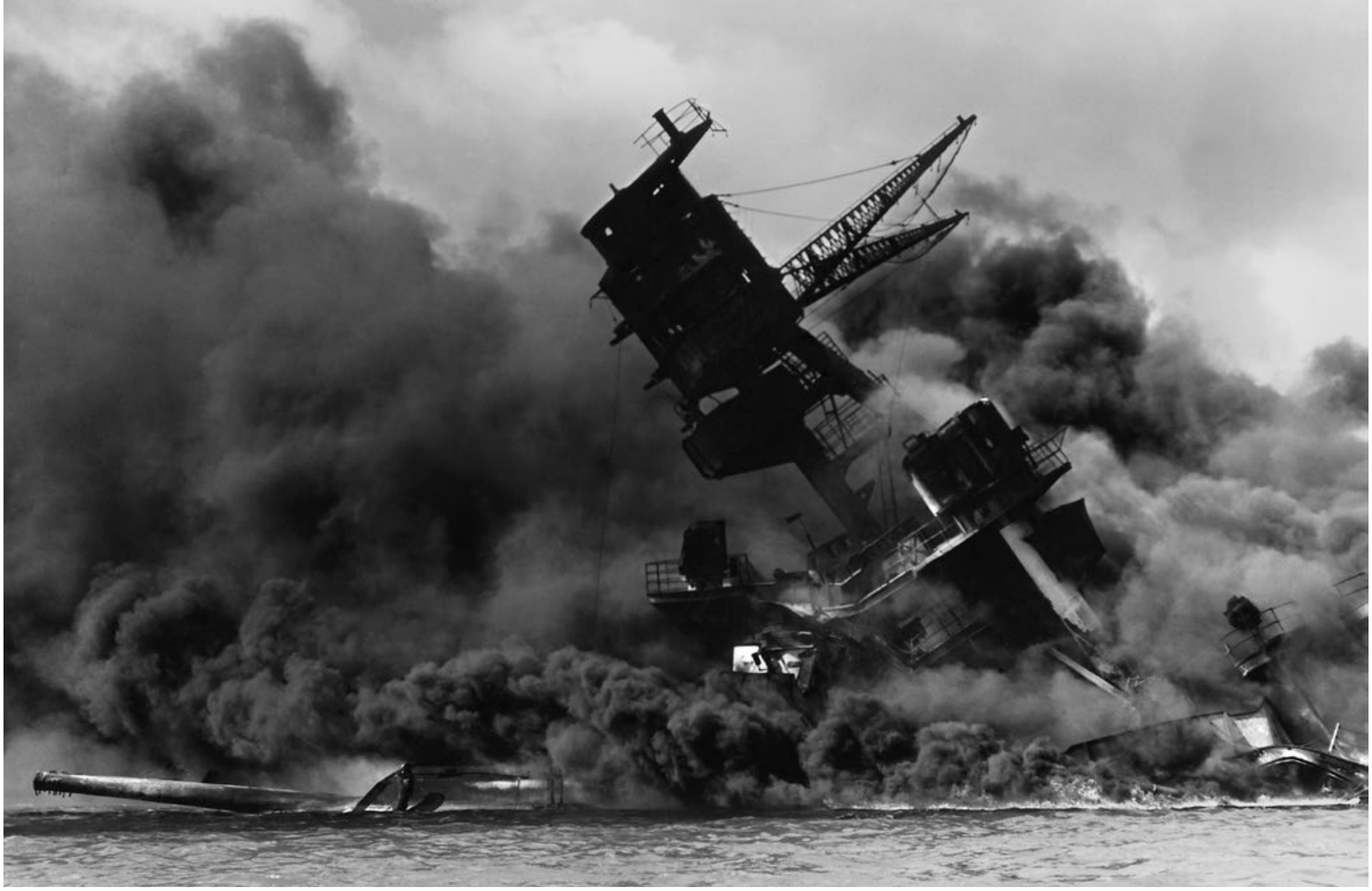
The successful business executive is a forecaster first.

PETER BERNSTEIN
AGAINST THE GODS (1996)

History hides Black Swans from us and gives us a mistaken idea about the odds of these events: this is the distortion of silent evidence.

What we see is not necessarily all that is there.

NASSIM NICHOLAS TALEB
THE BLACK SWAN (2007)



December 7, 1941: 'A date which will live in infamy'

Conclusion

'One enigmatical and paramount question'

The Japanese attack on Pearl Harbor, just over 80-years ago, caught the United States by surprise and left the nation stunned. What were the chances of an attack on Hawaii, commander of the US Pacific Fleet Admiral Husband E. Kimmel had asked his war plans officer, Captain Charles H. McMorris, on November 27th, 1941? "I should say none, Admiral," McMorris replied.[811]

On December 3rd, a communications intercept revealed Tokyo instructing its embassy in Washington to burn messaging codes and destroy cipher machines.[812] On December 4th, President Roosevelt received a memo from US naval intelligence: "Japan is vigorously utilizing every available agency to secure military, naval and commercial information, paying particular attention to the West Coast, the Panama Canal and the Territory of Hawaii," it read.[813] How were military and civilian leaders caught so unawares, only three days later?

How were military and civilian leaders caught so unawares, only three days later?

To find out, in September 1945, Congress formed a Joint Committee to investigate events leading up to the Pearl Harbor attack. "Virtually everyone was surprised that Japan struck the Fleet at Pearl Harbor at the time that she did," the Committee concluded in its June 1946 Final Report. "Yet officers, both in Washington and Hawaii, were fully conscious of the danger from air attack; they realized this form of attack on Pearl Harbor by Japan was at least a possibility; and they were adequately informed of the imminence of war." Thus:

> *The Committee has been intrigued … by one enigmatical and paramount question: Why, with some of the finest intelligence available in our history, with the almost certain knowledge that war was at hand, with plans that contemplated the precise type of attack that was executed by Japan on the morning of December 7 — Why was it possible for a Pearl Harbor to occur?*[814]

The report details breakdowns in communication and cooperation, muddled lines of authority and accountability, insufficient vigilance and follow-through, misapprehension of information and failures of judgment. In short, "supervisory, administrative, and organizational deficiencies" combined to leave leaders blind to what later seemed an obvious conclusion: an attack on Pearl Harbor was imminent.

The "debacle," the Committee concluded, was not a consequence of egregious errors on the part of particular individuals. Rather, it stemmed from "deficiencies of the system" by which Army and Navy intelligence collection was coordinated, evaluated, and communicated onwards. Of the more than two dozen conclusions the Committee set forth in its report, at least three are likely to resonate with those calling for an update in our approach to non-financial risk governance in the financial sector:

1. ***"It would seem that War and Navy Department officials both in Washington and Hawaii were so obsessed by an executive complex that they could not besmirch their dignities by 'stooping' to determine what was going on, or more especially what was not going on, in their organizations."***

   The Basel Committee on Banking Supervision (BCBS) conducted a *Thematic Review on Risk Governance* in 2013,[815] listing updated learnings in its 2015 *Guidance on Corporate Governance Principles for Banks*.[816] "One of the primary objectives of this revision," the BCBS made plain, "is to explicitly reinforce the collective oversight and risk governance responsibilities of the board." In a 2015 report on measures to reduce misconduct risk, the Financial Stability Board asserted, "A strong governance framework is essential to determining the allocation of authority and responsibilities in a company, in particular its board and senior management."[817]

   In October 2017, a California court denied a motion to dismiss a complaint that had been filed against the board and officers of Wells Fargo, in the wake of its false accounts scandal. The defendants, the court found, had "consciously disregarded an obligation to be reasonably informed about the business and its risks or consciously disregarded the duty to monitor and oversee the business."[818]

   Lesson: risk management responsibilities cannot be pushed down to first line business leaders — and particularly not the harder-to-quantify culture and conduct related risks — without first implementing reliable feedback mechanisms to assure that senior executives and their boards receive leading indicators of potential trouble, unfiltered and in real-time, so they can exercise the proactive oversight for which they are held personally accountable. *This begins with asking the right questions.*

2. ***"The committee has received the distinct impression that there was a tendency, whether realized or not, to relegate intelligence to a role of secondary importance."***

   Last March, the BCBS issued revised *Principles for the sound management of operational risk*.[819] "Improvements in operational risk management depend heavily on senior management's willingness to be proactive and also act promptly and appropriately to address operational risk managers' concerns," the Committee noted. It lists as its first Principle that the board of directors should, "take the lead in establishing a strong risk management culture, implemented by senior management." An independent 'voice of risk' is central in this connection. "Staff responsible for monitoring and enforcing compliance with the institution's risk policy should have authority independent from the units they oversee," the Basel Committee insisted.

Last September, the Commonwealth Bank of Australia (CBA) issued an update to its Remedial Action Plan, implemented after receiving sharp criticism for risk management failures in APRA's 2018 Prudential Inquiry report.[820] APRA had described CBA as, "an organisation that exhibited complacency and in which the senses of senior leaders had been dulled with respect to risk management."[821] Financial success overrode the "voice of risk" in decision-making forums, and operational risk and compliance issues tended to receive little attention until after they had fully emerged, by which time reputational consequences had begun to accrue. In sum, "risks were neither well understood nor owned, the frameworks for managing them were unwieldy or incomplete, and senior leadership was slow to act."

Lesson: risk management roles and responsibilities must not be regarded as subordinate to business leadership and its growth targets, but instead seen as essential to meeting business objectives sustainably. *The successful business executive is a forecaster first.*

3. ***"No amount of coordination and no system could be effected to compensate for lack of alertness and imagination."***

After the financial crisis, regulators made proactive testing for financial risk a priority. In its 2018 *Frameworks for early supervisory intervention*, the Basel Committee observed that, "More intense and effective supervision, coupled with pre-emptive and proactive early supervisory intervention, is a complex and challenging objective."[822] But regulators had taken up the task. The Monetary Authority of Singapore put in place an Intervention Framework, listing critical leading indicators of deterioration in a bank's financial soundness. The UK Prudential Regulation Authority established a Proactive Intervention Framework to equip its supervisors with means by which to identify and respond to emerging risks at an early stage. Others did likewise.

The crisis prompted creative responses and new approaches to financial risk management. We ought not to await another crisis before implementing new means by which to identify and manage non-financial risks proactively. At the Credit Suisse Annual General Meeting last month, marking his first speech as chair, Axel Lehmann was blunt in identifying the reasons behind the firm's scandal-ridden recent history. "It has become clear that the challenges of the past were not solely attributable to isolated poor decisions or to individual decision makers," he told shareholders. "Within the organisation as a whole, we have failed too often to anticipate material risks in good time in order to counter them proactively and to prevent them."[823]

Lesson: reliance upon the presumed efficacy of existing risk management systems is complacent and perilous; innovation and improvement in risk management must be persistent board and C-suite level priorities, with a goal of achieving predictive and preventative capacities. *What we see is not necessarily all that is there.*

In a recent *Financial Times* op-ed, the chairman of the European Risk Management Council spelled out the uniqueness of current challenges confronting the banking sector. "Today," Evgueni Ivantsov writes, "financial institutions must react to three seemingly unrelated global crises simultaneously: a public health crisis which, on average, occurs only once every 100 years; a major geopolitical crisis which has not happened in a generation; and a global climate crisis which has no precedent in human history at all."[824]

Echoing the counsel offered by the contributors to this report, Ivantsov advises that we: (1) make greater use of scenario analysis and stress testing to identify potential outcomes and plan accordingly; (2) develop enhanced tools that allow us to assess second- or even third-order effects, to include the risks of compliance lapses and reputational damage; and, (3) because the confluence of these once-in-a-lifetime risks is such that one amplifies another, it is vital that we bolster operational resiliency.

How is this to be achieved?

An ounce of prevention...

Formed in early 2021, the National Patient Safety Board (NPSB)[825] — modeled intentionally on the US National Transportation Safety Board — seeks to reduce medical errors by adopting risk and safety measures developed by airlines.[826] Having successfully persuaded pilots, controllers and mechanics to voluntarily report hazards, accidents and near-misses, airlines have used such incident data to draw safety lessons and disseminate those among one another. This coordinated industry exercise in risk management has significantly reduced the number of crashes and other safety management failures. Hospitals now look to do likewise. "The NPSB would support agencies in monitoring and anticipating adverse events with artificial intelligence," it proposes. It also aspires to, "conduct studies, create recommendations and solutions to prevent medical error, and leverage existing systems and bring key learnings into practice."[827]

Cross-industry collaboration[828] and public-private partnerships[829] have been central to the success of covid-vaccine development. AI is now enabling scientists to predict how viruses will evolve, positioning them to develop vaccines in advance of an outbreak, and to prime human immune systems to resist pathogens to which they have yet to be exposed.[830]

Doctors have begun to make use of AI in screenings for breast cancer — of particular benefit to women who were forced to forgo screenings during covid stay-at-home protocols.[831] Algorithms, designed at MIT, have proven capable of spotting warning signs in mammograms that trained physicians had missed.[832] "They're extracting information that my eye and my brain can't," one said.

The *Economist* recently featured a Technology Quarterly entitled "the quantified self," extolling the virtues of increasingly ubiquitous fitness trackers and other 'wearables' that collect health data from users.[833] "Machine learning can filter a torrent of data to reveal a continuous, quantified picture of you and your health," an opening article reads.[834] AI-powered wearables are expected to reshape healthcare through early diagnosis, personalized treatment guidance, and better management of chronic illnesses.

"Wearables can detect subtle changes that go otherwise unnoticed," the article continues, "leading to less severe disease and cheaper treatment." Moreover, more personalized data collection means that diagnoses and therapeutics will be targeted to specific individuals, rather than some generic 'average human.' Perhaps most importantly, real-time diagnostics will enable people to become more proactive in managing their own health, rather than relying on intermittent tests at the doctor's office.

But it is just as important to note what these personalized health analytics tools will *not* do.

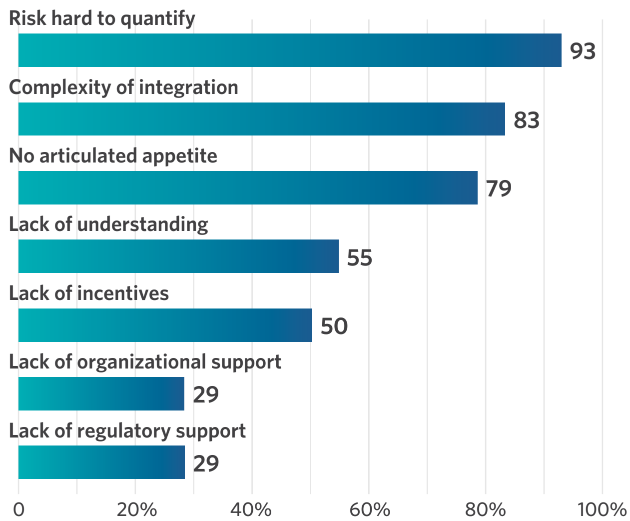
They will not replace a doctor's specialized education and judgment. Nor will they replace a patient's discussions with his or her doctors. Rather, they will suggest what doctors and their patients *should* be discussing, while offering non-obvious guidance as to *when* those consultations might be especially timely. The emerging doctor-plus-device paradigm supports medical professionals and their patients in jointly promoting good health proactively, rather than merely awaiting and treating disease.

What if we had similar capabilities by which to assess the health of organizations? To test for cultures that may be at risk of 'toxicity.' To spot where behavioral 'contagions' are likely to spread, so that we might intervene to protect those at risk. To identify non-obvious patterns in company data suggestive of impending trouble so protective measures could be deployed swiftly and before harm is suffered. To achieve the "lateral vision" Gillian Tett calls for in her opening Preamble to this report.

Such capabilities would not supplant management judgement, but would equip decision-makers to exercise such judgement with the benefit of otherwise unavailable information and insight. And, as David Kiron writes here, algorithmic tools can help managers not only to test for key performance and risk indicators, but to *identify* and define previously unrecognized KPIs and KRIs. "How you measure can be just as important as what you measure," Kiron argues. This is perhaps especially true in the context of assigning quantitative metrics to qualitative non-financial risks: a 2020 BCG survey, results of which were reported in April last year, shows 93% of respondents complaining that difficulty in quantifying non-financial concerns was their top risk management challenge.[835]

The Top Challenges for Institutions Seeking to Address Non-Financial Risks

Share of respondents who cited the challenges below (%)



Source: BCG-IACPM 2020 Survey.

Human factor analysis

The US Navy has struggled with "preventable" accidents, to include onboard ship fires such as that which cost it the amphibious assault ship USS *Bonhomme Richard* in July 2020, while moored pier-side in San Diego.[836] Last October, the Navy released a report into the causes — after investigating similar incidents that had occurred in the last dozen years.[837]

"Human factors analysis of root causes was performed to find common causes," read the Command Investigation into the circumstances surrounding the fire.[838] "Top causes were found to be procedural compliance, inadequate risk assessment, and lack of command or supervisory oversight." The loss of the *Bonhomme Richard* was "completely preventable," concluded Vice Chief of Naval Operations, Admiral William Lescher — the Navy's second-highest ranking commissioned officer.

Bank regulators are looking to develop their own capability to investigate the human factors found among the root causes of persistent conduct risk governance failures and the preventable losses and avoidable harms that they permit.

"The FCA must continue to become a forward-looking, proactive regulator," said CEO Nikhil Rathi in a July 2021 speech,[839] accompanying the release of the regulator's 2021/22 Business Plan.[840] His speech outlined three areas where the FCA would strive to make progress: making innovative use of data and technology; acting with increasing assertiveness; and being adaptive. "Over the next 5 years, we will become a data regulator as much as a financial one," Rathi said, announcing that the FCA would increase investment into its data and technology by some £120 million in the following three years.

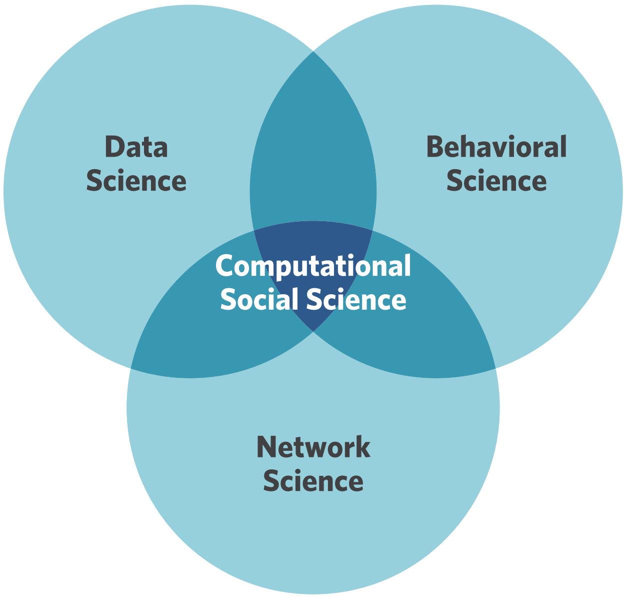
"Using techniques from data science and social science — especially behavioural science and economics — is already enabling us to make more robust, evidence-based decisions," Rathi added. "Whether that's predicting potential harm or identifying what works in terms of our interventions and the extent of our impact." In a November 2021 speech, Jessica Rusu, FCA Chief Data, Information and Intelligence Officer, said the regulator aims to define and codify "paths to harm" — behaviors and events likely to drive market failures or consumer injury, so it might intervene earlier.[841] "We have to make the best use of our own resources," Rusu argued, "connecting the dots in terms of intelligence across the organisation."

With the release of its 2022/23 Business Plan last month,[842] the FCA said that it would seek to become a more effective regulator, "by harnessing data, converting it into actionable intelligence and improving our real time understanding of what's currently happening and, crucially, of emerging risks." It also announced that preventing the misconduct that may lead to consumer harm would be a priority.

Just as it insists that the firms it oversees evidence, "strong prevention cultures and effective systems and controls," the FCA seeks to evidence the same itself. Data and technology are at the core in this regard. "Effective misconduct detection requires a new approach," McKinsey argues, "one that can 'connect the dots' across individual and team activities."[843] These connections are often hidden in data from multiple sources that can be spotted through advanced analytics and machine learning.

This may hold particular promise in the mitigation of conduct risk. Such risk is typically addressed, today, through the labor intensive and manual monitoring of customer complaints and internal whistle-blower reports, activity testing, and rules-based analytics such as suspicious trade alerts. Yet despite significant investment into these approaches, firms nevertheless, "find themselves failing to detect conduct-risk issues comprehensively," McKinsey observes. As an alternative, it suggests, "analytics-based conduct risk monitoring allows institutions to retire expensive manual controls, testing activities, and investigations of false positives associated with traditional risk-management methods."

Today, many firms and supervisors have begun to experiment with 'predictive analytics' capabilities.[844] Such tools feed historical data from a range of sources into algorithmic models that search out trends and patterns which may foretell future outcomes. Studies suggest that the effective use of predictive analytics can generate substantially improved business performance.[845] Others find that predictive analytics can help to identify risk[846] and reduce harassment, bias, ethical lapses, and other workplace misconduct.[847] Moreover, analytics testing for conduct risks can also yield profitable business insights, helping to turn risk related costs into revenue enhancing capabilities.[848]



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But data alone is insufficient. Because culture and conduct risk issues are tied to the evolutionarily hard-wired proclivities of human beings, it is essential that predictive analytics targeting such issues are informed by deep learnings from the behavioral sciences. And because humans operate in social groupings, it is as important that these models also draw upon network science.

As we will discuss in greater detail through a **Deeper Dive** supplement to this report, to be issued later this year, data science, behavioral science, and network science are being combined today to produce what have been called 'computational social science' tools. In turn, these tools enable the "creation of techniques for the structured representation and quantification of human behaviour through the lens of scientific measurement and its principles."[849]

That is, new computational methodologies permit for data-driven and predictively reliable "human factor analysis."

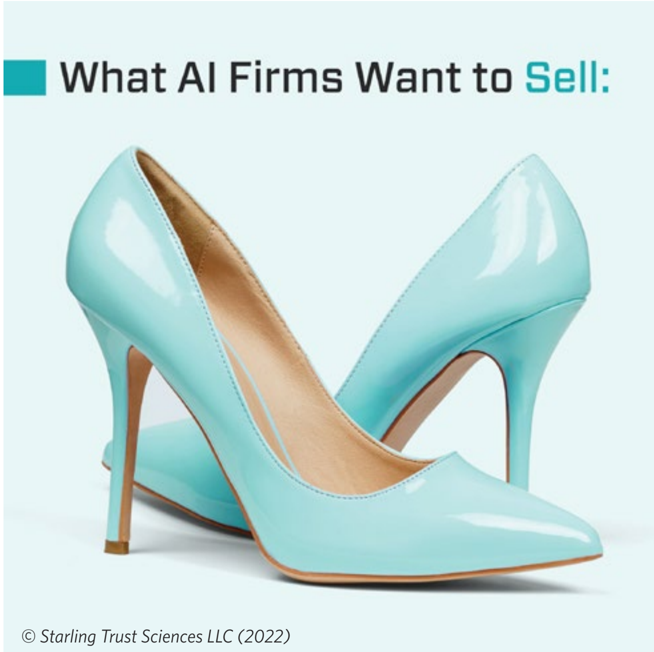
RegTech: if the shoe fits...

In 2020, the Hong Kong Monetary Authority (HKMA) launched a 'RegTech Adoption Index," finding that more than half of the financial institutions surveyed had begun to make use of regtech tools.[850] "Regtech constitutes an integral and important driver of the HKMA's 'Fintech 2025' strategy,"[851] HKMA chief Eddie Yue said in a June 2021 speech entitled Unlocking the Power of Regtech.[852] "We have developed a vision that by 2025, Hong Kong will be a leading hub for developing Regtech solutions and cultivating Regtech talents," he added.

Last year, the HKMA launched Anti-Money Laundering and Financial Crime Regtech Labs to facilitate experimenting with these new technologies and data analytics tools.[853] In late 2021, it issued a Regtech Adoption Practice Guide that focused on regtech applications in the context of governance, risk and compliance (GRC).[854] Last month, it launched a 'Regtech Knowledge Hub' designed to act as a repository of all regtech-related content it has assembled, and to facilitate broader sharing of the experience and learnings that some financial institutions have achieved through their regtech trials.[855]

Once a domain of niche interests, regtech has gone mainstream.[856] Advances in AI and machine learning are, "reshaping risk and compliance management by leveraging broad sets of data often in real time and automating compliance decisions," the IMF observed in an October 2021 report.[857] "Regulators have generally been supportive of the adoption of regtech by regulated financial entities," it adds. Despite such regulator enthusiasm, however, firms have been slow to trial regtech capabilities.[858]

"If these technologies are sports cars," one compliance specialist observed in a thoughtful 2021 essay,[859] "the business and risk management systems that they need to serve or integrate with, are often not more than gravel paths."



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Technology is developing faster than the pace of change within business and risk management. But just as banks have recognized the value of partnering with fintech players, if only to keep abreast of innovation,[860] so should they regard regtech — if only because, where firms are moving slowly, their regulators are gathering pace.

The HKMA is trialing a "Granular Data Repository" to explore means of bringing greater speed and efficiency to regulatory reporting.[861] In late 2021, the UK Financial Conduct Authority contracted with an AI firm to deploy an "Insight Engine" that is expected to increase its data management capabilities, provide it with more actionable intelligence, and identify leading indicators of trouble.[862] 'The Use Cases for Regulatory Technology,' a report issued late last year by the Financial Services Regulatory Authority of Abu Dhabi, details its own experience trialing regtech tools and distills key learnings that it hopes will benefit peer institutions.[863]

In late December, the Financial Stability Institute issued a report on the greater use of supervisory technologies ('suptech') during the covid pandemic.[864] "These tools allow supervisors to consider a broader range of information in their prudential risk assessments," the FSI report argues. In one illustration it offered, the Bank of Thailand and the Bank of Italy were said to have trialed sentiment analysis and natural language processing tools to assist their supervisors in reviewing the culture and conduct of bank boards.

Disruptions caused by the covid pandemic are, "driving us all towards greater use of data analytics as a basis for risk-based supervision," said the Australian Prudential Regulatory Authority's Wayne Byres in a December 2021 speech. In seeking the new insights that these tools promise, Byres noted, the greatest scope for improvement was found in the superior use of data and the adoption of machine learning to assess non-financial risks — "even risk culture," he added.[865]

Earlier this year, the Australian Securities and Investment Commission announced a Business Research and Innovation Initiative, through which it is working with five regtech firms to explore how their solutions may help to overcome challenges in connection with corporate disclosures.[866] The participating technology vendors were to receive up to AUD $100,000 in government funding.[867]

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Working with the Monetary Authority of Singapore, the Association of Banks in Singapore (ABS) last year issued a handbook,[868] suggesting a standardized approach and common language for the sharing of data between banks and non-bank data ecosystem partners.[869] "Access to data has become a key enabler of the digital economy, and banks are no exception," said ABS Director Ong-Ang Ai Boon, who contributed related views to our 2021 report.

This is the sort of "consensus structure" described herein by Bob Wardrop, of the Cambridge Center for Alternative Finance. Without such a structured and ecosystemic approach, technology innovation may stall. "AI exploration is somewhat expensive," a 2021 *MIT Sloan Management Review* article reads, "and AI development and production deployment is *really* expensive."[870] Leadership and personal engagement from senior-most management is therefore critical — along with the requisite budget commitments that often only CEOs can make.

Such investments may be necessary if firms are to keep abreast of the capabilities their supervisors are steadily developing. The MIT piece referenced above profiles the CEO of Singapore's DBS, Piyush Gupta. In recounting his own experience with exploring the potential AI represents, Gupta outlines the series of steps typical to regtech purchase decisioning. Expanding on Gupta's outline, these steps can be expected to involve:

- **Awareness** — usually informed by first and second line risk and compliance executives, the C-suite is becoming increasingly aware of what new regulatory technologies promise. While few are eager to invest in producing data insights that regulators are not specifically requesting, C-suite leaders regard closely what they see their peers doing in this space.

- **Inquiry** — with encouragement from above (or, at least, barring any resistance from the top), first and second line risk and compliance executives meet with regtech firms so as to develop a better informed appreciation of the use cases and value propositions they put forward.

- **Exploration** — once persuaded of the value such tools might enable, other executives are then brought into the discussion so that they may develop their own appreciation of the technologies on offer and raise any questions they may have. This often involves a mix of staff from the back office (e.g., HR) and front office (e.g., heads of business lines).

- **Debate** — after all relevant constituents have been informed and consulted, three camps tend to emerge: those who dismiss the need for or doubt the promise of these technologies; those who believe the promise is there and worth exploring — through their own in-house efforts; and those who are eager to explore what third-party vendors may provide with perhaps greater efficiency.

- **Dithering** — further progress is often stalled by insufficient consensus or conviction among constituents, who become vocal regarding budgetary questions and necessary bandwidth commitments. Unless a leader with budget discretion emerges, things grind to a halt here.

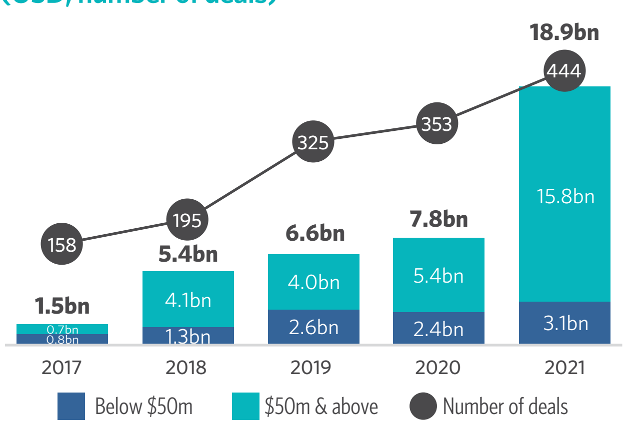
- **Dabbling** — if a leader with adequate budgetary authority and sufficient curiosity does emerge, they are most often inclined to authorize a relatively small 'pilot project' aimed at developing 'proof of concept' before they are ready to bring any learnings up to more senior management. Internal bureaucracy intervenes at this point, slowing progress — and often sufficiently so to halt the project altogether. Firms struggle to 'get out of their own way' and, as a result, the desired proof points are rarely achieved — and a lack of evidenced success justifies lack of investment.

- **Debacle** — occasionally, in the course of these hesitant investigations, a firm will suffer some risk or compliance failure, which touches directly upon the use case and value proposition that it had begun to explore with a regtech firm, inviting regulator or shareholder wrath. Under the glare of the subsequent spotlight, one might expect that regtech trials would accelerate. It is more often the case, however, that the organization becomes seized up by uncertainty, and demands from regulators, who most typically insist on greater investment in familiar means and methods.

- **Decision** — All too infrequently, C-suite leadership will engage at this juncture, to insist upon, fund, and champion the deployment of new capabilities. Those who choose to do so may see this as an opportunity to demonstrate industry leadership — expecting their regulators to take note.

Traversing these steps can regularly take two or more years. Few regtech firms enjoy sufficient funding to run this gauntlet. Sensing that change is inevitable and imminent, however, venture capital has been flowing into the regtech space in increasing volumes. A majority of that is devoted to 'growth stage' companies that can absorb a substantial amount of

Global RegTech Investment, 2017-2021 (USD, number of deals)



Source: FinTech Global

capital and demonstrate sufficient market traction, to assure investors that their capital will be deployed effectively to scale value capture.

The regtech landscape is thus comprised of a number of bigger players, who have most often 'pivoted' in the direction of established applications, like surveillance and monitoring, and a smattering of more anemically resourced innovators seeking to pioneer new directions. Firms targeting culture and conduct risk have tended to fall into this latter category. It is notable, however, that more well-established firms are beginning to articulate the value propositions sounded by their smaller rivals, and to argue that the tools they bring to market can be re-fitted to the more innovative use cases these smaller firms emphasize. More often this reflects an effort to fit a square peg into a round hole. But some take this shift in attention as evidence of a maturing of the culture and conduct risk management regtech space.[871]

If this is indeed so, then it is a timely development.

Enigma Machines

"We have to defend ourselves as a country against a growing threat from state actors," said Richard Moore, "within an international system which is not working as it should do to constrain conflict and aggression." Chief — or "C" — of Britain's storied Secret Intelligence Service, better known as MI6, Moore was giving his first public speech, in November last year, to address "an era of dramatic change in the security landscape," and to emphasize the importance of human intelligence in an increasingly digital landscape.[872] "We can not match the scale and resources of the global tech industry, so we shouldn't try," Moore conceded. "Instead we should seek their help."

Moore cited assessments suggesting that we may experience more technological progress in the next ten years than we have witnessed in the last century. "What we do, as a human intelligence agency, is essential," Moore insisted, "because at the end of the day, even in a digital world, critical decisions are made by real people." While an intelligence agency must keep with the vanguard of what technology makes feasible, and while a modern clandestine service must draw on insights found in data, it is more important still, Moore argued, that MI6 possess, "the talent to turn complex data into human insight."

If we struggle today with "one enigmatical and paramount question" in the financial sector it is perhaps this: why do misconduct scandals continue to catch us by surprise?

In a 2017 speech, presented at the FICC Market Standards Board, then Bank of England Governor Mark Carney spoke of the $320 billion in punitive fines that the banking industry had been forced to absorb in the wake of misconduct scandals over the decade prior.[873] "Capital," Carney emphasized, "that could otherwise have supported around $5 trillion of lending to households and businesses." Notably, some estimates put the tally of punitive fines, customer remediation costs, and damage awards triggered by misconduct since the financial crisis well in excess of $600 billion today. One industry body estimated that, just one year on from Carney's speech, in 2018

If we struggle today with "one enigmatical and paramount question" in the financial sector it is perhaps this: why do misconduct scandals continue to catch us by surprise?

Getty Images / Anthony Devlin

alone *conduct-related* events cost firms €27.7 billion, accounting for over 92 percent of the year's total operational risk related losses.[874]

"An industry of the scale, importance and complexity of finance needs social capital as well as economic capital in order to operate, innovate and grow," Carney argued in his 2017 speech. However, "repeated episodes of misconduct have called the social licence of finance into question." Carney's outspokenness has not always been appreciated,[875] and not everyone accepted his contention that banks operated by courtesy of some notional social license that might be withdrawn by an irate public — at least not in 2017. Five years on, it is hard to argue that Carney had it wrong.[876]

"With a war raging on European territory, it's clear that not being part of the current sanctions regime was not an option for banks. Not for UBS, not for Switzerland, not for anyone," former UBS chair Axel

Weber argues here. "Because this goes right to the heart of our current understanding of what humanity is about." Banks have to understand that they operate as a part of society, Weber adds. "This link between banking and society has never been as clear as it is today."

Shareholders, consumers and employees want to support organizations whose values resemble their own.

Weber's sentiments are echoed here by Royal Bank of Canada chair Katie Taylor. "Organizations of all shapes and sizes participating in the economy are, by definition, also participating in society," she says. Companies must therefore see themselves as participants in a shared "social journey." All the dots are connected, Taylor continues, "as we're learning in the world of the pandemic; as we're learning in a world suddenly confronted by war in Europe." Therefore, she concludes, "there's no real way to say, 'okay, my company has nothing to do with all that'."

"Shareholders, consumers and employees want to support organizations whose values resemble their own," argues OSFI Superintendent Peter Routledge in his essay herein. He points to broad societal shifts that have emerged more clearly in the course of the pandemic, arguing that this has contributed to the increased priority awarded to ESG-related concerns on the part of customers, employees, and investors. A firm's culture must reflect awareness of and sensitivity to these new social demands, Routledge says. "As the Board is ultimately responsible for an institution's culture," he argues, "these are the kinds of questions that should be on the minds of the Boards of OSFI-regulated financial institutions."

Former BCBS Secretary General, Bill Coen, agrees that the tenor of business — and of regulation — has changed dramatically as ESG-mindedness has become more pronounced. But he notes that interest in good governance can be "overshadowed" by the more vocal emphasis on environmental and social interests. "We see time and again the deleterious impact that poor governance — the G piece — has on bank performance and even on financial system stability," Coen says. "So, by all means let's continue to give due regard to environment and social issues, but not at the expense of paying less attention to governance."

"G is key," argues Barbara Novick, a founder, past vice chair, and now senior advisor to the leadership at Blackrock. Citing the Boeing 737 Max crashes, multiple and disastrous dam collapses at Brazilian mining company Vale, 'Dieselgate' at Volkswagen, and the false accounts scandal at Wells Fargo, Novick asks, "Where was the board in terms of the oversight of these risks?" One important question to consider in the wake of these events, she suggests, is this: "is management giving the board the information it needs to fulfill its role?"

Indeed, *can* it do so? IBM vice chair Gary Cohn points out that "senior management is only as good as the data it works with." And too often, the former president and COO of Goldman Sachs adds, relevant risk data captured by internal systems is "filtered and watered-down" as it travels from the bowels of the organization up to senior leadership.

Creating the right risk architecture is not remotely sufficient

At core, this is a governance challenge. "You only can go into a regulator and say, 'we're complying with the laws,' if in fact you have a governance structure that does that," argues Keith Noreika, former Acting Comptroller of the Currency. "And you can only go to a shareholder's meeting and say, 'our product / business is safe, reliable, etc.,' if you have a governance program that ensures that."

"Creating the right risk architecture is not remotely sufficient," Brad Karp, chair of the law firm Paul Weiss argues here. His firm's investigation into risk management failings at Credit Suisse, in connection with its over-exposure to Archegos, points to an important lesson for all investment banks, Karp asserts: cultivating a culture that allows risk managers to escalate matters of concern to executive management or the Board of Directors — and assures that they do so — is crucial. It is far too common that risk managers seek to avoid the confrontation this implies, instead "adopting a lackadaisical and overly business-friendly attitude," Karp concludes.

"How do we take the reality of human behavior and put some data behind our ability to inquire into it?" Gary Cohn asks. "Is there a way to put science behind the G in ESG?" Or, to return to MI6 Chief Richard Moore, can we examine culture and risk governance issues as they unfold, and "turn complex data into human insight"?

"We advise that economics and finance treat culture in the way that anthropologists and cultural psychologists have advocated recently," argue the authors of an October 2021 NBER paper.[877] "Culture is a complex system that should be analyzed in terms of its elements and how those elements relate," the professors at Yale and Duke business schools contend. Economists have made great progress in devising methods of measuring aspects of corporate culture, they argue in their paper. "A key aspect that we hope to convey," they emphasize, "is that culture emerges from social interactions."

Today, computational social science enables the real-time study of those interactions, permitting us "to turn complex data into human insight."

"When it comes to behavior change, or belief change, our social networks serve as prisms," Director of the Network Dynamics Group at University of Pennsylvania Damon Centola argues here. Today, we can study how the 'light' is refracted through such prisms to anticipate what is likely to emerge.

"We're at the point in our science where we have an understanding of networks and of norms such that, if we're going to invest in culture change, we know where to look," adds Betsy Levy Paluck, Deputy Director of the Center for Behavioral Science & Policy at Princeton. "We have really good ideas about where and how to intervene to drive change," Paluck emphasizes.

"Organizational culture is caught, not taught," Michael Arena, Vice President of Talent & Development at Amazon Web Services explains, with Babson professor Rob Cross. And once organizations recognize this, "they can fully leverage the more organic, network patterns driven approach towards shifting culture."

Organizational culture is caught, not taught.

The Quantification of Margins and Uncertainties — "QMU" — was critical to assessing the soundness and assuring the safety of the nation's nuclear weapons stockpile, past-Director of Los Alamos Charlie McMillan explains. "We wanted to assure that our margins (for error, or failure) were much greater than the uncertainties with which we are confronted," McMillan continues, "so that the reliance that the country (and the world) places on the stability of these systems is well founded." It is impossible to test for the margins and uncertainties surrounding culture and conduct related risks without a reliable means of quantifying "human factors."

New science and new technologies today allow for a modern Enigma Machine, capable of cracking the code on the "human factors" that drive organizational outcomes. As David Kiron argues here, such tools enable the discovery of previously unrecognized Key Performance Indicators and Key Risk Indicators. This, in turn, equips management with greater ability to achieve "predictive alignment" between goals, strategies and outcomes — and to evidence to the satisfaction of supervisors that this is indeed so.

The way forward

Achieving these desired outcomes is necessarily a community endeavor that must involve regulators, supervised firms, and technology pioneers. Only through their collective action can we establish a "consensus structure" around critical questions which demand answer: what data is relevant; how is that data to be collected and shared securely; how are privacy interests and ethical considerations to be met; how may algorithmic models be adequately trained and tested for bias and reliability; how are these models to be made compellingly 'explainable'; how are the insights they yield to be harnessed to create collective goods; and how might we deploy industry-standard 'utilities' that facilitate knowledge sharing, adoption of best practices, and horizontal peer review capabilities.

In the last year we have seen big banks banding together to measure and manage climate risk.[878] Ana Botín, of Spain's Santander, has called on central banks to coordinate climate-related stress testing.[879]

With the participation of DBS, OCBC, UOB, Standard Chartered, Citibank and HSBC, the Monetary Authority of Singapore has facilitated public-private collaboration towards the creation of a platform for the sharing of risk information between firms, to help prevent money laundering, the financing of terrorists, and illicit financing in the proliferation of weapons of mass destruction..[880]

New science and new technologies today allow for a modern Enigma Machine, capable of cracking the code on the "human factors" that drive organizational outcomes.

Through its Innovation Hub initiative, the Bank for International Settlements has joined with MAS, the Bank of England, and the International Swaps and Derivatives Association to establish a shared platform that would permit for the extraction and analysis of large quantities of data from diverse sources, and make analytic outputs visible through real-time dashboards.[881]

The US Treasury Department's anti-money-laundering bureau, FinCEN, is considering the creation of a series of regulatory "sandboxes" within which firms can experiment with new technologies aimed at modernizing the nation's financial crime safeguards.[882] With the 2021 National Defense Authorization Act, legislation tied to national security policies and budgets has established the "FinCEN Exchange,"[883] to facilitate public-private information-sharing partnership between law enforcement, national security agencies, financial institutions, and FinCEN to better combat money laundering, terrorism financing, organized crime, and to protect the financial system from illicit use and promote national security.[884]

As these examples illustrate, we know how to establish public-private initiatives that facilitate the creation of consensus structures, through which we may collaborate towards shared goals more efficiently.

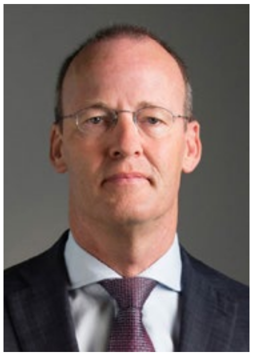
If we are to avoid 'enigmatical' questions arising from further misconduct scandals in the banking sector, we must agree to a multilateral program of work that is sponsored — at senior levels — by regulators, supervised financial institutions, and technology pioneers. It is our fervent hope that this report will help to shape such an endeavor.

Take Good Care of Eachother.

Closing Comments

Sound Governance for Navigating the Changing Financial Landscape

by KLAAS KNOT


Klaas Knot

There is a saying: "lessons in life will be repeated until they are learned". The lessons of the 2008 global financial crisis led to the creation of the Financial Stability Board (FSB) to coordinate the international responses to address the fundamental weaknesses that the crisis laid bare. These reforms have served the financial system well, as it has shown resilience when it has been confronted in recent years by very different crises.

Nevertheless, challenges remain.

The direct and indirect economic consequences of Russia's invasion of Ukraine are highly uncertain. The FSB is closely monitoring critical nodes of vulnerabilities and possible transmission channels. Financial institutions need to be prudent and responsive to possible unexpected shocks to ensure resilience.

The onset of the COVID-19 pandemic, and ensuing market turmoil in March 2020, demonstrated that not all the vulnerabilities related to non-bank financial intermediation had been addressed. In response, the FSB has launched an ambitious programme to enhance resilience in the non-bank financial intermediation sector.

The COVID-19 pandemic also served as a timely reminder of the need to look not only at risks emerging from within the financial sector, but also from outside of it. A key FSB priority is the implementation of our July 2021 Roadmap for Addressing Climate-related Financial Risks. The roadmap coordinates the work of standard setting bodies and international organisations. It covers the key pillars of disclosures, data, vulnerability analysis, and regulatory and supervisory approaches.

Sound risk management by financial institutions is as vital when addressing climate risks as it is in other aspects of firms' operations. The FSB published this April a report with recommendations on Supervisory and Regulatory Approaches to Climate-related Risks. We look forward to feedback and dialogue on these important issues. Reliable data is crucial: after all, what gets measured, gets managed. To this end, we need better data, consistent classification, global disclosure standards, and quantifiable risk metrics for financial institutions to integrate climate change into in their risk management.

More generally, a key lesson from the 2008 financial crisis was the importance of effective conduct, culture and risk management practices within the financial sector. The FSB issued in 2014 a framework to assist supervisors in their assessment of risk culture. The framework identifies some foundational elements that contribute to the promotion of a sound risk culture with a financial institution.

In recent years, there has been increasing recognition that governance and culture relating to financial risks cannot be separated from governance and culture of firms' activities considered more broadly.

In recent years, there has been increasing recognition that governance and culture relating to financial risks cannot be separated from governance and culture of firms' activities considered more broadly. Financial institutions need to take into account the impact of their activities on other stakeholders. Indeed, the business model of a financial institution is only sustainable if it is based on providing services to society with long-term added value. If this is not the case, such shortcomings will ultimately undermine its operations, reputation and financial position.

Governance and culture are also crucial in managing operational risks. Operational resilience within the financial sector has become more important as cyber risks have increased. In this context, balanced decision making, effective risk control mechanisms, checks and balances, and appropriate incentives are key ingredients that need to be assessed as part of regulation and supervision.

Effective governance is an essential precondition for financial stability.

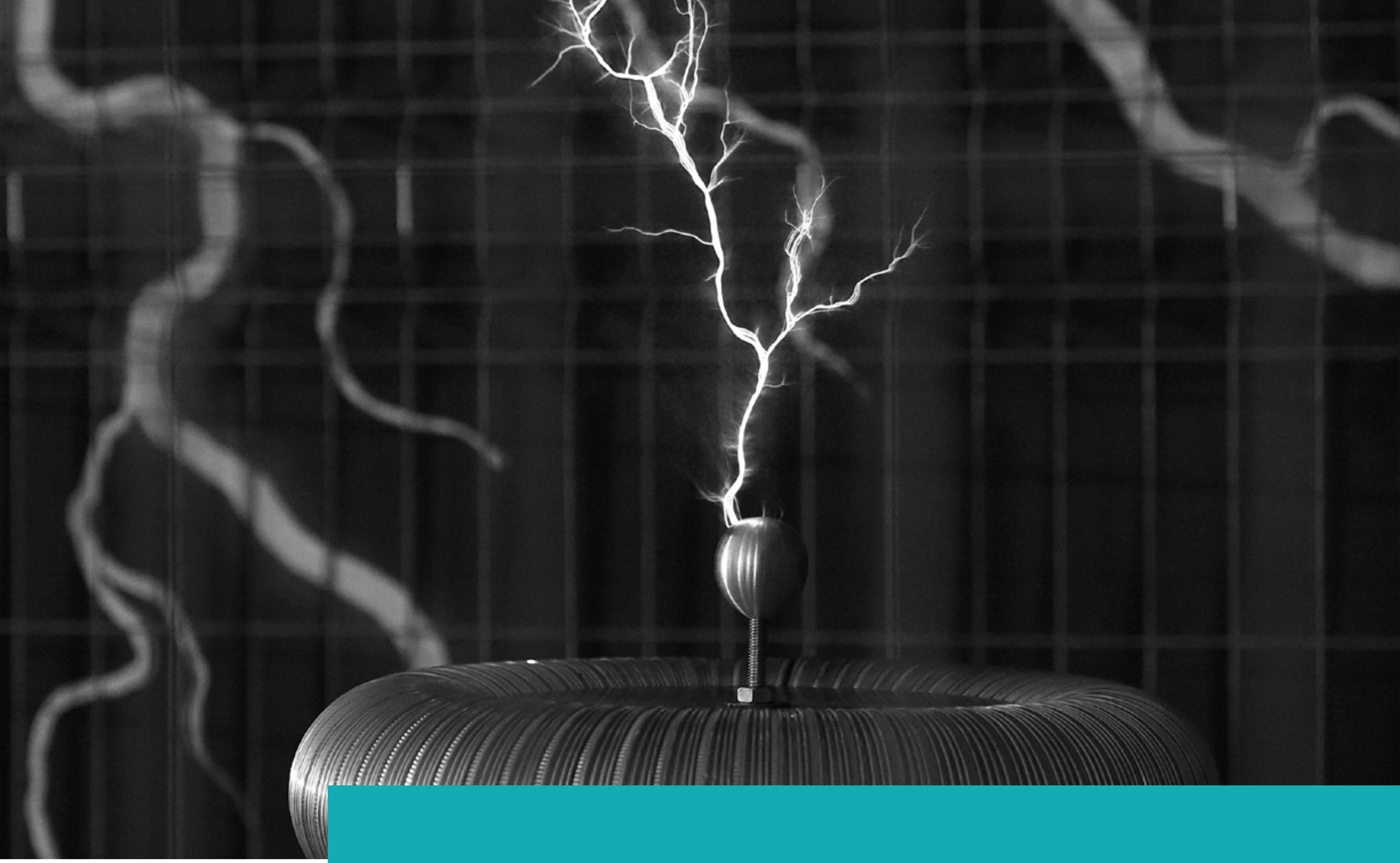
Digital innovation presents new challenges. For instance, crypto-asset markets are rapidly evolving. Crypto-assets can improve the efficiency and reduce the cost of payments, promoting financial inclusion. However, there are also important governance problems related to consumer and investor protection and integrity. The challenges here are higher in cases where there are decentralised business models.

In sum, the financial system is currently confronted with both an uncertain economic situation, as well as structural changes as a result of climate change and digital innovation. The stability and integrity of the financial system is a public good, and effective governance is an essential precondition for financial stability. Strong governance frameworks provide crucial safeguards, enabling institutions to be adequately prepared for unexpected developments and structural changes in the financial system. International coordination among supervisors and regulators to keep their frameworks relevant for today's challenges is crucial.

***Klaas Knot** has been President of* De Nederlandsche Bank *(DNB) since 1 July 2011 and has served as Chair of the Financial Stability Board since 2 December 2021. He is a member of the Governing Council and the General Council of the European Central Bank, member of the European Systemic Risk Board, member of the International Monetary Fund's Board of Governors and a member of the Board of Directors of the Bank for International Settlements.*

Before assuming DNB's presidency, Knot was Deputy Treasurer-General and Director of Financial Markets at the Dutch Ministry of Finance (2009–2011). Earlier, from 1995, he worked for DNB for almost twelve years in various positions including senior economist in the Monetary and Economic Policy Department and Director of the Supervisory Policy Division.

Since 2005, he has been Honorary Professor of Economics of Central Banking at the University of Groningen and since 2015 he is also Honorary Professor of Monetary Stability at the University of Amsterdam.



APPENDIX

"The scientific man doesn't aim at an immediate result. He doesn't expect that his advanced ideas will be readily taken up. His work is like that of the planter — for the future. His duty is to lay the foundation for those who are to come, and point the way."

NIKOLA TESLA

Appendix

Compendium Survey 2022

1. What organization are you representing in this survey?

2. The Coronavirus pandemic has reoriented regulatory priorities. For instance, there is heightened concern for business resilience and risk governance in the hybrid work context. What changes to regulatory priorities do you expect will persist into the future?

3. Does your agency have a mandate to supervise culture or conduct risk concerns, is that mandate express or implied? If your agency does not currently have a mandate, do you expect that to change in the coming year?

4. Is there anything you would like to share regarding new initiatives planned for the coming year, specifically targeting non-financial risk governance?

5. Is culture and conduct risk supervision communicated to the firms you oversee in a rules or principles based manner?

6. Do you have a dedicated culture or conduct supervision/risk assessment team?

7. If so, when was that created, and can you provide some relevant history?

8. If not, can you offer insight into what drove that decision? Do you expect to initiate efforts in that direction in the coming year?

9. Have you engaged in any significant supervisory actions or assessed fines for perceived cultural issues or instances of misconduct?

10. If so, how has that shaped forward-looking views regarding culture or conduct risk supervision?

11. Do you hold senior managers accountable for their organization's culture and/or any conduct related risk management failures?

12. If so, is this reflected in a formal 'senior managers accountability regime'?

13. In your examination efforts, or other supervisory engagement with firms, is culture and conduct specifically assessed or discussed?

14. If so, do you engage only with senior management, or do you also engage mid-level managers?

15. Firms in many jurisdictions have established behavioral science units to support culture and non-financial risk governance. Are you engaged with any firms in your market trialing this novel approach?

16. In the past year, has your organization sponsored or participated in any conferences or events focused on culture or conduct risk governance and supervision?

117. Which events have you participated in, and which have you found to be most useful?

18. Do you have plans to organize or participate in any such events in the coming year?

19. Does your organization engage in any international collaborations relating to culture or conduct risk supervision? (e.g., through the

Global Financial Innovation Network, or BIS Innovation Hub, etc.) Do you expect to engage in any such during the coming year?

20 Has your organization established a center that aims to promote innovation?

21 If so, have you conducted any trials of innovative products or services in the context of culture or conduct risk supervision?

22 If not, do you expect to initiate efforts to promote innovation or trialing innovative approaches in the coming year?

23 Have you engaged with RegTech or SupTech companies with a view to developing the use of these technologies within your agency?

24 If so, has this been in the context of culture and conduct risk supervision?

25 If not, are you otherwise engaged in efforts to promote the adoption of RegTech tools?

26 Some firms and regulators have begun to consider RegTech as providing a means to "predict and prevent" misconduct, rather than the more common surveillance and monitoring methodologies which operate on a backward-looking, "detect and correct" basis. Has your organization seen or supported any firms in your jurisdiction with efforts in this direction?

27 Are any financial institutions in your jurisdiction implementing regular culture and/or conduct risk audits? If so, has this been at your agency's prompting?

28 Can you provide additional detail about you engagement with audits? (e.g. encourage firms to forward completed audits for review, etc.)

29 Has your organization issued any new rules or mandates to address culture or conduct concerns?

30 To what extent are firms in your jurisdiction facing pressure to demonstrate a higher standard of care vis-a-vis their non-financial risk management capabilities?

31 The past year has focused attention on ESG disclosures. To date, much of this has focused on Environmental and Social Interest disclosures. Do you anticipate an increase in focus on Governance disclosures in 2022?

32 If so, on which topics do you expect these disclosures to focus?

33 Supervisory agencies in multiple jurisdictions have faced significant criticism for a perceived failure to hold themselves to the same accountability standards as those they apply to the firms they oversee. Has your agency faced such criticism?

34 If so, how are you seeking to address such criticism?

35 Would you call our attention to any past or expected legislation that your government specifically intends to address culture and conduct related risks in the financial sector?

36 One of the highlighted features of the Compendium is our Culture & Conduct Regulatory Risk Regulatory Landscape where we offer our analysis of the different strategies and approaches the global regulatory community has taken on this subject. If your organization appears on this chart, would you like to offer some reactions to where it is located?

Appendix

Culture and Conduct Risk Regulatory Landscape

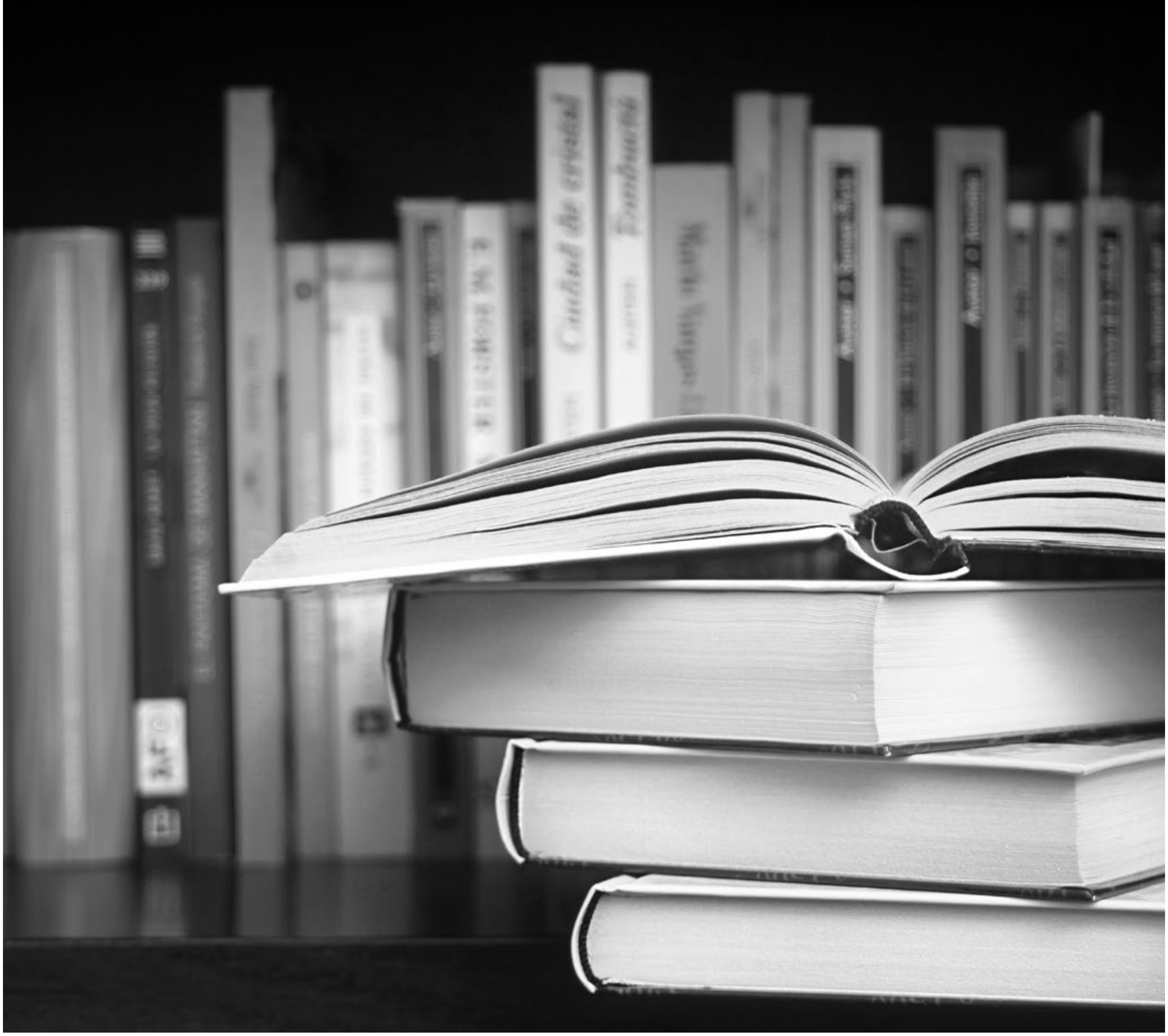
Our Methodology

For the third year, Starling offers its Culture and Conduct Risk Regulatory Landscape, summarizing in chart form the various culture and conduct-related strategies and initiatives pursued by leading global regulators and supervisors. Our intent is to provide a framework for a broadly objective means to summarize approaches that regulators and supervisors have taken across their respective jurisdictions—one which permits for a trend-line comparison.

As with previous years' charts, the inputs for this analysis were drawn from public as well as nonpublic sources. Each year Starling collects responses to a survey of global regulators, supervisors, standard setters, industry associations, and other relevant organizations. These responses are complemented by the detailed submissions we received from many regulatory authorities that went into the production of this report, as well as by policy papers, interviews and other public commentary collated by our staff in the past year. This data was then used to generate scores for each regulator on over a dozen factors.

We are grateful to the many supporters that offered input into this process. In this, our third year of producing this chart, we have been grateful for the attention it has generated and we look forward to continued changes in years to come as regulators continue to evolve their approaches to addressing the challenge of culture and conduct risk supervision. We welcome reactions at compendium@starlingtrust.com.


FIRE EXIT

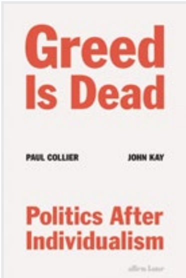


APPENDIX

The Starling Bookshelf

We speak a fair bit on the topics herein, at events where the organizers and audience are interested in learning how behavioral science, organizational network analytics, and machine-learning techniques are coming together in the context of culture and conduct risk governance and supervision. Nearly always someone asks, "What can I read to learn more about this stuff?"

So we've complemented our *Compendium* with reference to some of the works that sit dog-eared on our bookshelves, yellow highlighter marks competing with coffee stains and notes in the margins. We hope our readers will be inspired to give one or two of these terrific books a glance — and most particularly those by contributors to this year's report, noted in bold below.



Greed is Dead:
Politics After Individualism

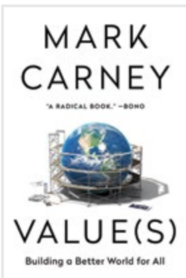
Paul Collier & John Kay

"Humans have become successful not by being selfish and smart, but by being social."

"Businesses are the most important communities we have."

"We see no inherent tension between community and market: markets can function effectively only when embedded in a network of social relations."

"The organization whose purpose is shareholder value has little to offer its employees other than their paychecks."

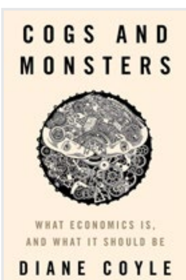


Value(s):
Building a Better World for All

Mark Carney

"Markets are not ends in themselves, but powerful means for prosperity and security for all. As such, they need to retain the consent of society — a social licence — to be allowed to operate, innovate and grow."

"A series of scandals have called the social licence of finance into question. This malaise in corners of finance can be remedied only by a combination of regulatory measures and true cultural change."

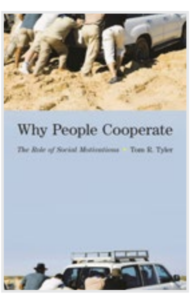


Cogs and Monsters:
What Economics Is, and What It Should Be

Diane Coyle

"Individual human choices have a social as well as an environmental context. We make decisions amid greater social complexity than many other biological creatures, or AI agents."

"The economist's analytical perspective of benign objectivity, while essential to devising policies in the broad public interest, cannot survive the transition from ivory tower to the streets, or even to the quiet and shabby corridors of regulatory office blocks."

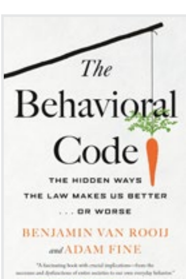


Why People Cooperate:
The Role of Social Motivations

Tom R. Tyler

"The suggestion that the structure of a group, organization, or community shapes the behavior of people within it, and through that, influences the group, is one of the core assumptions of social psychology, which views human behavior as a response to the nature of the social institutions within which people are embedded..."

"However, legal institutions are designed based upon the assumption that behavior is shaped by the instrumental risks of sanctioning."

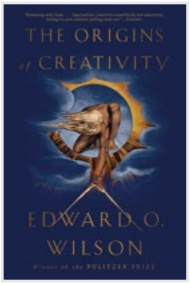


The Behavioral Code:
The Hidden Ways the Law Makes Us Better or Worse

Benjamin van Rooij & Adam Fine

"If we truly care about making law more effective, we must learn to understand the behavioral code."

"We must delve into the social science that shows us what has remained hidden. Science has made the invisible behavioral code visible... Over the last four decades, scientific insights have revolutionized our understanding of how humans act and why they misbehave. But the science has yet to be adopted in our laws."



The Origins of Creativity

Edward O. Wilson

"The philosopher's stone of human self-understanding is the relation between biological and cultural evolution."

"Regardless of how subtle, fleeting, and personalized human thought may be, all of it has a physical basis ultimately explainable by the scientific method."

"Human nature... is not the genes that prescribe it... It is the herediary propensity to learn certain forms of behavior and to avoid others."

Wired for Culture:

Origins of the Human Social Mind

Mark Pagel

"We appear to be the only species able to copy and imitate others' ideas, an ability we called social learning."

"Social learning is to ideas what natural selection is to genes."

"The distinctive and salient feature of much of our social existence is the sense of belonging to a cultural group towards which we feel an allegiance that we often do not easily extend to others outside of that group."

"These are adaptations that have wired our minds and bodies for culture."

The Secret of our Success:

How Culture is Driving Human Evolution, Domesticating our Species, and Making Us Smarter

Joseph Henrich

"The key to understanding how humans evolved and why we are so different from other animals is to recognize that we are a cultural species."

"Humans are adaptive cultural learners who acquire ideas, beliefs, values, social norms, motivations and worldviews from others in their communities."

"Once we understand humans as a cultural species, the toolbox for designing new organizations, policies and institutions begins to look quite different."

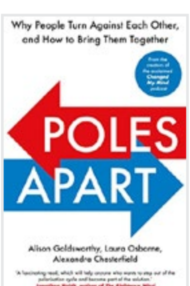
Friends:

Understanding the Power of our Most Important Relationships

Robin Dunbar

"Being part of a group makes us feel properly human. We feel more relaxed when we know we belong."

"Our choice of friends is heavily dictated by trying to find like-minded people, people we feel comfortable with in casual company, people we don't have to explain the joke to every time, people who think like us and whose behaviour we don't have to work hard at trying to understand... In short, people we can trust because we think we know how they think."



Poles Apart:

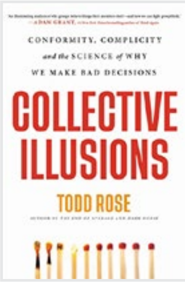
Why People Turn Against Each Other, and How to Bring Them Together

Alison Goldsworthy, Laura Osborne, & Alexandra Chesterfield

"Who we are is, at least partly, about the groups we belong to."

"We each feel that our beliefs are entirely our own, chosen at will, consciously considered. We don't see, or don't acknowledge, that they are formed from a mix of innate predispositions (our biology) and the unwritten rules and norms we learn from our social world..."

"It may be our individual predispositions that drive us to seek membership of particular groups, but once we are members it is likely we will change. We want to fit in."



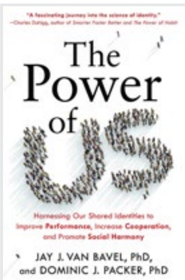
Collective Illusions:

Conformity, Complicity and the Science of Why We Make Bad Decisions

Todd Rose

"We humans are so profoundly social that just our awareness of others can shift our behavior. This desire to be aligned with other people — what scientists call our "conformity bias" — isn't optional: it's a hardwired part of our biology."

"Simply put, collective illusions are social lies. They occur in situations where a majority of individuals in a group privately reject a particular opinion, but they go along with it because they (incorrectly) assume that most other people accept it."



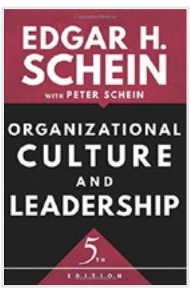
The Power of Us:

Harnessing Our Shared Identities to Improve Performance, Increase Cooperation, and Promote Social Harmony

Jay J. von Bavel & Dominic J. Packer

"[A]spects of one's identity have an influence on all sorts of daily decisions, often outside once's conscious awareness. Your preferences are fundamentally shaped by your social identity, and the reason is quite simple: your social identity is you."

"The ways in which you strive to be an independent self are influenced by the norms of the group you identify with. Norms are the accepted standards of behavior within social groups and influence how you behave."

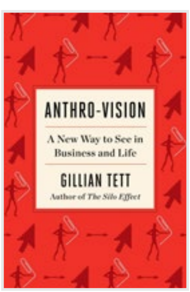


Organizational Culture & Leadership (5th edition)

Edgar Schein

"The culture of a group can be defined as the accumulated shared learning of that group ... a pattern of systems or beliefs, values, and behavioral norms that come to be taken for granted and eventually drop out of awareness."

"Public scandals force senior executives to examine norms and practices and assumptions that had been taken for granted and operated out of awareness... These reexaminations sometimes lead to new practices, but they do not automatically create new cultures."



Anthro-Vision:

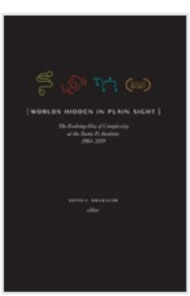
A New Way to See in Business and Life

Gillian Tett

"We need to recognize that we are all creatures of our environment, in an ecological, social, and cultural sense."

"Just as adding salt to food binds the ingredients and enhances the flavor, adding anthropological ideas to disciplines such as economics, data science, law, or medicine creates a deeper, richer analysis. Blending computing and social science should be a particular priority today."

"Computer science needs social science, if you want to make sense of data."



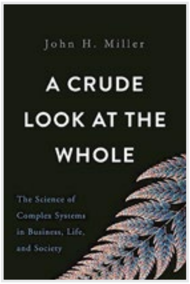
Worlds Hidden in Plain Sight:

The Evolving Idea of Complexity at the Santa Fe Institute 1984-2019

David C. Krakauer (ed.)

"Complexity science is an effort to discern and theorize common patterns in complex systems from multiple scientific perspectives."

"In biology, for example, there is the theory of evolution; in economics there is utility maximization and game theory; and in engineering mathematics there is Alan Turing's theory of computation. Complexity science seeks to connect these theories, to find explanatory and predictive frameworks..."



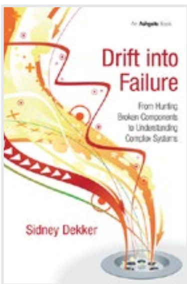
A Crude Look at the Whole:

The Science of Complex Systems in Business, Life, and Society

John H. Miller

"Complexity arises in systems of intracting agents. Take some agents with simple behavior, connect them together in a particular way, and some global behavior arises. Given this, knowing how patterns of interactions — that is, networks — influence behavior is fundamental to understanding complex systems."

"Without a science of complex systems, we have little chance to understand, let alone shape, the world around us."



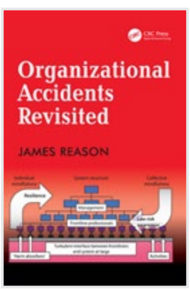
Drift into Failure:

From Hunting Broken Components to Understanding Complex Systems

Sidney Dekker

"Perhaps the terms most closely associated with protective structures — regulation, compliance, oversight and inspection — are fundamentally mismatched to complexity."

"The traditional model would claim that for accidents to happen, something must break, something must give, something must malfunction... [But] in the dirft into failure, accidents can happen without anything breaking, without anybody erring, without anybody violating rules they consider relevant."



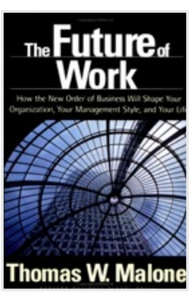
Organizational Accidents Revisited

James Reason

"When systems have many layers of defenses, they are largely proof against single failures, either human or technical. The only types of accidents they can suffer are organiational accidents."

"Organizational failures are deficiencies in either the structure of a company or the way in which it conducts its business that allow safety responsibilities to become ill-defined and warning signs to be overlooked."

"Latent conditions act like resident pathogens..."



The Future of Work:

How the New Order of Business Will Shape Your Organization, Your Management Style and Your Life

Thomas Malone

"If decentralization becomes highly desirable in business, then we will need to manage in new ways. But most of us still have — deep in our minds — models of management based on the classic, centralized philosophy of command and control. To be successful in the world we're entering, we will need a new set of mental models."

"We need to shift our thinking from command-and-control to coordinate-and-cultivate."

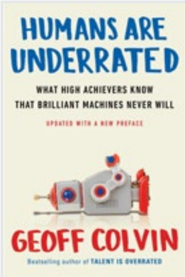
Adaptive Space:

How GM and Other Companies Are Positively Disrupting Themselves and Transforming into Agile Organizations

Michael Arena

"Most organizations are designed to facilitate, motivate, or constrain an individual's behavior toward driving its core purpose. This was a successful strategy when organizations were operating in relatively stable environments. However, in today's dynamic environment, organizations need to be more liquid than static."

"Adaptive Space creates connections that serve to discover, develop, and diffuse new ideas across an organization... to become more agile."



Humans Are Underrated:
What High Achievers Know that Brilliant Machines Never Will

Geoff Colvin

"It is striking that as information technology has grown more powerful and influential, the importance of human groups — as distinct from individuals — in creating knowledge has increased enormously."

"More than ever, work today gets done in teams, and every team is a social unit. The quality of its social interactions — intrateam and interteam — determines its success or failure."

The Age of AI and Our Human Future

Henry Kissinger, Eric Schmidt & Daniel Huttenlocher

"Without significant fanfare — or even visibility — we are integrating nonhuman intelligence into the basic fabric of human activity."

"This development will transform entire fields by enveloping them in AI-assisted processes, with the lines between purely human, purely AI, and hybrid human-AI decision making sometimes becoming difficult to define."

"AI will transform our approach to what we know, how we know, and even what is knowable."

New Accountability in Financial Services:
Changing Individual Behaviour and Culture

Ciaran Walker & Joe McGrath

"[In] order to achieve the regulatory objective of behavioural change, a "command and control" regulatory approach ... is unlikely to be sufficient."

"Whilst the imposition of sanctions on firms and individuals for serious regulatory breaches is a necessary and important aspect of an effective accountability regime, new accountability is focused on mechanisms, in addition to the implementation of legal requirements and sanctions, which may sertve to improve behaviours in financial services."

Culture Audit in Financial Services:
Reporting on Behaviour to Conduct Regulators

Roger Miles

"Conduct regulators see it as an essential task of their own — since it's what they are striving to regulate — to understand the raw material of conduct through studying the science of human behaviour."

"Conduct regulators expect firms to develop leading indicators of misconduct and to intervene earlier to improve unhealthy workplace cultures. Reg tech, tougher live supervision, and rising public expectations all play a part in supporting this."

Regtech, Suptech and Beyond:
Innovation in Financial Services

Bill Coen & D.R. Maurice

"For authorities, the use of suptech could improve oversight, surveillance and analytical capabilities, and generate real-time indicators of risk to support forward-looking, judgement-based supervision and policymaking."

"For regulated institutions, the use of regtech could improve compliance outcomes, enhance risk management capabilities and generate new insights into the business for improved decision making."

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