



JUNE 2024

Culture & Conduct Risk in the Banking Sector

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





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Stephen Scott, Lead Author & Editor

Cameron Lawrence, Research Director

Steve Leacock, Graphic Designer

Starling Trust Sciences LLC

insights.starlingtrust.com

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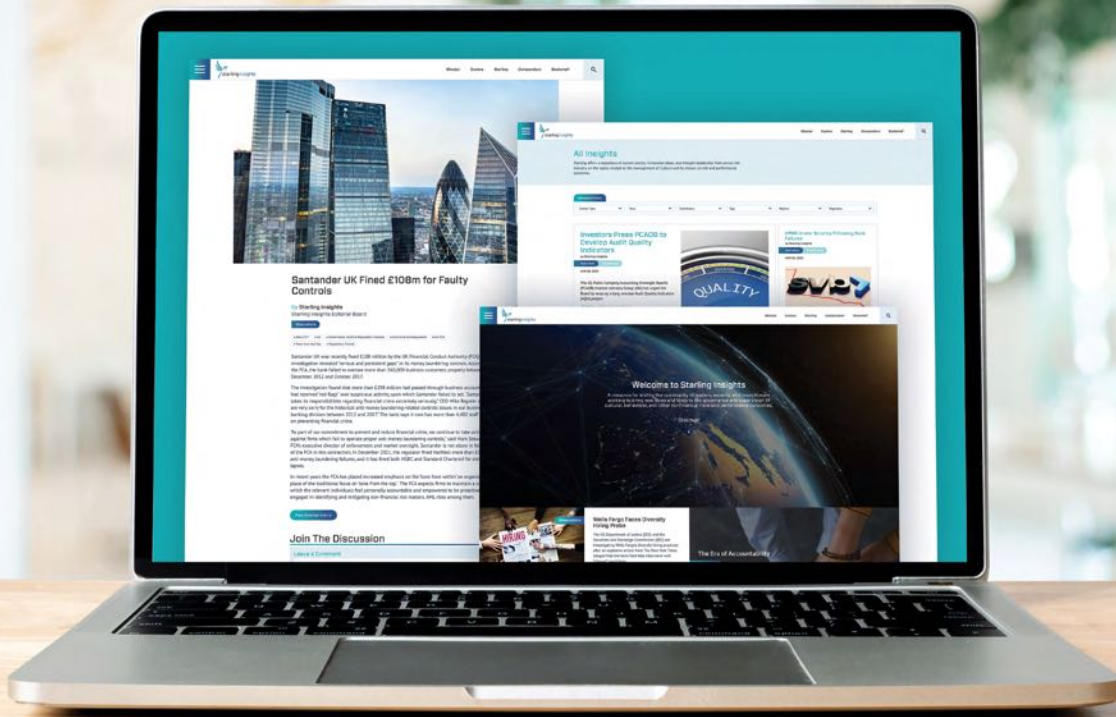
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The *Compendium* is a publication of Starling Insights, a membership-based platform that is a resource for and by the community of leaders, experts, and practitioners working to bring new ideas and tools to the governance and supervision of cultural, behavioral, and other non-financial risks and performance outcomes.

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Throughout the year, Starling Insights publishes *Deeper Dive* reports long-form white papers expanding upon themes briefly discussed in this *Compendium*.

Our *Deeper Dive* reports feature comprehensive research on pressing topics and offer contributions from subject matter experts. These are complemented by detailed footnotes and references to guide further inquiry.

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 into the enjoyable and easy-to-use reference that it has become. Learn more about him at leacockdesign.com.

Many thanks to the other excellent designers, editors and writers that support Starling Insights and the *Compendium*: **Daniela Arceo** (Arrow, CA); **Fred Gomez** (Arrow, CA); **Caleb Siaw Darfour** (Aya Data, Ghana); **Keyur Patel** (UK).

Our greatest appreciation goes to the many deeply informed industry experts who were kind enough to aid us in the preparation of this report — it is substantially improved by their support: **Calvin Benedict** (FMA, NZ); **Romil Ghelani** (FMA, NZ); **Valencia Letsoalo** (FSCA, ZA); **YunXiao Lim** (MAS, SG); **Ted MacDonald** (FMSB, UK); **Tamara Scicluna** (Rhizome Advisory, AU); **Ronald Sin** (MAS, SG); **Kershia Singh** (FSCA, ZA); **Melanie de Waal** (MAS, SG).

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 and AI to management challenges, Starling reduces your reliance on periodic employee surveys and intrusive surveillance by generating continuous leading indicators of risk and other key performance metrics across your entire organization. By revealing root causes of critical risks to operations, Starling enables leaders to move from a position of 'detect and correct' to one of 'predict and prevent.'

To learn more about Starling and our Predictive Behavioral Analytics solutions, visit us at www.starlingtrust.com.

Our Advisors

FINANCIAL & INDUSTRY ADVISORS



GARY COHN

Gary Cohn is Vice Chairman of IBM. 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 nonfinancial risk governance, allowing for more meaningful horizontal reviews. That capability becomes all the more important in the wake of last year's banking sector turmoil, which reflected the challenge of managing and supervising non-financial risks that can undermine any capital cushion."



MIREA RAAIJMAKERS

Mirea Raaijmakers is an independent advisor on culture transformation and behavioral risk. She is also a core teacher at the VU/School of Business and Economics at Amsterdam and

an Expert Partner at Axialent. Prior to that she was Managing Director/Global Head of Behavioural Risk Management at ING and previously led the Dutch central bank (DNB)'s supervision programme for Behaviour and Culture.

"Some industry overseers have begun to incorporate learnings from the behavioral sciences into their approach to supervision, and some firms have established behavioral science teams to explore applications in risk governance. But we can do much more — behavioral science has tremendous practical insights to offer the financial services industry. It needs to become a standard tool in supervision and governance alike."



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. She also serves on the Peterson Institute for International Economics

Board, 100 Women in Finance Board, Center for Financial Stability Advisory Board, and others.

"Corporate governance and corporate culture are critical to the long-term value of companies. Too often, shortsighted 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."



MARK COOKE

Mark Cooke is the founder of a dedicated marketplace to support Fintechs in promoting their innovative solutions to manage non-financial risk in Financial Services. He served as Group Head

of Operational Risk for HSBC from 2014 through 2020. He also served as Chairman of ORX, the financial services industry association for Operational Risk Management.

"An over-reliance on surveillance & monitoring has not resulted in desired nonfinancial 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."

ACADEMIC & SCIENCE ADVISORS



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.'"



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 book, *The Fearless Organization: Creating*

Psychological Safety in the Workplace for Learning, Innovation and Growth, has been translated into 11 languages. Her latest book, *Right Kind of Wrong: The Science of Failing Well* is now available.

"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."



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: The Surprising Power of People and Computers Thinking Together* 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."



SCOTT PAGE

Scott Page is the John Seely Brown Distinguished University Professor of Complexity, Social Science, and Management at the University of Michigan. He has authored several books, most recently *The*

Model Thinker: What You Need to Know to Make Data Work for You.

“Organizations are complex adaptive social systems. If we hope to understand the performance of such systems — how and why they behave as they do — no single model will suffice. But a mix of models can yield powerful insights that would otherwise be unavailable to us. By taking this approach, we provide leaders with non-obvious insights that allow them to make better decisions and to drive better outcomes for their organizations.”



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 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 respond to emerging risks proactively — predicting and preventing bad outcomes rather than merely detecting and correcting for them after harm is done.”

Past Advisors

PAST FINANCIAL & INDUSTRY 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, Corning 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.”



THOMAS CURRY

Thomas Curry was US Comptroller of the Currency. As Comptroller, he also 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.”



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 AntiMoney Laundering chief for the

Deutsche Börse Group. He also served as the final CEO of Wirecard, winding it down after uncovering its ruinous fraud scheme.

“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.”

PAST ACADEMIC & SCIENCE ADVISORS



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.”



MARTIN WHEATLEY

Martin Wheatley helped to form the Financial Conduct Authority (FCA) and served as its inaugural CEO. The FCA is the principal conduct regulator for the UK’s financial sector. Earlier, he served as CEO of

the Hong Kong Securities & Futures Commission.

“It is clear from numerous scandals in the financial services sector that mere compliance with a rule book is not enough, and that good outcomes will only be seen if there is a fundamental change of mindset among firms — and not just a few well-meaning speeches from the CEO. As an industry reference, Starling’s Compendium advances that change of mindset usefully.”



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.”



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.”

CURATION & CONTRIBUTION

In the production of this annual report, we strive to curate and present information without imposing our own views on such. 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 otherwise capture and convey, based on public records.

This we do in two ways:

- First, by forwarding a questionnaire 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 more specific and fulsome commentary, through articles and interviews appearing in the many **In Focus** segments herein.

For this, our seventh annual *Compendium*, we have made a concerted effort to include voices that have not been included in past editions. We are delighted that this year's report includes contributions from the New York Department of Financial Services, the US Federal Reserve Board of Governors, the European Central Bank, and the Central Bank of Ireland, for instance. We have also extended our coverage to feature related developments in India and Ghana.

We hope that this 2024 update will help to prompt further informed discussion among our contributors and readers alike. We are proud that so many have entrusted 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 — both here and in our earlier reports — 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.

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2024 Key Takeaways

1 Failed Governance — The “turmoil” of 2023 shows that capital buffers don’t compensate for risk governance weaknesses, to include those driven by culture and the conduct it promotes. Better tools, and metrics, are needed to assess culture risk governance efficacy, and this is key to managing financial and non-financial risks proactively.

2 Failed Supervision — Warning signs are often obvious only in hindsight. This highlights a significant risk of over-reliance on supervisory judgement in bank examinations. Where culture and risk governance remains a subjective matter, supervisors and managements will remain challenged in deciding when corrective intervention is necessary, and timely.

3 Systemic Idiosyncrasies — Non-financial risk governance failures are often taken to be idiosyncratic. Yet these events regularly reflect a shared set of persistent and recurrent underlying cultural drivers. Specific manifestations should thus be viewed as ‘uniquely similar’ in of their root-causes. These, in turn, must be recognized as representing systemic risks of prudential concern.

4 Prudential Concerns — The conduct risks that follow from organizational culture are not typically treated as matters of concern to prudential regulators. Yet, as the near-failure of Credit Suisse attests, deposit flight is rapid when customers and investors lose faith in management, and this faith can be lost after persistent misconduct scandals. As such, conduct risk governance should be seen as a prudential matter.

5 As Above, So Below — 2023 exposed culture challenges among supervisors. From concerns about ineffective problem escalation to reports of toxic workplaces, regulatory agencies face the same culture and conduct risk governance challenges they point to among firms. Their common struggle to address these issues presents an opportunity for public-private collaboration aimed at crafting reliable solutions.

6 Character vs Context — Policymakers are exploring the question of “good character” and asking how financial sector overseers may examine it effectively, amidst efforts to assure that those working in the financial sector are “fit and proper” for their roles. But while character is important, it is cultural context that condones or challenges its expression.

7 ‘Do Process’ vs Due Process — Assessment of management capabilities and of risk governance efficacy remains a largely subjective supervisory exercise, shrouded in secrecy by design. Without reliable objective metrics, supervisors are open to charges of indefensible tick-box analysis (“do process”) while firms may conclude litigation is necessary to assure bank exams afford them appropriate due process.

8 Accountability vs ‘Speak-Up’ — Regulators have embraced senior manager accountability, to ensure clear consequences when executives neglect risk governance. At the same time, they encourage psychological safety to promote ‘speak-up’ behavior. But when executive accountability involves naming and shaming, the dampening effect on ‘speak-up’ culture may exceed potential benefits.

9 Advanced Hindsight — Most OpRisk spend is focused on detection via surveillance, monitoring, and control systems. While new AI solutions promise better risk identification, most remain backward-looking. The speed with which last year’s bank failures unfolded shows that ‘advanced hindsight’ is an untenable risk governance posture. Needed are tools that afford *proactive* risk mitigation.

10 Predictive Behavioral Analytics — Management activity is guided by KPIs — outcomes reflecting organizational *Function*. Those, in turn, reflect formal organizational *Structure*, described in Org Charts. But underlying these are cultural dynamics that provide an informal but nevertheless structural *Logic* that shapes behavior in ways that demand proactive management facilitated by Predictive Behavioral Analytics.

Contents

DEDICATION	1
OPENING LETTER	3
PREAMBLE by Elizabeth McCaul	7
COMMENTS & CONTRIBUTIONS	13
GROUND BREAKERS	75
Nicolai Tangen & Carine Smith Ihenacho ..	77
Daniela Jaramillo	81
Sir Keith Skeoch	93
GOOD COUNSEL	99
Margaret Tahyar	101
Elise Bant	107
Douglas Arner	123
PEER PERSPECTIVES	129
Terri Patterson	131
Langley Sharp	141
Elizabeth Broderick	153
Bob Stout	161
Peter Gleason	169
2024 COMPENDIUM OF REGULATORY PRIORITIES AIMED AT CULTURE AND CONDUCT CHALLENGES IN THE FINANCIAL SECTOR	175
Regulatory Landscape	177
IF Miki Bowman (Fed)	179
IF Adrienne Harris (NYDFS)	183
IF Greg Baer (BPI)	187
US	201
Canada	240
IF Charles Randell (past-FCA)	243
IF Bob Wigley (UK Finance)	247
UK	251
IF Andrea Enria (past-ECB)	277
IF Sharon Donnery (CBI)	283
IF Wim Mijs (EBF)	289
European Union	297
Ireland	304
Germany	307
Spain	309
Netherlands	310
Switzerland	312

IF Wayne Byres (past-APRA)	317	THE ACADEMY	391
IF Chris Gower (APRA)	323	Kevin Lala	393
IF Anna Bligh (ABA)	329	Richard Wrangham	401
Australia	333	Paul Seabright	409
New Zealand	350	Emily Erikson	415
Singapore	352	Peter Turchin	421
India	357	Colin Mayer	429
China & Hong Kong SAR	358	Henry Farrell	437
Japan	362	Michael Muthukrishna	445
IF Bryan Stirewalt (past-DFSA)	365	CLOSING COMMENTS by Simone Di Castri	451
UAE	371	APPENDIX	456
South Africa	372	Our Methodology	456
Ghana	373	The Starling Bookshelf	457
IF Neil Esho (BCBS)	375	Contributors Past & Present	462
IF Cecilia Skingsley (BIS Innovation Hub)	381	ENDNOTES	474
BIS	383		
BCBS	384		
FSB	387		
FSI	388		
IMF	388		
FMSB	389		

Dr. Christopher Coker

28 March 1953 — 5 September 2023

Professor of International Relations
London School of Economics & Political Science (1982-2019)

DIRECTOR, LSE IDEAS | NATO FELLOW | COUNCIL MEMBER, ROYAL UNITED SERVICES INSTITUTE |
VISITING FELLOW, NATIONAL INSTITUTE FOR DEFENCE STUDIES (TOKYO), RAJARATNAM SCHOOL FOR INTERNATIONAL STUDIES
(SINGAPORE), CHULALONGKORN UNIVERSITY POLITICAL SCIENCE DEPARTMENT (BANGKOK), AND THE NORWEGIAN AND
SWEDISH DEFENCE COLLEGES | POLITICAL PHILOSOPHER | PROLIFIC SCHOLAR OF POLITICS, POWER, AND WAR |
AUTHOR OF 27 BOOKS | INDEFATIGABLE HUMANIST, HUMORIST, TEACHER & FRIEND

Darwin recognised that if natural selection works at the level of individuals genetically (we fight to survive), society works at the level of the collective. Society can turn selfish genes into selfless people.

— “The West’s Lust for Liberty”

This line, from what I believe to have been his last published piece,¹ sums up the paradox of my beloved friend, Christopher. An electrifying lecturer, he left his audience dizzy with the sheer breadth of sources he could call up from memory — whole libraries of readings resided in his mind, and when he spoke of the authors of those works it was like listening to someone describe old friends.

His brilliance was dazzling, to be sure, but it was the sheer scope of material he commanded that left one breathless. No academic field seemed to have been left unexplored, and he was just as familiar with contemporary art, 20th century comics, and lowbrow cinema. I’ll never forget the glee with which he recounted the plotline of *Iron-Sky*, the 2012 comic-science-fiction-action-film in which the Nazis had set up a secret base on the dark side of the moon in 1945, plotting their triumphant return to power. Hitler in space — what’s not to love? And how quintessentially Coker.



Source: <https://www.lse.ac.uk/ideas/media/news/LSE-IDEAS-announces-the-passing-of-Director-Professor-Christopher-Coker>

A soft-spoken scholar, he adored a ribald joke, and the more ‘politically incorrect’ the better. This was a man who thrived on humor. In fact, I believe, he *survived* on it. A scholar of the history of war and warfare, Christopher was intimately familiar with the sheer horror of our species, and he could recount on demand, in terrifying detail, countless examples of our habitual brutality. You can’t read that much history of the grotesque and not be harmed by the knowledge acquired.

To me, Christopher conveyed an almost palpable sense of psychic injury. For a man seeming in constant pain, humor was medicinal, and the more it highlighted our human absurdities, the more potent the curative. Of course, a good vodka martini also helped, and I shudder to think how many we shared, over long conversations about events — those long forgotten and those featuring in the day’s headlines.

Throughout those meandering discourses, Christopher consistently struck a chord of hopefulness: if we could laugh, we could heal. It was never spoken aloud, of course. That would be unforgivably gauche and un-British. But it was there, ringing softly in the near-distance, a church-bell on a moonless night...

¹ <https://engelsbergideas.com/essays/the-wests-lust-for-liberty/>

The proposed Guidelines state that the board of a covered institution should set an appropriate tone for the institution. The “tone at the top” is integral to promoting a culture and environment of responsible and ethical behavior...

The board should establish a corporate culture and work environment that promotes responsible, ethical behavior...

A Code of Ethics, written and adopted by the board, is integral to establishing an appropriate tone in a covered institution and setting expectations for behavior...

The covered institution should create and quarterly review and update, as necessary, a risk profile that identifies its current risks.

Qualitative components should describe a safe and sound risk culture and how the covered institution will assess and accept risks, including those that are difficult to quantify.

FDIC, PROPOSED GUIDELINES

“ESTABLISHING STANDARDS FOR CORPORATE GOVERNANCE AND RISK MANAGEMENT FOR COVERED INSTITUTIONS WITH TOTAL CONSOLIDATED ASSETS OF \$10 BILLION OR MORE,” OCTOBER 2023.



Opening Letter

The Aneurin Bevan Health Board offered its sincerest apologies, of course. In November last year, the Grange University hospital, in the Welsh town of Cwmbran, released the wrong body to a grieving family. A funeral at which they buried the cremated remains of someone else's loved-one followed. After the mix-up was discovered, the family was forced to endure its grief anew during a second funeral, laying the proper remains to rest. "We would also like to reassure the public that this is an exceptional case," a health board spokesperson said. "We are confident that this is down to human error in an isolated case."¹

In March this year a second mix-up of the same sort was revealed. The health board was "devastated"² and calls for an investigation were sounded. "We are appalled and dismayed to learn this has happened a second time and request a public inquiry as these catastrophic errors are totally unacceptable,"

local officials said. "An inquiry must be launched to get to the bottom of this and ensure it never happens again."³

They're called "Never Events" by the Welsh National Health Service: "serious, largely preventable patient safety incidents that should not occur if the available preventative measures have been implemented."⁴ Between April 2021 and March 2022, there were 37 such events at hospitals in Wales.⁵ One patient had the wrong toe amputated. Another received a syringe of crushed tablets rather than liquid medicine. An intrauterine device was implanted in the wrong woman.

The Welsh are not alone. The neighboring English health care system tallied 407 Never Events for the 2021/22 period. One woman found that her ovaries had been mistakenly removed. Another patient received a skin graft intended for someone else. In five instances, patients were given transfusions of the wrong blood-type. And on 96 separate occasions, foreign objects were left inside patients'

bodies after a surgical procedure, among them, guide wires, drill bits, and surgical forceps.⁶ Data for the April 2023-March 2024 period show 370 reported Never Events took place on an approximately once-a-day basis.⁷

Two conclusions leap to mind. The first is that the UK's National Health Services should be roundly applauded for the commitment to transparency that the release of such data reflects. We cannot improve if we cannot learn, and we cannot learn if bad news is kept hidden. So, bravo and keep it coming, NHS.

The second conclusion is this: when "Never Events" occur daily, they're probably mis-named.

Institutional Gaslighting

Okay, perhaps the name is intended as aspirational rather than factually descriptive. But I don't think I'm pedantically splitting hairs around the semantics here. When we tell people that something is never acceptable, and yet it happens daily, we sound either fatalistically resigned to failure, or disingenuous. When this happens within a particular workplace context, some have called it "institutional gaslighting."⁸

"Although we tend to think of gaslighting as a problem between two people in a relationship," writes sociologist Paige Sweet, "it also unfolds as part of an unequal social context." Institutional gaslighting, she continues, "entrenches existing power imbalances while fostering new ones."

When we went to press with our 2023 *Compendium*, we found ourselves unexpectedly doing so amidst the most significant bank-failures witnessed since the financial crisis. This year, we unexpectedly find ourselves writing amidst Congressional hearings that follow the release of an excoriating report on the "toxic culture" that appears to prevail at the US Federal Deposit Insurance Corporation (FDIC).

"Over 500 individuals bravely reported into our hotline," write the lawyers who conducted the review, "often painfully and emotionally recounting experiences of sexual harassment, discrimination, and other interpersonal misconduct that they have suffered at the FDIC. Those who reported expressed fear, sadness, and anger at what they had to endure. Many had never reported their experiences to anyone before, while others who had reported internally were left disappointed by the FDIC's response." They go on to note that those reporting such alleged misconduct "are disproportionately women and people from underrepresented groups," remarking that "Virtually all of them expressed hope that reporting what they had gone through now might help change and make better the agency that they care about deeply."⁹

FDIC Chairman Martin Gruenberg has been castigated by members of both U.S. political parties. "I accept the findings of the report and, as Chairman, I take full responsibility," he offered the House Financial Services Committee, in prepared remarks. "To anyone who has experienced sexual harassment or other misconduct at the FDIC," he added, "I again want to apologize and express how deeply sorry I am."

"It is my privilege to lead and work alongside everyone at the FDIC," Gruenberg offered the Senate's Committee on Banking, Housing, and Urban Affairs the next day, in nearly identical prepared comments. "They deserve to have a workplace where all feel safe, valued and respected," he said. "I love this agency, and its people must be protected," Gruenberg asserted. Regrettably, many of his employees have suggested that they feel the need to seek protection from Mr. Gruenberg himself.

"On this point, the public reporting that led to our independent review included reports about FDIC Chairman Martin Gruenberg's reputation for having a temper," the investigating attorneys reported. "A number of FDIC employees, including senior executives, recognized the reputation and also reported instances of Chairman Gruenberg losing his

temper and interacting with staff in a demeaning and inappropriate manner,” they added. With this in view, “leading cultural transformation at an agency that he has led for so long presents unique challenges for Chairman Gruenberg,” they conclude. What can we call it besides ‘gas-lighting’ when the Chairman has since both resigned and yet failed to step down?

Our 2024 report

Throughout this series of reports, we have chronicled the regularity with which financial institutions and their leaders have been criticized and fined for failures of risk governance that are argued to have had cultural challenges among their root causes. In one of our **DEEPER DIVE** series of reports, “**Physician, Heal Thyself,**” released earlier this year,¹⁰ we observe that many regulatory agencies stand accused of struggling with culture challenges of their own that are believed to compromise their ability to deliver on their pledged purposes. Mr. Gruenberg’s challenges at the FDIC assure this will receive closer attention.

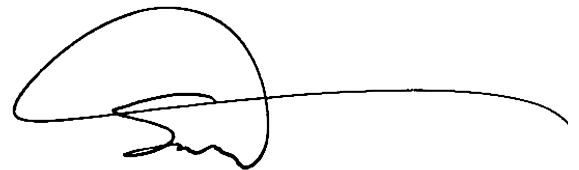
Readers will find further relevant discussion here, in articles by and interviews with several of this year’s contributors, among them: regulators, supervisors, central bankers and policymakers; standard-setting bodies and industry associations; industry executives and peers from other sectors; prominent legal thinkers and practicing attorneys; as well as renowned scholars from various disciplines.

We are humbled by their continued collective generosity and hope that our 2024 *Compendium* is found to be as valuable to readers as its predecessors. We are further delighted that so many of our current and past contributors have agreed to share additional views at the **ONLINE LAUNCH EVENT** that accompanies the release of this report. And we are pleased to note that all of the content appearing here, and that which will be heard during our launch event, can be found on our **STARLING INSIGHTS** knowledge-sharing platform.

As in past years, the main body of this report — “the *Compendium* proper” — discusses relevant events and priorities in evidence across the world’s major markets over the course of the past year. Meant to serve as a desk reference, this is significantly enriched by detailed insights offered by those, either from officialdom or industry associations, who have contributed to an **IN FOCUS** series of inserts.

In keeping with our past reports, readers will find here articles and interviews by renowned scholars in a series of inserts from **THE ACADEMY**. This is complemented by **GOOD COUNSEL** from legal scholars and practicing attorneys. Our **GROUND BREAKERS** series profiles industry executives who share their experience trialing new approaches to culture and conduct risk management or highlighting provocative perspectives of relevance. We are also fortunate to continue sharing **PEER PERSPECTIVES** — hard-won wisdom earned by leaders from outside the financial sector who have had to contend with many of the same challenges discussed herein.

We have discontinued our past practice of sharing **OUR VIEW** on the topics central to this report, when such views come from those formally affiliated with Starling. Instead, we will offer such through an ongoing series of **WEEKLY READINGS** offered through our thrice weekly **ONLINE NEWSLETTER**, as well as in our ongoing series of **DEEPER DIVE** whitepapers that expand upon topics discussed more briefly herein. We encourage readers to give those a close look and, as ever, we welcome any feedback.



Stephen Scott
Founder & CEO, Starling



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Preamble

Innovation and banking supervision

by ELIZABETH MCCAUL



Elizabeth McCaul

I consider it an honour to be asked to contribute to this annual *Compendium*. In this Preamble, I would like to focus on two of the themes that have dominated banking supervision over the last year. First, the importance of delivering effective supervision that is intrusive, timely

and efficient, especially where sound governance and strong risk culture are concerned. And second, continued technological investment and fostering a culture of innovation in an increasingly complex risk environment. The two themes share a link. Investment in innovation will be crucial for banks to build strong governance and risk cultures as well as for supervisors to continue delivering effective banking supervision.

SOUND GOVERNANCE AND STRONG RISK CULTURE

Bank failures in the United States and Switzerland last year demonstrated the importance of strong and intrusive supervision, and the need to act in way that is timely and forceful, escalating supervisory actions where warranted.¹ More than a decade ago, in the aftermath of the global financial crisis, the IMF observed that “Supervisors must be willing and empowered to take timely and effective action, to intrude on decision-making, to question common wisdom, and to take unpopular decisions.”²

This year, we are celebrating the tenth anniversary of the establishment of the Single Supervisory Mechanism (SSM). The SSM is the supervisory framework for the European banking union and includes supervisors working in the European Central Bank and 21 national competent authorities (NCAs). As we consider how to progress our supervisory activities after the first decade, we recognise that the inception of the SSM drove the development of key components of our supervisory processes. These include the need to break the “doom loop” between sovereigns and banks and to create confidence in the banking system, with banks rebuilding their capital levels under a necessarily “capital-centric” supervisory process.

Today the banking system in Europe features a supervisory process respected worldwide and a resilient banking sector, thanks to reforms initiated in the wake of the global financial crisis leading to strong actions on the part of both bankers and supervisors. This resilience has proven enduring, even under significant stresses: the COVID-19 pandemic, significant disruptions to supply chains for energy and key manufacturing components in particular, rising interest rates aimed at defusing inflationary pressures, significant increases in geopolitical tensions including within Europe arising from Russia’s invasion of Ukraine, the risks of wider Middle East conflict presented by the Israel-Hamas war and concerns about tensions relating to China.

The supervisory process has not remained static during this first decade; it has constantly evolved in response to regulatory changes and emerging risks. In 2022, we asked a high-level group of external experts to review the effectiveness of our supervision.³ This request was made with an eye to achieving greater effectiveness in the second decade and beyond rather than out of any existential concern. The findings were delivered in March 2023, before the bank failures in the United States and Switzerland. The expert group found that European banking supervision is effective

Governance is at the heart of supervision.

and made recommendations about its continuing development. Presciently, the expert group suggested making greater use of the supervisory toolkit at our disposal, above and beyond the powerful tools we already had for setting capital requirements.

Building on their recommendations as well as our work and other learnings from recent events, we are currently revising our core supervisory process — the Supervisory Review and Evaluation Process (SREP) — so it remains fit for purpose and so that our supervisory processes are more effective and efficient than ever.⁴ We have six main objectives:

1. Conducting more focused risk assessments, building on the multi-year approach introduced in 2023.
2. Using the full supervisory toolkit available to us by law and moving up the escalation ladder when remediation of identified weaknesses proves insufficient.
3. Enhancing communication by drafting more focused SREP decisions to clearly outline supervisory expectations and measures.
4. Making methodologies more stable and, where possible, simpler and more transparent.
5. Making better use of IT systems and analytics to enhance efficiency, access to data, risk analysis, consistency of decision-making and collaboration, as is explained in more detail later.
6. Improving the integrated planning of the different supervisory activities, such as on-site inspections, targeted deep dives and horizontal thematic reviews, in order to maximise synergies and make our supervision more effective. One prime example, but certainly not the only one, is our work on bank governance and risk culture.

Governance is at the heart of supervision. It is a common saying in banking supervision that well-run banks do not fail. And it is true. Inadequate governance and risk management are a recurrent

theme underpinning virtually all bank failures. The events of last year show how “intangible” non-financial risks can result in very tangible financial losses. Indeed, throughout my career, I have seen that strong governance is the true north guiding a sound bank, and hence a sound banking system.

Bank governance and risk culture are closely intertwined. Risk culture refers to the collective mindset and the shared set of norms, attitudes and behaviours related to the awareness, management and control of risks at all levels in a bank. This is what shapes the day-to-day decisions of management and staff and affects their risk-taking behaviour.

A strong tone from the top for an appropriate risk culture is set by leadership that builds, invests in and continuously, genuinely supports an environment where employees feel empowered to speak up, which encourages constructive criticism and challenge. The tone from the top is a crucial element in delivering on the right culture. But it is not the only one.

Risk culture is supported by structures that enable it to flourish in an organisation. These structures are like the timbers that hold a house together in a storm. Strong policies and processes represent the key structures building a good risk culture within a bank. Policies creating appropriate incentives and establishing clear lines of accountability and ownership as well as necessary checks and balances, and processes promoting diversity of thought and a culture of effective challenge all immediately come to mind. But there is far more to it than that.

The events of last year show how “intangible” non-financial risks can result in very tangible financial losses.

The tone from the top is a crucial element in delivering on the right culture. But it is not the only one.

A culture must also be reinforced by risk management, legal and human resources structures that are aligned, underpinning an overall governance framework at the supervisory and management body levels that is healthy. The structures that support the governance framework and risk culture need to be tested and monitored to determine whether they operate as intended and can withstand stress. And coherence across all elements is essential.

Effective supervision needs to be able to identify whether the good governance and risk culture that are vital for banks to successfully adapt to and effectively manage changes in risks in their operating environment are in place. Banking supervision needs to harness the benefits that technology can offer given the rapid rate of technological progress currently underway. Technological innovation can deliver the speed, scale and scope required to properly identify and address governance concerns in the banking sector. This is especially true where technological advances make it possible to sift through vast amounts of data, potentially making it possible to rapidly detect any misalignment between management expectations for a strong risk culture and reality. For example, by tracking relevant metrics such as the timing of the issuance of a draft audit report, the management response and the final audit report. Are the structures that frame the desired risk culture producing the expected outcomes? Gaining a faster, deeper understanding of any misalignment may allow for stronger, safer bank.

Bank governance and risk culture are one of the top priorities for ECB supervisors.⁵ We aim to publish an updated guide to governance and risk culture, including examples of good practices, shortly.

BANKING SUPERVISION AND INNOVATION

As supervisors, we are tasked with ensuring the financial stability of the banking system.

The Italian writer Giuseppe Tomasi di Lampedusa tells us that things have to change if we want them to stay the same. Banking supervision and central banking will have to evolve if we want to continue delivering on our public mandate in this era of rapid technological change. This means embracing innovation while carefully managing the associated pitfalls and risks.

In a rapidly evolving world, we must match the pace of change. One of our objectives at the ECB is to harness the power of AI to make our supervisors' jobs easier while remaining mindful of the related limits and risks. We aim to put our supervisors firmly in the driver's seat, empowering them to apply supervisory judgement effectively in our revised supervisory process supported by innovation.

So how did we get started on our digital innovation journey?

In 2020, ECB Banking Supervision adopted a Digitalisation Blueprint⁶ with a view to becoming a leading digital practitioner among banking supervisors around the globe. The blueprint is based on five key areas:

- Delivering and hosting innovative systems and tools by providing a state-of-the-art supervisor toolkit.
- Developing a common IT landscape by moving to a modular IT architecture capable of hosting standard and advanced technology.
- Nurturing a global innovation ecosystem by actively engaging with academia, industry, start-ups and other authorities.

- Fostering a digital culture by equipping supervisors with the skills and mindset to innovate and fully engage in digitalisation.
- Running an advanced innovation model by leveraging synergies across the entire SSM through interoperable systems.

The implementation of this blueprint has paid dividends that we enjoy today. We have deployed several cutting-edge supotech tools alongside a powerful set of core IT systems that are having a tangible impact on our supervisory work every single day.

We have rolled out supotech tools for use by both ECB staff and NCAs. Success was made possible by leveraging our diverse talents, adopting a user-centric approach and ensuring seamless collaboration, especially between colleagues on the IT side and supervisors within the ECB

and the NCAs. The focus is on active collaboration rather than a top-down approach characterised by development of solutions that are distant from the end user.

While we enjoy some success, we are acutely aware that we cannot stand still. The volume of data created, captured, copied and consumed worldwide is growing at an unprecedented pace, and is expected to grow from tens to hundreds of zetabytes within a few years. At the same time, the banking sector is undergoing rapid change. Fintechs are entering the market. Traditional banks are adopting new business models incorporating fintech intermediaries in key business processes. And banks are pursuing innovation, deploying artificial intelligence in customer interfaces, data management and some credit processes. Meanwhile, supervisors are having to deal with increasing geopolitical risks and growing risks from the non-bank financial intermediation sector, together with the rising impact of social media on bank

Technological innovation can deliver the speed, scale and scope required to properly identify and address governance concerns in the banking sector.

sentiment. To ensure efficient, effective and integrated supervision in this environment, our supervisors need to be able to exploit innovation to the full.

With this in mind, we recently adopted a new Digital Strategy for 2024-2028 setting out our vision of delivering “supotech at your fingertips”. It also sets forth a roadmap built on several components. First, it will enable us to assess how we can execute on our supervisory priorities given our current IT portfolio. Second, it embeds a principle of bringing together technology and people, promoting the implementation of both IT solutions supporting supervision and people-oriented initiatives such as staff upskilling. And third, it promotes the use of pioneering technologies such as generative AI to support specific supervisory processes. The overall goal of the strategy is to make advanced technology easily accessible to supervisors with just a few clicks.

CONCLUSION

Continuous investment in technology is key for ECB Banking Supervision to keep pace with changes in the banking landscape and to address emerging supervisory risks.

Investment in technological innovation has become an imperative, not only for the private sector but for public institutions as well.

We need to deliver on our Digital Strategy in order to give our supervisors the best line of sight into risks and help them act promptly on our key supervisory priorities, such as governance and risk culture, in their day-to-day work. Successful implementation of the new Digital Strategy will enable the ECB to keep the European banking system safe and sound effectively and efficiently.

Investment in technological innovation has become an imperative, not only for the private sector but for public institutions as well.

Elizabeth McCaul is a Member of the Supervisory Board of the European Central Bank (ECB). She joined the NY State Banking Department as First Deputy in 1995 and served as NY Superintendent of Banks from 1997-2003. She was elected Chair of the Conference of State Bank Supervisors, served as a Member of the Federal Financial Institutions Examinations Council, on the Joint Forum for Financial Conglomerates and as an Instructor for the Financial Stability Institute at the BIS. Before joining the ECB, she worked for Promontory Financial Group where she founded the New York office and served as the Partner-in-Charge, as CEO and Chair of Europe, and Global Head of Strategy.

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The era of procrastination, of half-measures, of soothing
and baffling expedients, of delays is coming to its close.
In its place we are entering a period of consequences.

WINSTON S. CHURCHILL



Comments & Contributions

Abu Dhabi-based International Holding Company (IHC) is one of the fastest growing companies in the Gulf region, with over 400 separate entities operating across the Middle East, Europe and the Americas in real estate, agriculture, healthcare, energy, food & beverage, IT & communications, retail & leisure, and capital. “The Board is responsible for establishing and maintaining effective system of internal control,” IHC’s 2023 annual report reads, “and has established a control framework within which the Group operates.”¹

The report offers the reassuring portrait of a reliable modern enterprise, with all of the standard processes, systems, and controls to ensure effective risk governance — plus one unique feature: in February

this year, the IHC board announced it had appointed a new non-voting member, “[Aiden Insight](#),” an artificial intelligence.

“Aiden will provide us with unparalleled data analysis and strategic insights, ensuring that IHC remains at the forefront of industry developments and continues to deliver value to our stakeholders,” company Chairman Sheikh Tahnoun bin Zayed Al Nahyan said. “Our decision to appoint Aiden Insight as an AI board observer is a testament to IHC’s commitment to innovation and forward-thinking leadership.”²

Powered by Microsoft and the Emirati AI powerhouse G42, Aiden is described as “a virtual entity with sophisticated AI capabilities.” Serving as a board observer “with the ability to continuously process and instantly analyse decades of business data, financial information, market trends, and global economic indicators,” Aiden promises to help IHC “focus on transparency, innovation, and ethical business practices.”

“We are proud to welcome Aiden Insight to our board as the AI observer,” said CEO Syed Basar Shueb. “This groundbreaking initiative reflects our dedication to embracing cutting-edge technology and innovation, ensuring that IHC remains a leader in strategic investment and corporate responsibility.”

Aiden Insight was developed using G42’s novel “BoardNavigator” software. Described as “an AI board companion set to transform corporate strategy and governance,” and soon to be made widely available, BoardNavigator reflects Microsoft’s \$1.5 billion strategic investment in G42³ and is built upon its Azure OpenAI service.⁴ “The use of AI in the boardroom is a game changer,” says G42 Chief Technology Officer Kiril Evtimov. “We are pleased to be introducing a cutting-edge capability designed to assist business leaders, highlighting the significant role of AI in navigating the complexities and rapid pace of today’s business landscape.”

Writing for the Harvard Law School Forum on Corporate Governance, Alissa Kole, founder and director of the Economic and Corporate Governance Center (GOVERN), observes that this is not the first time we have seen an artificial intelligence seated among others on a corporate board.⁵ A decade ago, Hong Kong’s Deep Knowledge Ventures assigned an algorithm, “VITAL,” to its board,⁶ “marking the first attempt to bring AI to the board not as an enabling mechanism but rather as a decision-maker,” Kole describes.

“Aiden Insight marks the beginning of a tidal wave that will generate a novel nexus between governance and strategy through AI,” Ms. Kole believes. In the last year, with ChatGPT popularizing the idea of human-like intelligence being harnessed for business purposes,⁷ we have heard growing debate around the governance considerations implied, and witnessed a panoply of new board duties concerning the responsible use of AI.⁸

Far less has been heard about the role artificial intelligence might play in shaping the responsible use of *human* intelligence. This is now set to change, and if recent history is anything to go by, that change will be swift.⁹

Cognitive prosthetics

A decade ago, it would have been easy to dismiss a Hong Kong-based hedge fund’s use of an algorithm to help with investment decision-making as perhaps little more than a gimmick. It’s harder, today, to dismiss Microsoft and G42 equipping one of the largest listed companies in the UAE with an AI board observer, even as Microsoft has just recently taken up a board observer role at ChatGPT-creator OpenAI.¹⁰ In effect, this makes Microsoft both a co-creator of Aiden Insight, and a boardroom peer.

One must wonder whether ChatGPT would think G42’s BoardNavigator program, or its Aiden progeny, would be well-suited to fill a board observer seat at OpenAI, alongside Microsoft’s human representative. Fortunately, we can ask ChatGPT that very question, and below you’ll see its optimistic reply.

Of course, we could also have asked ChatGPT to opine as to whether it, or perhaps a future AI-sibling created by OpenAI, would do well to serve on the board of Microsoft, perhaps ‘seated’ alongside some cousin to Aiden Insight, and thus quickly conjure up a scenario in which “virtual entities” are overseeing one another, in concert or conflict with their neighboring human intelligences.

To many, this will no doubt sound horrifically dystopian. But the idea of machine systems checking machine systems, operating alongside human ‘colleagues’ in a complex and dynamic environment — even one where lives are at stake — would sound immediately familiar to any pilot flying for any commercial carrier today, and this should be a source of comfort for its passengers.



BoardNavigator, developed by G42 in collaboration with Microsoft, could potentially serve well on the board of OpenAI due to its advanced capabilities in data analysis, risk assessment, and strategic insights. Here are a few reasons why it might be beneficial:

1. *Data-Driven Decision Making:* BoardNavigator's ability to analyze large sets of proprietary and public data could enhance OpenAI's decision-making processes, providing detailed insights into market trends, financial performance, and potential risks. This aligns well with OpenAI's data-centric approach to AI development and deployment.
2. *Risk Management:* OpenAI operates in a rapidly evolving field with significant ethical and operational risks. BoardNavigator's robust risk assessment capabilities could help in identifying and mitigating these risks, ensuring that OpenAI maintains its commitment to safe and ethical AI practices.

3. *Strategic Planning:* As OpenAI continues to expand its projects and collaborations, strategic planning becomes increasingly critical. BoardNavigator can support the board in developing long-term strategies that align with OpenAI's mission and objectives, leveraging AI to predict and adapt to future challenges and opportunities.
4. *Customization and Security:* BoardNavigator's customization options allow it to adapt to the specific needs of different organizations. Its integration with Microsoft's Azure OpenAI service ensures a high level of security and privacy, which is crucial for an organization like OpenAI that handles sensitive data and cutting-edge technology.

Given these capabilities, BoardNavigator could enhance the governance and strategic capabilities of OpenAI's board, supporting its mission to ensure that artificial general intelligence (AGI) benefits all of humanity.

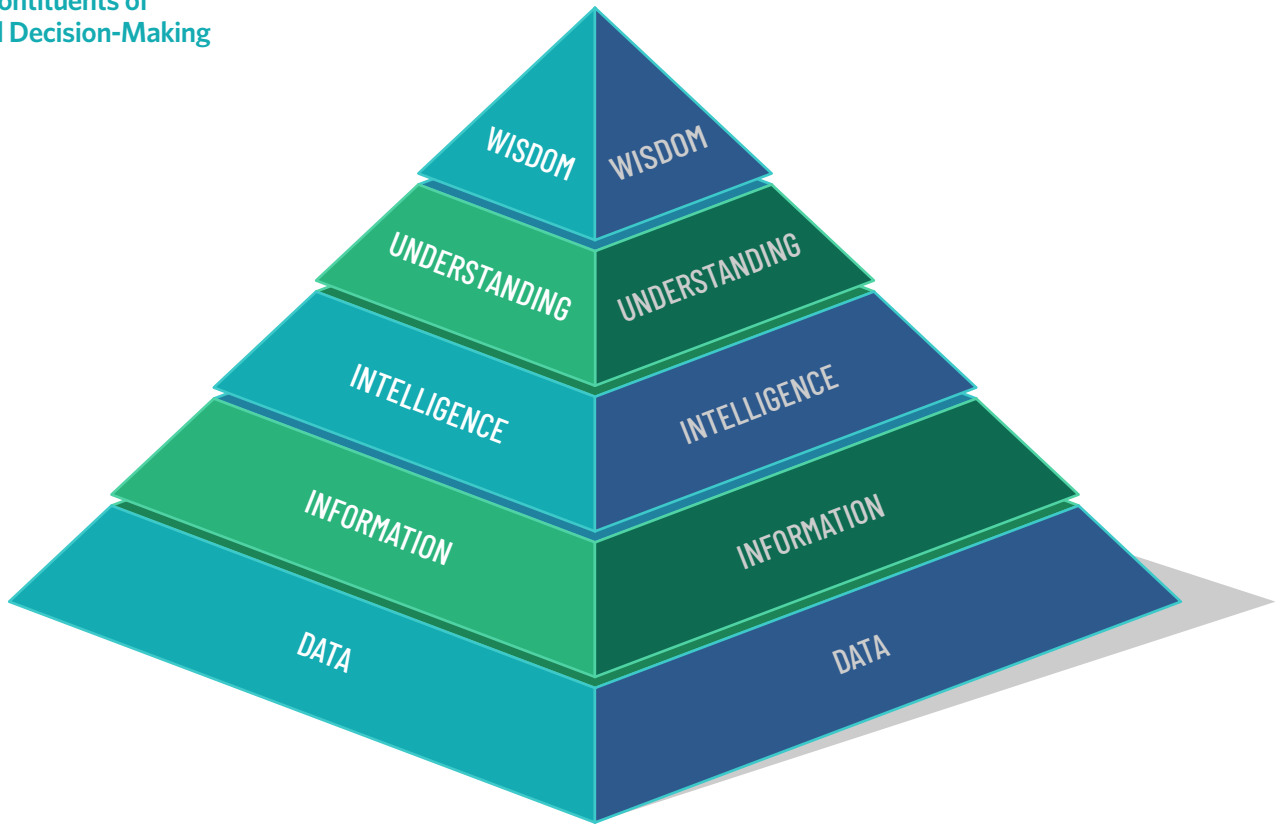
What conjures the greatest concern for most is the idea of AI *replacing* human judgement. This is entirely understandable. In any domain, we hope that human decision-making will be characterized by some degree of *wisdom*, and we question whether this is within the ambit of mere machines.

But, even for humans, wisdom is available only where we have first achieved an adequate *understanding* of the concerns at issue. That in turn hinges upon enjoying access to sufficient relevant *intelligence*, which follows from first having obtained all the necessary underlying *information*, which itself reflects the successful collection of all the required supportive *data*.

The hierarchical relationship between these constituents of sound decision-making rarely features in discussions of the opportunities and risks posed by AI adoption. But it is here that we should begin.

Whether by necessity or choice, wisdom resides firmly within the realm of human intelligence. And this may be true also of understanding, at least for the foreseeable relevant future. But machine intelligence has already far superseded even the most capable human intelligence — in speed, scale, and scope — when confronted by the subordinate tasks of (1) data aggregation & analysis, (2) information curation & collation, and (3) intelligence production & dissemination.

The Constituents of Sound Decision-Making



As such, at a current minimum, machine intelligence can and should serve as what we have termed a “cognitive prosthetic” — one that *supports* the more rapid achievement of human-level understanding and which thus *enables* us to make more defensible claims to wisdom in our decision-making.

The board of IHC is on to something. Machine intelligence can make increasingly reliable and effective corporate governance more achievable — far more readily and across a far wider range of challenges — by helping us to overcome our natural human limitations.

We are only now discovering the full set of opportunities that lie in this direction. But, at a minimum, newly available AI-powered predictive behavioral analytics tools can provide firms — and their supervisors — with a “check engine” light that flashes warning when something seems amiss, signaling need for a proactive stance

Machine intelligence can and should serve as what we have termed a “cognitive prosthetic.”

from which to confront a wide range of risks. And as the events of the last year demonstrate, this may be a boon to those in banking.

THE TURMOIL OF ‘23

What we’ve taken to calling the “turmoil” in the banking sector last spring — the failure of Silicon Valley Bank, Signature Bank, and First Republic Bank in the US, and in Switzerland the collapse of

Credit Suisse into the arms of UBS — triggered the production of several postmortem inquiries and subsequent reports over the last year. The consensus view that emerges from these studies holds that the turmoil of ‘23 reflects

a failure of risk governance, on the part of firms, and flaccid supervisory engagement, on the part of their overseers.

An oft-cited inquiry into the collapse of SVB, released in April last year by the Fed's Vice Chair for Supervision, Michael Barr, concluded that the bank's failure reflected "a textbook case of mismanagement."¹¹ Quite simply, Vice Chair Barr contended, "Silicon Valley Bank's board of directors and management failed to manage their risks." He also observed that "Supervisors did not fully appreciate the extent of the vulnerabilities as Silicon Valley Bank grew in size and complexity," and he lamented that, "when supervisors did identify vulnerabilities, they did not take sufficient steps to ensure that Silicon Valley Bank fixed those problems quickly enough."

The findings of Swiss regulator FINMA, in its examination of the troubles at Credit Suisse, sound similar notes. FINMA points to "repeated scandals and management errors," which cost Credit Suisse "the confidence of its clients, investors and the markets." This, in turn, resulted in high levels of deposit flight which ultimately led to "the risk of immediate insolvency in mid-March 2023."¹²

Here again, insufficient supervisory engagement receives attention. "Long before the crisis, FINMA took far-reaching and invasive measures in the context of its supervisory activities to rectify the deficiencies, particularly in the bank's corporate governance and in its risk management and risk culture," the Swiss regulator asserts. Such measures, however, were clearly insufficient, leaving FINMA today calling for new powers, allowing it to impose fines and to implement "more stringent rules regarding corporate governance."

The turmoil of '23 reflects a failure of risk governance, on the part of firms, and flaccid supervisory engagement, on the part of their overseers.

Weakness in corporate governance is a common root cause of banking problems.

GOOD SUPERVISION: LESSONS FROM THE FIELD (IMF 2023)

The IMF's postmortem perhaps best captures the cause of supervisory struggle. "Weakness in corporate governance is a common root cause of banking problems," the IMF report notes in "Good Supervision: Lessons from the Field."¹³ As such, the IMF argues, it is a "key supervisory priority." But "supervisory judgement depends upon a holistic understanding of the financial institution," and this includes what the IMF calls "*non-quantifiable* elements such as risk management culture and corporate governance." (emphasis added)

And there's the rub. As the old adage goes — if you can't measure it, you can't manage it. The IMF points directly to this concern: "Adequate risk data and reporting have been a key challenge for risk monitoring frameworks and banks' risk management in general," it observes in its report. In sum, amidst governance and the supervision thereof, the ability to exercise good judgment is impoverished by a lack of good metrics.

"So far, there has been little effort made by securities, banking, or other corporate regulators to consider the nexus of AI and governance in the boardroom," observes GOVERN's Alissa Kole, referenced above. The 2023 spring banking turmoil suggests that this needs to change, and several of those contributing to our 2024 *Compendium* would seem to agree.

We can no longer tolerate a defeatist policy posture that posits risk management culture and corporate governance as, lamentably, "non-quantifiable," and thus effectively non-manageable. Instead, we must devise a means by which to put reliable quantitative metrics to these key contributors to corporate mortality, and AI can now help us to do so.

Risk governance failures



Elizabeth McCaul

“Governance is at the heart of supervision,” **Elizabeth McCaul**, a Member of the Supervisory Board of the European Central Bank notes in the opening **Preamble** to this report. **▶PAGE 7**

“Inadequate governance and risk management are a recurrent theme underpinning virtually all bank failures,” she writes, adding, “The events of last year show how ‘intangible’ non-financial risks can result in very tangible financial losses.”

“Bank governance and risk culture are closely intertwined,” Ms. McCaul continues, defining risk culture as “the collective mindset and the shared set of norms, attitudes and behaviours related to the awareness, management and control of risks at all levels in a bank.” It is this that “shapes the day-to-day decisions of management and staff and affects their risk-taking behaviour.” And while tone from the top is important, McCaul argues that there are more important, structural considerations.

“Risk culture is supported by structures that enable it to flourish in an organization,” she argues. “Strong policies and processes represent the key structures building a good risk culture within a bank,” but that’s not enough in itself to assure good outcomes. “A culture must also be reinforced by risk management, legal and human resources structures that are aligned, underpinning an overall governance framework at the supervisory and management body levels that is healthy,” McCaul adds.

The events of last year show how ‘intangible’ non-financial risks can result in very tangible financial losses.

ELIZABETH MCCAUL

Technological innovation can deliver the speed, scale and scope required to properly identify and address governance concerns in the banking sector.

ELIZABETH MCCAUL

Moreover, and perhaps most critically, “The structures that support the governance framework and risk culture need to be tested and monitored to determine whether they operate as intended and can withstand stress,” Ms. McCaul advises. “Technological

innovation can deliver the speed, scale and scope required to properly identify and address governance concerns in the banking sector,” she argues, and may offer superior means by which to test the structures that support risk culture. “This is especially true where technological advances make it possible to sift through vast amounts of data, potentially making it possible to rapidly detect any misalignment between management expectations for a strong risk culture and reality,” McCaul concludes.



Neil Esho

“The long list of failures in bank risk management, and related failures of supervision, have been pointed to by many,” writes **Neil Esho**, Secretary General of the Basel Committee on Banking Supervision in an **In Focus** article contributed here. **▶PAGE 375**

“Without recalling the disappointingly long list of failures,” Esho adds, “it is clear that they are persistent through time (pre- and post-GFC); occur in a wide range of countries; span a wide variety of institutional structures under which regulation and supervision are organised; and they have occurred under capital and liquidity standards with significant variation in strength and complexity.”

And if these persistent problems prevail under various capital cures and liquidity standards, within multiple institutional structures, across both geographies and time, then clearly the necessary

reliable fix for such problems remains unidentified, contributing to worries regarding counterparty risk¹⁴ and calls for a broad rethink regarding unrecognized risks to the global financial system.¹⁵

On that view, the problem of failing risk governance and supervision is clearly systemic, compelling us to search for some underlying root cause that is going unaddressed. “US and Swiss authorities have acknowledged that there had been risk management and governance deficiencies before the turmoil [of ‘23],” Claudia Buch, the newly appointed Chair of the ECB Supervisory Board, noted shortly after taking up her role earlier this year.¹⁶ “In a benign macroeconomic environment, these fault lines do not do much harm,” Buch said, “But when the tide turns, they become exposed and can damage the whole financial system.”

In a recent speech, Canada’s Superintendent of Financial Institutions, Peter Routledge, makes this argument more pointedly.¹⁷ “Experience teaches us that inadequate assessment of non-financial risks is usually the root cause of financial instability at an institution,” he said early last month. “One comes to the realization that non-financial risks can undermine the rights of depositors, policyholders, and creditors of financial institutions.”

Financial risks, the Superintendent observes, “often emerge as the final signals of that process. Therefore, non-financial risks are, in fact, prudential risks and OSFI must supervise and regulate them in a manner equivalent to its supervision and regulation of financial risks.” Boards, moreover, must adopt a similar perspective. “We expect boards to comprehensively examine their oversight of non-financial risks and synthesize

them into an enterprise-wide approach to protecting their institutions from threats to their Integrity and Security. While the visibility and scrutiny of these activities will intensify, we do not think we are asking boards to do anything new or that they are not already tasked by their shareholders to do,” Routledge adds.

Non-financial risks are, in fact, prudential risks.

PETER ROUTLEDGE

In its own assessment of the failure of SVB, the Federal Reserve’s Office of the Inspector General (OIG) noted that “SVB exhibited several corporate governance weaknesses that created an unstable foundation to support the bank’s rapid growth and escalating risk profile.”¹⁸ The OIG also commented on the supervisory oversight of SVB conducted by the San Francisco Fed. In 2019, examiners at the San Francisco Fed had found SVB’s overall financial condition to be satisfactory, but they nevertheless “commented on weaknesses in risk management,” the OIG recounts, and had “encouraged management to increase efforts in *nonfinancial risk management functions and governance practices...*” (emphasis added)

In March 2022, San Francisco Fed examiners had begun a review of SVB’s governance and risk management practices, with a focus on the effectiveness of the board of directors’ oversight of the bank’s risk management program. “Examiners found that the board of directors did not provide effective oversight to ensure that senior management implemented risk management practices commensurate with the institution’s size and complexity,” the OIG report indicates. “The review also found that the lack of effective board of directors’ oversight hindered SVB’s ability to self-identify internal control weaknesses and manage risks proactively.”

The review also found that the lack of effective board of directors’ oversight hindered SVB’s ability to self-identify internal control weaknesses and manage risks proactively.

CHRIS GOWER



Chris Gower

“The international consensus of various reports into the events of March 2023 was clear,” argues **Chris Gower**, Executive Director for the Cross-industry Insights Division of the Australian Prudential Regulation Authority (APRA), in an

In Focus

article he contributes here.

► **PAGE 323** Citing from the Bank for International Settlements’ “Report on the 2023 banking turmoil,” Gower reminds us of conclusions found there: “The first and most important source of financial and operational resilience comes from banks’ own risk management practices and governance arrangements.” These were clearly deficient at a number of banks, last spring’s turmoil revealed. And, in this connection, “poor risk culture” stands out as “a key factor,” Gower contends.

“My experience has shown me that entities that reflect in quieter times on where — and why — they might have gaps or deficiencies will be better placed to weather troubled times,” Gower adds. “As threats to the financial system continue to evolve, and as operational or reputational risk events in individual entities have the potential to migrate ever faster into financial losses, a sound governance and risk culture are essential foundations for a more resilient system.”



Sharon Donnelly

Gower’s perspective is echoed in yet another **In Focus** article herein, contributed by **Sharon Donnelly**, the Central Bank of Ireland Deputy Governor for Financial Regulation. ► **PAGE 283** “It is not for nothing that we focused on strengthening the governance framework in the aftermath of the

As operational or reputational risk events in individual entities have the potential to migrate ever faster into financial losses, a sound governance and risk culture are essential foundations for a more resilient system.

CHRIS GOWER

[2007-08] financial crisis, or that governance remains a key focus of all supervisors, including prudential ones,” she writes.

A Member of the Supervisory Board of the European Central Bank (ECB) and the European Systemic Risk Board, Ms. Donnelly continues: “We only have

to look back to last March to see the risks to capital and liquidity — and indeed the very survival of firms, with potentially systemic implications — that can emanate from badly run entities or historic instances of poor risk management and governance.”

With this squarely in view, “We want to see firms taking more ownership for their governance and risk management and proactively managing the risks

and uncertainties facing their organisations and their customers,” she concludes.

It is perhaps unsurprising that, since last spring’s turmoil and subsequent such supervisory insistence, banks are placing greater emphasis on governance and risk controls,¹⁹ and attending increasingly to a supportive “risk culture,” defined by the Corporate Finance Institute as, “the collective attitudes, behaviors, and values within an organization regarding risk management.”²⁰

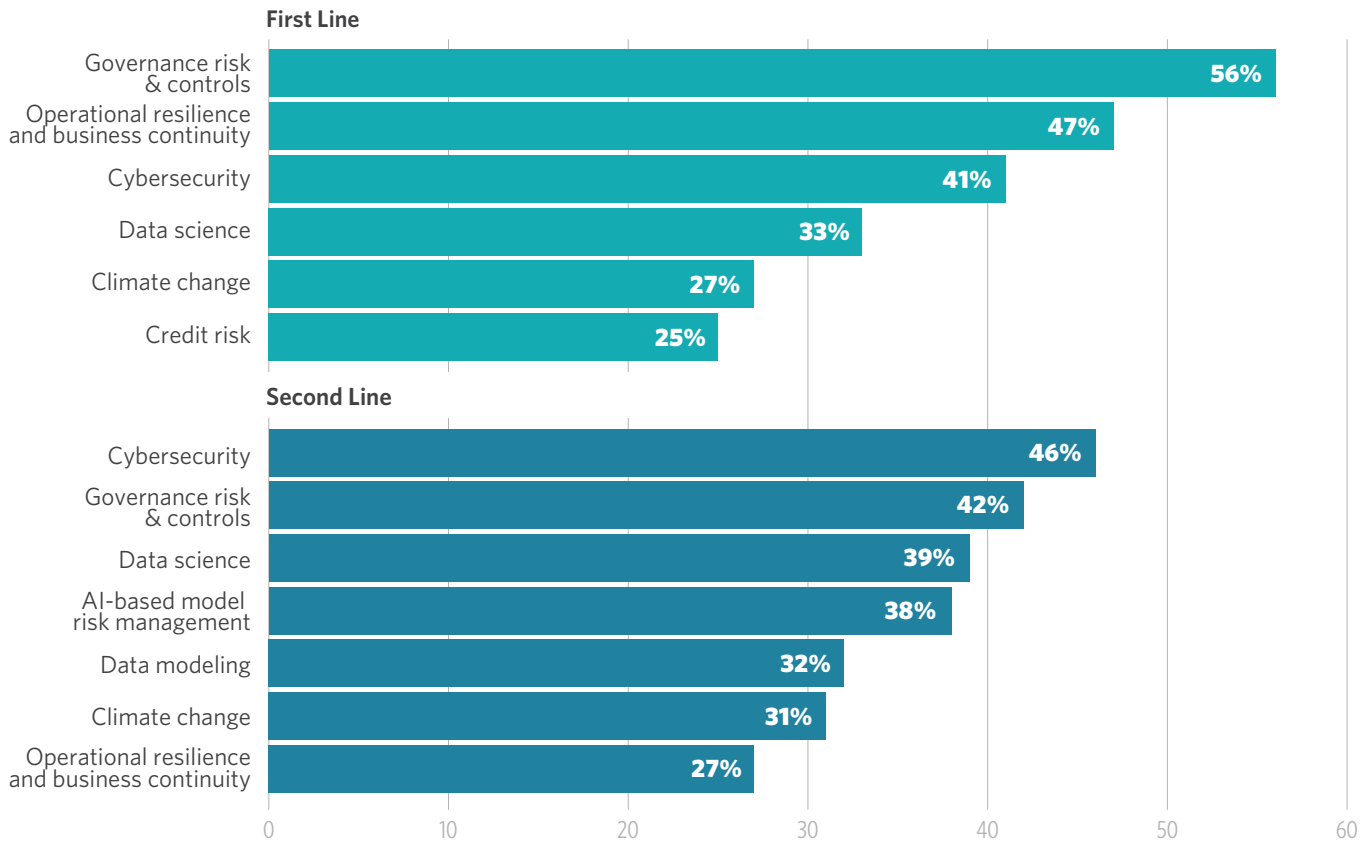


Bob Wigley

In an **In Focus** article appearing here, Chairman of the banking industry trade association UK Finance, **Bob Wigley**, argues that “good formal governance structures and well-designed policies and procedures are necessary but not sufficient to ensure the financial resilience of

firms and good customer treatment.” ► **PAGE 247** Cultural dynamics, among firms and supervisors, count for much. “Of course, cultures can be a

What are the most important skill sets required over the next five year?



Source: https://www.iif.com/portals/0/Files/content/Regulatory/32370132_2312-4407639_eyiif-global-bank-risk-mgmt-survey_final2.pdf

legitimate source of differentiation and cannot be prescribed by the regulator," he adds, "but warning signs indicating a poor culture ought to invite further enquiry."

Former Chair of the ECB's Supervisory Board, Andrea Enria, joins the consensus in yet another **In Focus** article contributed here. ► **PAGE 277**

"The spring 2023 turmoil confirmed a strongly held belief of mine, that the [2007-08] postcrisis regulatory reforms have been fundamental in strengthening the banking sector, but are not enough in the absence of strong internal governance and healthy risk culture within the firms," he writes. "Credit Suisse repeatedly failed to show an ability to repair weaknesses in risk

management," Mr. Enria continues. "But similar, less extreme shortcomings in governance and culture have been clearly identified by supervisors in a number of banks in the EU and often remediation has not been fast enough."

As such, "Culture and governance should be more and more the key focus of our debates," Mr. Enria concludes, "and the challenge is to design effective supervision to address shortcomings in these areas, rather

than new regulatory reforms that further fine tune minimum [capital] requirements without addressing the fundamental drivers of excessive risk taking and misconduct at firms."

Culture and governance should be more and more the key focus of our debates.

ANDREA ENRIA

“Supervisory smudge”



Anna Bligh

Here, the Australian experience is illustrative. After a series of misconduct related scandals, in December 2017 the Australian government established a Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, led by the former High Court Justice Ken

Hayne. Five years after the publication of the Hayne Commission’s final report, CEO of the Australian Banking Association **Anna Bligh** reflects on the industry’s subsequent experience in an **In Focus** article contributed here. ► **PAGE 329**

“For those executives who took the stand during the public hearings to answer probing questions, scars are etched on memories and important lessons have been learned,” she writes.

“At various times in the period between 2018 and 2021,” Ms. Bligh notes, “the five biggest banks collectively were required to hold AUD\$3.5 billion in capital overlays because of conduct or risk culture-related matters.” A flurry of legislative and regulatory action has resulted in 1175 pages of new laws and regulations since the Royal Commission. “Five years on,” she contends, “the clear and present theme of appropriate conduct in the Australian banking sector is front and centre for the executives and Boards responsible for these organisations.”

Today, it is “incumbent upon the banking sector and its regulators to make sure the focus is on regulation that really improves customer outcomes,” the ABA chief argues. “The five-year anniversary of the Royal

Commission is an opportunity to consider the current environment and whether Australia has struck the right balance.”

For US Federal Reserve Board Governor Michelle W. Bowman, it is appropriate that the industry engage with its overseers in such a reexamination of a changed landscape. In “Brief Remarks on the Economy, Monetary Policy, and Bank Regulation” offered last month, Governor Bowman argues, “Within a bank, virtually everyone has a role to

play in promoting [a] culture of compliance with applicable law.” But various industry stakeholders, she reminds, including bankers themselves, “have an important role in the stewardship of the banking system that goes beyond compliance — namely, participating in the administrative rulemaking process.”²¹

Many banking organizations find themselves in situations where they must clean up enforcement actions or other supervisory smudges before the organization can grow or merge.

MARGARET TAHYAR

Today, the US is home to over 4500 banks, and industry experts agree that the coming years will be marked by an inexorable consolidation of the sector. As we saw with SVB, smaller banks will get bigger, and their front offices will grow more quickly than their back offices. This represents regulatory and supervisory challenges for oversight agencies,²² as well as governance challenges for growing firms.



Margaret Tahyar

“To prepare to grow into a larger, more complex organization and to be integration ready, a banking organization must keep its house in order,” advises **Margaret Tahyar**, head of the Financial Institutions Group at the renowned international law firm Davis Polk, in a **Good Counsel**

article appearing herein. ► **PAGE 101**

“Alas, in this imperfect world, many banking organizations find themselves in situations where they must clean up enforcement actions or other supervisory smudges before the organization can grow or merge,” Ms. Tahyar laments. In this connection, she notes that “Supervisory findings related to weaknesses in liquidity and interest rate risk management have been on the rise, but the majority of the large bank outstanding findings relate to governance and risk control shortcomings.”

And a veritable “tsunami” of regulatory changes is set to make this needed house-keeping chore all the more tasking, Tahyar warns. “Since 2021, the Federal Reserve, OCC, FDIC and CFPB have proposed or finalized regulations that account for 3,192 pages in the Federal Register. If one includes the SEC, there are 4,697 additional pages, for a total of 7,889 pages,” she notes. “These numbers do not capture guidance from the agencies, a few examples of which include: proposed bank merger guidance, proposed changes to corporate governance, climate guidance, third party guidelines and limits on novel activities,” she adds.

Moreover, Ms. Tahyar cautions, “Another fundamental change is the increase in litigation, both against the agencies and in the private sector.” In the practice group she leads, Davis Polk has been tracking 17 litigations affecting the banking sector, six of which are at the Supreme Court. Viewed in the context of a historical run rate of one or two such actions per year, “The increase in litigation reveals that something major has changed in the banking sector, which historically has been reluctant to sue its regulators.”

And complicating matters further still is the breakdown of the technocratic consensus that typically prevails among the supervisory agencies, Tahyar relates, “increasingly revealed by the strong

uptick in dissenting votes and public spars between agency principals on key topics of the day.” Here again we see a clash in judgment as to how reliable risk governance, and particularly non-financial risk governance, is to be best achieved — and *demonstrated* — to the satisfaction of bank examiners, where no established metrics for such are available.

One hump, or two?



Greg Baer

The many ways in which this plays out in the US is detailed in another **In Focus** article to be found here, offered by **Greg Baer**, President and CEO of the Bank Policy Institute. ▶ **PAGE 187** Baer, complains that, today, “the C-suite of the average bank spends 42 percent of its time on

compliance tasks or examiner mandates, while the board of directors spends 44 percent of its time on those tasks.”

Further, since the 2016, “the average percentage of C-suite time focused on compliance tasks or examiner mandates has increased 75 percent; percentage of board time 64 percent; FTEs in compliance functions 62 percent; [and] percentage of IT budgets 40 percent.” This is evidence of Tahyar’s “tsunami” of regulatory burden, consistent also with what we have heard from Australia’s Anna Bligh. But Baer’s complaint runs deeper.

“In recent years,” he argues, “bank examination has expanded significantly in scope and increasingly is used as a substitute

for regulation, imposing significant restrictions on banks outside of public view.” Details of the examination regime are kept secret and thus are difficult to ascertain. This is frustrating in itself, but Baer’s criticism is sharpest where he points

The C-suite of the average bank spends 42 percent of its time on compliance tasks or examiner mandates, while the board of directors spends 44 percent of its time on those tasks.

GREG BAER

to the standard 'CAMELS' rating system by which examiners seek to assess a bank's: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk.²³ His critique in this connection is thorough and warrants some detailed reiteration here.

Baer observes that "banks that are well capitalized and liquid can be — and frequently are — rated in unsatisfactory condition because of amorphous and inherently subjective 'governance and controls' concerns alone." It is not clear how these ratings are decided, and because the CAMELS score is a composite figure and the 'M' (management quality) "dominates for purposes of determining the composite rating," the lack of transparency Baer decries is further compounded by an element of examiner subjectivity that cannot be scrutinized, even were such scrutiny permitted.

A standard response often heard from bank supervisors in this connection is that the examination process must invariably involve an element of informed judgement, exercised by experienced and highly trained professionals whom we must trust to act wisely and in the best interest of broad public interests.

But leaving aside the fact that the nature of such professional training is not well documented publicly, as critics would note, and ignoring the fact that their exercise of professional judgement failed to prevent last spring's banking sector turmoil, it remains fair nevertheless to question how such supervisory judgement is informed, with a point back to the 'Constituents of Sound Decision-Making' hierarchy outlined above.

Ultimately, Baer's argument raises questions of due process because, "in practical effect, a Management downgrade (the 'M' in CAMELS) is no longer an examination criticism but rather effectively a large

financial penalty, a multi-year cap on organic and inorganic growth, and potentially an order to divest whole businesses." Nonpublic ratings downgrades, or even the threat of such, are as effective as formal enforcement actions, Baer argues, because of what Davis Polk's Meg Tahyar refers to above as "supervisory smudge":

- when a financial holding company receives a "3" (or lower) rating for Management, it becomes subject to significant limits on its non-bank activities;
- a "3" rating triggers significantly higher insurance premiums and limits on access to federal bank funding resources; and,
- under guidance from both the Fed and the OCC, a "3" rating disqualifies a bank from engaging in mergers and acquisitions. ▶ **PAGE 101**

Notably, these impacts are imposed for a period of years, until some future examination cycle perhaps results in a revision to an earlier punitive rating.

While banks may be expected to object in these circumstances, in fact, this seldom takes place, for several reasons.

"First and foremost, there can be no public objection whatsoever," Baer notes, because "the agencies take the position that any disclosure

of examination-related information is criminal theft of government property, so there can be no public complaint or discussion of the rating at all."

Further frustrating to Baer, and many among the firms his organization represents, "while these consequences of a ratings downgrade are significant and concrete, the assignment of these ratings is effectively left entirely to the subjective judgment of the examiner: the relative ratings frameworks themselves provide no meaningful standard at all to govern their use (or misuse)."

There is no established research or metrics by which an examiner could cogently and consistently assess culture.

GREG BAER

Moreover, concerns for things like reputational risk and ‘credible challenge’ behavior have become areas of increasing examiner focus in recent years, with their assessments made on the basis of “judgments that are effectively in the eye of the examiner, with no objective standard against which they can be disproved.”

These concerns are central to the discussion we have sought to curate throughout the full history of this series of reports, and equally so to the various inquiries, reports, and policy-debates that have ensued in the wake of last spring’s banking sector difficulties: namely, the means by which we are to assess non-financial risk profiles proactively, most particularly those risks that stem from culture and the conduct it is believed to promote.

Baer summarizes the core challenge thus: “More broadly, there is no established research or metrics by which an examiner could cogently and consistently assess culture,” he writes. “Instead, examiners pore through meeting minutes — which they insist be voluminous — to determine whether risk officers or board members are providing ‘credible challenge.’” Such a circumstance, Baer notes wryly, requires that those keeping the minutes “adjust them accordingly, and that they assure discussion participants perform for the minutes.”

Reasonable people will have different perspectives on the criticisms Baer raises here, but they highlight a key challenge that flows from an examination regime that relies upon uncontested supervisory judgement in the absence of any established, data-driven metrics by which to assess qualitative risk governance challenges.

Without such, it is not only difficult to effect risk governance as efficiently and successfully as firms may wish, but neither do they have agreed measures by which to evidence that their risk governance efforts can be reasonably expected to deliver desired outcomes.

Instead, firms are left pointing to governance *inputs* as a proxy for the presumed efficacy of the *outputs* for which they are accountable, and both management and supervisors alike are left scratching their heads when risk governance failures manifest, as they persistently do.

Without leading indicators of trouble, we are left to ‘discover’ it only after it erupts and can’t be denied.

Supervisory culture

“It’s especially confusing, if not extraordinary, to see many of the people who were in charge over the years saying they did everything correctly in relation to the management and supervision of Credit Suisse,” UBS chief Sergio Ermotti said during a May 15th speech at the University of Zurich.²⁴ “Everyone who was involved needs to critically analyse the role they played and face up to their responsibilities,” Ermotti urged. “It takes courage to own up to shortcomings,” he added, “But we must learn from past mistakes.”

There have been many efforts at learning from the events of last spring. Speaking at London’s Mansion House in October, UK Prudential Regulation Authority chief Sam Woods summed up one important lesson succinctly: “Money isn’t everything,” he said. “Financial resources are important, but they are not everything a firm needs to survive.”²⁵ Pointing to Credit Suisse, in this connection, Woods noted several factors that contributed to the loss of confidence it suffered, “serious recurrent conduct and risk management failures” chief among them.

Credit Suisse had plenty of financial resources at group level before it began to experience a run, and later won the full support of the Swiss National Bank. But, as Woods notes, “Financial resources — capital and liquidity — do not solve these kinds of problems.” For prudential regulators, Woods suggests, this highlights “the importance of non-financial regulation and supervision, covering topics that could impact

the credibility and profitability of the firm — things like governance and controls, risk culture, and operational resilience.”

In January this year, the Group of Thirty echoed Woods’ perspective. “Earlier G30 reports have stressed the importance of proper culture and governance in banks, nonbank financial institutions, and supervisory agencies,” it reminded. “The events of March 2023 again illuminated poor bank conduct and cultures within certain firms’ boards and senior management.”²⁶ We discover, and rediscover, trouble only after it appears.

In 2010, the FSB issued a white paper, “Intensity and Effectiveness of SIFI Supervision: Recommendations for enhanced supervision.” It remarked then on supervisory mandates, noting that those “geared toward active early intervention can facilitate a culture where supervisors have the will to act early.”²⁷ As the just-cited G30 report argues, the events of last spring “make clear that the independence, experience, and culture of responsible supervisory agencies greatly matter for actions, maybe more so than formal rules.”

The postmortem reports produced since last spring question whether many supervisors feel themselves to be operating with the proactive mandate that the FSB envisions and the G30 highlights.



Wayne Byres

Throughout this report, several contributors offer concurring remarks, collectively arguing that the culture of the supervisor plays a role in the performance of its oversight responsibilities, just as the culture of a firm is argued to shape the success of its risk governance infrastructure. But

few make the case as plainly and as forcefully as **Wayne Byres**, former head of the Australian Prudential Regulation Authority and a past Secretary General of the Basel Committee on Banking Supervision, in an **In Focus** article he contributes. ► **PAGE 317**

“If poor culture and governance can produce poor decisions and practices in any sort of firm,” he writes, “why should we not expect these issues to challenge a financial supervisor too?” Byres goes on to assert that an emphasis on risk governance infrastructure over risk culture has been found to be insufficient in assuring good governance outcomes among financial institutions, “and it’s no different in supervisory agencies.”

If poor culture and governance can produce poor decisions and practices in any sort of firm, why should we not expect these issues to challenge a financial supervisor too?

WAYNE BYRES

“Time and time again the issue of supervisory mindset and culture are prominent features of postmortems conducted in the wake of a financial failure,” Byres writes. He regrets that this challenge remains one of the few yet to be addressed adequately by the

international regulatory and supervisory standard-setting community. “It would be a pity if this remained consigned to the ‘too-hard’ basket,” he writes.

Metrics & mirrors

In an interview appearing in our 2023 report, the Fed’s past Vice Chair for Supervision, Randal Quarles, offered the view that the international regulatory and supervisory standard-setting community ought to take up the question of metrics for culture related risks, as these clearly have impact on the confidence placed in firms. “That’s a real challenge for the official sector,” Quarles said, “And it’s something critically important — particularly since financial institutions depend fundamentally on confidence.”

Byres agrees. “The current guidance on establishing an effective supervisory function focuses primarily on the necessary infrastructure — mandates, legal powers, skillsets, etc. — but neglects any mention of the role of leaders in setting the right culture for their organization,” he writes. “It’s akin to saying that, as long as a financial firm has all the right policies and frameworks, it will automatically generate prudent outcomes.”

“We have learnt that this emphasis on risk governance infrastructure over risk culture is insufficient in financial institutions, and it’s no different in supervisory agencies,” Byres concludes.

“There would be a huge benefit to having a data driven, analytically rigorous process that provides reliably comparable metrics by which to assess incremental progress on culture improvement,” Quarles argued in our 2023 report, with reference to supervisory oversight of firms’ risk governance. “The development of [such] identifiable markers of culture should be sponsored by a body that spans all financial institutions — which, in our current international regulatory architecture, is the Financial Stability Board,” he noted.

Byres argues that supervisors themselves would benefit greatly by the kind of international effort Quarles suggests. “Supervisors are far from having an internationally agreed framework or the necessary skillsets for comprehensively reviewing culture within banks and other financial institutions, let alone agreeing an approach that could be applied to supervisors themselves,” Byres observes here. “It’s time for the relevant international bodies tasked with promoting good supervision to take a closer look at the issue,” he insists, “and to play their part in promoting a stronger supervisory culture more widely.”



Andrea Enria

“As always, I fully share Wayne Byres’ views and consider his call particularly important given the role he played in the Basel Committee,” writes **Andrea Enria**, the former ECB Supervisory Board Chair, in his article found here. “International efforts have been for a long while focused on standard setting, and reviewing the implementation of those standards across jurisdictions,” Enria adds. “I think this was the right thing to do in a post-GFC setting,” he argues. “Now, it would be important to focus on culture at supervisory authorities.”

“Supervisors rightly put a lot of emphasis on diversity among boards, on the need to avoid groupthink, and to nurture challenge and open debates within boards,” Enria notes. “They also require banks to strengthen the effectiveness of the three lines of defence in their organization,” he adds. “I believe supervisors should also abide by the same principles in their own internal governance.”

“I believe we should collect examples of good organisational features and internal practices at supervisors to foster a culture that empowers supervisory

judgment, develops a risk appetite framework for line supervisors, and ensures checks and balances, fairness and transparency of processes,” Enria encourages. Importantly, Enria adds, “Such an effort would also increase the credibility of supervisors when challenging governance and culture at banks.”

In its “Peer Review of Switzerland,” released in February this year, the Financial Stability Board argued that “The Credit Suisse case illustrates that the bank did not have an effective response option to either

We have learnt that this emphasis on risk governance infrastructure over risk culture is insufficient in financial institutions, and it’s no different in supervisory agencies.

WAYNE BYRES

the 'slow burn' issues of governance, risk culture and strategy that led to the ultimate crisis, or the ensuing 'fast burn' crisis with high liquidity outflows."²⁸

With a view to addressing such shortcomings going forward, the FSB noted that Swiss regulator FINMA is currently working on a proposal to introduce a 'Senior Managers regime' akin to those in place in the UK, Ireland, and Australia. "This would allow FINMA to more easily take action against individual managers who fail their duties, and is also conducive to strengthening banks' corporate culture," the FSB argued. It's not clear how the FSB would suggest FINMA act to ensure that its own culture is similarly strengthened.

Do as I say, not as I do



Charles Randell

In another **In Focus** piece offered here, **Charles Randell**, past Chairman of the UK Financial Conduct Authority (FCA) suggests that "Many regulators (financial or otherwise) would probably admit that they have not always held themselves to the standards they require of the businesses they regulate." ► **PAGE 243**

"It is noteworthy that when Michael S. Barr, the Vice Chair for Supervision of the Board of Governors of the Federal Reserve System, produced a report on the failure of the Silicon Valley Bank," Randell observes, "he called out failures in SVB's 3LoD system but had much less to say about how to change the Fed's own 3LoD system," with reference to the industry-standard 'Three Lines of Defense' risk management paradigm.²⁹

Many regulators (financial or otherwise) would probably admit that they have not always held themselves to the standards they require of the businesses they regulate.

CHARLES RANDELL

The case is the same in Switzerland. "The Swiss Financial Market Supervisory Authority's ("Finma") report on 'Lessons Learned from the Credit Suisse Crisis' covers deficiencies in Credit Suisse's 3LoD

system quite extensively, but does not suggest how Finma's own 3LoD system could be improved," Randell notes.

"Financial regulators generally put the largest businesses they supervise through a carefully structured annual assessment, which includes the control

environment, governance and culture," Randell adds. "The board of a financial regulator could work towards subjecting the regulator itself to the same assessment in order to answer the question: 'Do we do what we say?'" Randell observes that "There is sometimes a view that, because regulators do not have a profit motive, they are at less risk of control failures." He questions this.

For the last 10-years, the New York Federal Reserve Bank has held a conference at which the topic of bank culture and related governance and supervisory questions is explored. Speaking in connection with the most recent such event, under the banner of 'Ten Years of Governance and Culture Reform: Taking Stock,' the University of Chicago Booth School of Business professor of entrepreneurship and finance, Luigi Zingales, observed that, "There was clearly a huge reaction and soul searching following the financial crisis."³⁰

Thereafter, Zingales feels, "everything has reverted back to the mean." He attributes this to a failure to hold individuals accountable for their actions. "The best way to restore trust is to show that actually, people who make mistakes are paying the cost of these mistakes," he said. Today, however, "Responsibility is so diffused that nobody is taking it."

In his article here, Charles Randell takes up Zingales' argument. "Regulators should also expect to be judged against evidence of their impact," Randell asserts.

"A healthy culture is one where colleagues not only feel that they must make an impact, but where they are also impatient to see that impact and empowered to make it happen," Randell argues. But "without measurement of impact over the medium to long term, the regulator cannot hold itself to account — and neither can others," he adds.

"It's great to have colleagues with a strong sense of public duty — but that is simply not enough, and confronting a regulator with evidence of its impact (or lack of it) can help to move the culture from feeling good to doing good."



Michelle Bowman

"Accountability is no less important for bank regulators than it is for banks," argues Fed Governor **Michelle Bowman** in an **In Focus** here. ▶ **PAGE 179** But achieving such accountability "requires transparent policies and procedures and conducting supervision in a way that is predictable and fair," she adds.

"We should embrace holding ourselves to high standards — just as we hold banks to high standards — and do so in a way that promotes public accountability," Bowman contends, noting that doing so with a high degree of transparency would help with "ensuring accountability, in addition to building legitimacy and public trust."

"Speed, force, and agility"

In a speech offered in February this year,³¹ the Fed's Vice Chair for Supervision, Michael Barr, explained, "a supervisor's job is to evaluate a bank's material risks in light of its operations, and to help make sure that the bank has sufficient governance and controls, capital, and liquidity to operate their firm, both in normal times, and in stressful ones." The goal of supervision, Barr continued, "is to help bank managers and boards focus their attention on weaknesses in their risk measurement and management practices," and he suggested that "proactive supervisory action helps firms address issues before they grow so large as to threaten the bank."

With this in view, Barr indicated that, after the turmoil of last spring, Fed supervisors are today focused on "improving the speed, force, and agility of supervision."

Accountability is no less important for bank regulators than it is for banks.

MICHELLE BOWMAN



Source: ChatGPT Dall-E

"Federal Reserve and FDIC policies require staff to include specific information when communicating supervisory concerns to banks," the US Government Accountability Office (GAO) noted in its March 2024 report, entitled, "Bank Supervision: More Timely Escalation of Supervisory Action Needed."³² However, while both regulators established internal procedures stipulating when concerns should be escalated to

informal or formal enforcement actions, the GAO found that the Federal Reserve's procedures were often vague. "The procedures often did not include *measurable criteria* for examiners to use when recommending informal or formal enforcement actions," the GAO remarked. (emphasis added)

As such, the GAO recommended that, "Congress should consider requiring the adoption of non-capital triggers that require early and forceful regulatory actions tied to unsafe banking practices before they impair capital," and look to incorporate these unspecified *noncapital triggers* "into the prompt corrective action framework."

It continued to suggest further that, "The Chair of the Federal Reserve Board of Governors should ensure that the Director of the Division of Supervision and Regulation revise its procedures on when to escalate supervisory concerns to informal or formal enforcement actions to be clearer and more specific and to include *measurable criteria*." (emphasis added) Here again, we see the trouble that can arise when supervisory judgement is exercised without appeal to measurable criteria matched by reliable relevant metrics.

It is questionable whether supervision will be more successful if conducted with greater speed, force, and agility absent such criteria and metrics. And nowhere is this perhaps more important than in assessing the cultural drivers of performance outcomes — for firms and supervisors alike, as the contributors to this report have argued in unison.

"I believe the turmoil of last year raised important questions for all supervisors," Andrea Enria writes here, arguing, "we should move on from the debate on calibration of capital requirements and focus more on the issue of effective supervision." He notes that the banks that failed last spring "shared major

weaknesses in risk management, internal governance and culture, and the supervisors have not always been able to promptly identify shortcomings and, especially, drive prompt remediation" in connection with these weaknesses.

As such, "Supervisors need to understand broader cultural aspects that may well affect the viability of the firms under their responsibility," Enria argues,

"And if they see something wrong, they have a duty to increase the pressure on management and boards for cultural change, even though the traditional supervisory toolkit might not be well suited to deal with cultural issues." It is this toolkit that cries for attention today.

I totally agree that the importance of supervising governance, risk management, and culture is one of the key takeaways from the banking turmoil last year.

SHARON DONNERY

"I totally agree that the importance of supervising governance, risk management, and culture is one of the key takeaways from the banking turmoil last year," writes the Central Bank of Ireland's Sharon Donnery. "I see this more as re-learning old lessons, rather than revealing anything new," she adds. Last year's turmoil, she suggests, "merely confirmed, and re-enforced, the focus and importance we have placed on governance, risk management, and culture."

But if supervisors are to deliver "state of the art supervision" in this connection, Ms. Donnery reminds, they will need first to be equipped with "the right skills, the right mind-set, the right tools and the right data to do their jobs." The supervisory toolkit wants for new tools.

"It has long been recognised that deficiencies in governance and risk culture can be early indicators of potential financial risks," APRA's Chris Gower concurs here. "In a world where complex non-financial risk is growing rapidly, global regulators are increasingly recognising that the key to viability is not

only to require more capital and liquidity, but also for supervisors to require good governance and a sound risk culture.”

But it is one thing to “require” good governance and a sound culture, and another thing to test for it reliably.



Bryan Stirewalt

In an **In Focus** essay appearing herein, former Dubai Financial Services Authority (DFSA) chief and past co-chair of the Basel Consultative Group, **Bryan Stirewalt** offers his own relevant

perspective. ► **PAGE 365**

“The international regulatory community has yet to establish precisely how we are to create and embed supervisory cultures that are appropriately intrusive, skeptical, proactive, comprehensive, adaptive, and conclusive,” he writes. Nor have many regulators sought “to try and implement measures that address the importance of culture” within the firms they oversee. Instead, Stirewalt criticizes the “all too easy” inclination to maintain supervisory focus on capital and liquidity.

“Increased capital should not permit for a tradeoff that allows bad culture to prosper,” Stirewalt admonishes. Neither is it at all clear that added speed, force, or agility would be helpful to supervisors boxing in the dark. “Perhaps it is time to be more explicit in articulating the factors driving supervisory culture and effectiveness?” Neil Esho of the Basel Committee suggests here.

“There is broad agreement that culture is an important driver of institutional performance,” Esho agrees with many others writing alongside him in this report. “However, for the most part, our assessments are implicit. There is no explicit or quantitative

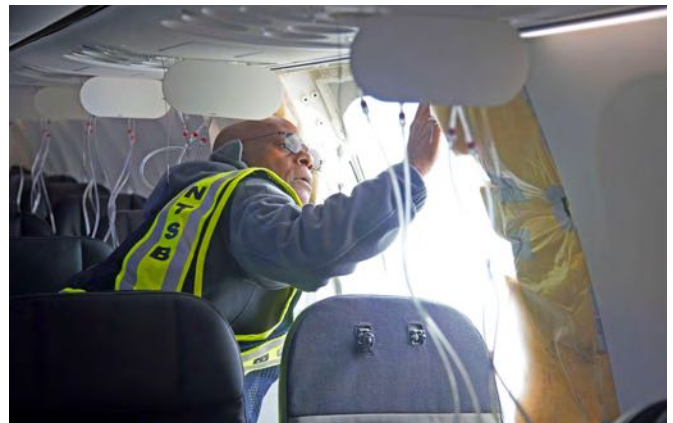
measurement,” he further concurs. “The question therefore arises as to whether we need to be more systematic and consistent in our assessments of culture (both of our own and other organisations),” Esho reiterates.

Increased capital should not permit for a tradeoff that allows bad culture to prosper.

BRYAN STIREWALT

“If a more systematic / structured / quantitative approach is needed,” Esho asks, “what tools are available to supervisory agencies to embed their own desired supervisory culture into their agency and effect the required changes at regulated institutions?”

This question is worth exploring, he argues. “A more explicit and analytical approach will provide a stronger basis to justify and build consensus around the changes necessary to improve risk culture and help achieve the desired supervisory outcomes,” Esho concludes.



American Photo Archive / Alamy Stock Photo

CULTURE MATTERS

When the door on a Boeing 737 Max blew out mid-flight over Portland Oregon earlier this year, incident reports swiftly tilted in the direction of culture problems at the airplane manufacturer. A study subsequently conducted by the US Federal Aviation Administration cited a “disconnect” between leadership and employees around the safety culture that was formally emphasized in the ‘tone from the top’ of the organization, and a fear of retaliation

that prevailed among those employees who kept silent although they felt that safety concerns needed reporting.³³

“Boeing employees did not demonstrate knowledge of Boeing’s enterprise-wide safety culture efforts, nor its purpose and procedures,” the FAA found.³⁴ Moreover, “Employees did not understand how to utilize the different reporting systems, which reporting system to use and when,” and many of them were unfamiliar with the details or expectations of the company’s “Reporting Culture” and its “Speak Up” program. It is perhaps therefore unsurprising that the FAA’s Expert Panel could not “verify whether safety concerns reported directly to the management chain were captured and resolved in a systematic manner.”³⁵

What we see in this is a clear connection between culture and subsequent behavior. It’s notable, in this regard, that a survey conducted among insurance sector chief risk officers, by the Institute of International Finance and EY, reported in April this year that 54% of respondents pointed to “conduct risk” as their principal concern.³⁶

Here again, this is unsurprising: organizational culture is known to be a key driver of organizational behavior and, as we hear throughout this report, organizational leaders are ill-equipped to put good measures to culture and are thus poorly equipped to anticipate the conduct it may promote. Instead, we learn of culture-related ills only *after* they have been made manifest in observable mishap and misconduct.

And, as seen at Boeing, those employees who are best placed to sound warning are often those most reluctant to voice their concerns — until a door blows off an aircraft in flight. Culture, conduct, and even safety risks are thus inseparably intertwined.

Perhaps nowhere has this been more evident in the past year than in the cases of bullying and harassment that have featured in news headlines: deplorable behavior that appears to have been made at least *permissible* by the culture of organizations as distinct as oil companies in Australia,³⁷ tech giants in China,³⁸ and craft beer-makers in the UK.³⁹ In recent months we have heard allegations of bullying raised at Canadian bank BMO⁴⁰ and at Citigroup in the US.⁴¹ We’ve heard continuing accounts of sexism and harassment across the City of London, sufficient enough to have drawn government inquiry.⁴² And of course we have been confronted with the sordid details of an ongoing sexual harassment scandal that has engulfed the US Federal Deposit Insurance Corporation.⁴³

Some will argue that these problems have always been with us — all that has changed is that people are now more ready to speak out, if only because social media has provided them with an easily accessible means by which to do so.⁴⁴ Others will argue that we are witnessing a generational change in the

workplace, energized by the success of the #MeToo movement and other popular demonstrations decrying social injustice.⁴⁵

Both may be right. Or neither. But I’m not sure the debate is worth having. What is more significant and clearly incontrovertible is the fact that, in today’s workplace, culture matters. And yet we’re managing it, to the extent we’re doing so at all, either as a tick-box HR-exercise of little strategic value, or as a post-crisis remedial-exercise that we hope to wrap up as quickly as possible so we can get back to ‘real work.’ This cannot stand.

It is a matter of boardroom concern when the *Financial Times* feels it is timely to ask, “are things going backwards for women on Wall Street?”⁴⁶ It is a matter of C-suite concern when bank employees don’t wish to return to the office, for some because

Ultimately, culture is more important than anything else in banking, and you really need to attend to it.

CARINE SMITH
IHENACHO

they find their workplace cultures intolerable.⁴⁷ And it is a matter of concern to risk and compliance officers when evidence suggests that working from home may facilitate insider trading or other misconduct, for which firms will be held liable.⁴⁸

It is a matter of concern to chief people officers when workplace relationships no longer create the 'connective tissue' that promotes a sense of belonging and mutual commitment among peers.⁴⁹ It is a matter of concern to chief information security officers and corporate counsel when employees reject stepped up efforts at remote surveillance and monitoring.⁵⁰ And it is a matter of concern to all when young bank employees are found dead amidst allegations that a workplace culture demanding grueling hours was a key contributing cause.⁵¹

Culture-based financial risk

And culture is a matter of concern when the world's largest investor — Norges, the Norwegian "oil fund," which owns on average some 1.5% of every listed company on the planet — decides that culture matters.



Carine Smith Ihenacho

Notably, this applies not just to the culture of companies in its portfolio, but to the culture of the oil fund itself. **Nicolai Tangen**, CEO of Norges Bank Investment Management, and **Carine Smith Ihenacho**, Chief Governance and Compliance Officer, discuss these themes in a **Ground Breakers**

interview appearing here. ► **PAGE 77**



Nicolai Tangen

Trained in interrogation by the Norwegian Intelligence Service before becoming a highly successful hedge fund manager, Tangen took time out in his early career to pursue an MA in Art History and did so again, mid-career, to study Organizational and Social Psychology at the London School of Economics.⁵² His eclectic background is somewhat atypical for those in the financial sector,⁵³ and Tangen brings a refreshingly atypical perspective to the matters under consideration in this report.

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in banking.

NICOLAI TANGEN

"There are some industries where culture is extremely important because you can't see the risks from the outside, and banking is perhaps the most important one," Tangen offers here. "There is no way you, as an investor, can really understand what's going on inside a bank. You saw that in the extreme with Silicon Valley Bank and Credit Suisse," he adds.

"Ultimately, culture is more important than anything else in banking, and you really need to attend to it," Tangen concludes. "The consequences of banks doing the wrong thing are disproportional. If you don't have proper control systems and a sound culture in a bank, there can be humongous consequences."

Governance and compliance chief Carine Smith Ihenacho agrees and is leading the charge as Norges seeks to drive greater attention to corporate governance across the portfolio. She relocated to New York earlier this year to help grow the oil fund's stewardship presence in the market that accounts for some 50% of the fund's returns and, at a time when many institutional investors are backing away from the 'woke' debate that has come to surround ESG interests, Norges is leaning in.

“ESG is about managing long-term risks that have financial consequences,” Ihenacho asserts. “We’ve seen the ESG backlash in the US,” she says. “We think the issue has been too politicized.”

The oil fund raised eyebrows late last year when it was named co-lead plaintiff in a class action suit against SVB.⁵⁴ “The sheer scale of SVB’s mismanagement, rapid collapse and investors’ losses make this an important case for all the affected investors,” Ihenacho says, explaining why Norges opted to take a lead role in such a suit for the first time in its history, and why it has named SVB’s Wall Street advisors and outside auditors⁵⁵ — “the gatekeepers,” Ihenacho calls them — as co-defendants.

“We also wanted to take a visible stance against the huge corporate governance failures seen in this case,” she says. “Hopefully, we can also create a legal precedent and raise the bar for governance.”

Norges brings to itself the kind of culture and governance related scrutiny it would encourage others to adopt, not least those companies in which it invests its vast holdings. “By taking a scientific approach to the evaluation of our work we can understand better *why* things are effective,” Ihenacho argues. “This allows us to be even more targeted in our approach to human and financial performance.”

For instance, in 2021, Norges launched an internal “Human Performance Program” with a view to enhancing psychological safety and resilience within the organization. “First, they worked one-to-one with people, to improve performance at the individual level,” Ihenacho tells, “and then they worked with teams, to help them perform and communicate better.”

Although Norges tracks operational and investment errors, through their Human Performance Program, follow up inquiry aims at learning from error rather than assigning blame. As a consequence, staff is

“much more willing to speak up in meetings when we disagree, rather than waiting to discuss things afterward,” she claims.

These ideas were tested earlier this year, the *Financial Times* reports, when a simple human calculation error resulted in a \$92 million loss.⁵⁶ An anthropologist, Dr. Tone Danielsen, had been hired to examine the oil fund’s culture, and happened to capture the surrounding events in a report that Norges subsequently made public.

“We published Dr. Danielsen’s findings so that the entire organization could read them and, thereafter, we discussed the study in a townhall meeting,” Tangen explains here. “I didn’t want this to be a secret report, which would be leaked in the media and taken out of context,” he adds. “So, we also published it publicly on LinkedIn for the whole world to see.”

In Dr. Danielsen’s report, the employee involved in the costly error is quoted as saying “I openly express that this was my mistake, and mine alone. I felt miserable and was ready to take the consequences — whatever they might be.” In an email quoted by the *Financial Times*, Tangen is reported to have offered his anxious employee this reaction: “These things happen! We run a complex operation and I am more surprised that we historically have had very few, or no incidents like this... Don’t let this ruin your weekend.”

“As soon as you have any confidence in your job, start to admit mistakes,” Tangen advises here. “That really accelerates the building of trust.” He explains why he invites anthropologists and even a sports psychologist in to assess Norges’ people and practices.⁵⁷ “I worked with a sports psychologist for many years in my previous job, and I just saw how incredibly useful it is,” Tangen says. “The funny thing is, when you ask your colleagues to work with a psychologist, they think that you feel they’re ill. But when you ask them to work with a sports psychologist, they think they’re heroes. And the exercise has really helped change how we think.”

“The important thing for me,” Tangen concludes, “was to discover if there were things I wasn’t aware of in the organization, or problems I hadn’t seen.”



Bob Stout

In a **Peer Perspectives** interview offered here **▶PAGE 161, Bob Stout** past head of US policy and regulatory affairs with bp (formerly British Petroleum), describes the costs of such unseen problems. The 2010 Deepwater Horizon spill was ruinously costly, with bp’s total outlay to rectify the spill tallied at some \$65 billion.

“We knew the stakes for the company were existential, in this case literally rather than figuratively,” Stout recalls here. He then describes the steps needed to assure the company’s continued existence, and those necessary to regain the trust upon which its social license to operate depends.

“Within twenty-four hours of the explosion of the rig, bp commissioned a detailed investigation of the root causes of the incident,” Stout recounts. “And despite the tens of billions of dollars in potential costs and liabilities that bp would face coming out of the largest environmental case in history, we decided that the investigation would not be conducted by lawyers operating under legal privilege, but instead by operational and safety professionals under the supervision of bp’s global head of Safety & Operational Risk.”

Beyond that initial commitment to transparency, the company made clear that it would assume full financial responsibility, quickly and publicly reassuring stakeholders that it would not seek shelter under the \$75 million dollar cap that the federal Oil Pollution Act put on oil spill liabilities. “We knew that we could

only rebuild the company’s credibility over time with our actions and not merely with our words,” Stout explains.

“Our primary goal was to conduct a detailed, thorough and non-privileged inquiry into what went wrong and then report it publicly for all to see,” Stout adds. “We wanted to help prevent such an incident from ever happening again — not only at bp, but throughout the industry.”

The company’s commitment to transparency and collaboration with all stakeholders was duly noted. Stout cites a January 2011 Incident Specific Preparedness Review, conducted under the direction of the Coast Guard with a view to capturing best practices and lessons learned during the response. “bp was very proactive and placed no limits on what was needed to make this response successful,” a subsequent report notes.

“The government officials involved, and their counsel, saw bp’s commitment to begin making things right, and this was an early and critical step in rebuilding bp’s credibility with government stakeholders,” Stout says.

He also describes various culture shifts within bp during and after its remedial efforts. Safety and operational risk leaders, for instance, sat among line leadership and were valued for proactively identifying and recommending practical ways in

which to mitigate safety and operational concerns as they arose in operations, rather than being brought in amidst, or after, problem had arisen.

“Regardless of the business sector — whether it is in finance or banking, manufacturing or energy — I believe that in any organization employees will assess the seriousness of a company in implementing change by the expertise and character of the leaders

We wanted to help prevent such an incident from ever happening again — not only at bp, but throughout the industry.

BOB STOUT

appointed to the task, and the extent to which they are actually empowered to identify problems and effect change," Stout counsels.

Thus, when officials elect to impose an external monitor to oversee pledged corrective post-crisis measures, Stout urges that candidates be considered on the basis of their "understanding of and experience in dealing with corporate cultures rather than solely or primarily their law enforcement background and expertise."



Elizabeth Broderick

Elizabeth Broderick illustrates Stout's wisdom. After horrific tales of sexual harassment, bullying, racism, and other misconduct erupted at mining giant Rio Tinto, the former Australian Sex Discrimination Commissioner was retained to conduct an internal inquiry. Rio

Tinto later published Broderick's comprehensive review of the company's workplace culture — releasing the report in full.⁵⁸ In yet another **Peer Perspectives** offering here, Broderick offers her own relevant advice on the matters addressed in this report. ▶ **PAGE 153**

"The call for businesses to improve workplace culture reverberates well beyond the legal mandates," she begins.

"The evolving expectations of our communities and society demand that contemporary workplaces be safe and respectful." Managed well, workplace culture sets the foundation for an organization's success, she argues, by "linking the lived experiences of employees with the performance metrics of the organisation." By contrast, "cultures that tolerate human harm also harbour financial risks for prospective investors."

Cultures that tolerate human harm also harbour financial risks for prospective investors.

ELIZABETH BRODERICK

As such, "The approach to managing culture-based risks needs to shift beyond human resources departments to the enterprise risk level, with greater visibility and accountability from CEOs and boards," Broderick argues. "Boards must pivot towards proactive governance, actively addressing culture-based risks and fostering an environment conducive to transparency and accountability."

"Harmful behaviours are not isolated workplace grievances but, rather, leadership issues that are symptomatic of an unhealthy culture," Broderick continues, adding that when organizations permit for harmful behaviors it is not only specific individuals who suffer, but the organization as a whole suffers a cultural deterioration with multiple knock-on consequences that ultimately leave shareholders and society more broadly harmed.

"Whereas historically these matters may have been dealt with 'in-house' and without media coverage," Broderick notes, "today there is a greater likelihood that media will seek out opportunities to examine the extent to which a business is meeting societal norms and expectations." When that is not found to be so, legislative responses may be necessary, and seen.

"In Australia, recent legislative amendments to the Sex Discrimination Act have created a positive duty — that is, an employer's responsibility to take 'proactive and meaningful action' to prevent sexual harassment and sex-based harassment from occurring in the workplace or in connection to work," Broderick tells. "This reflects a proactive shift, mandating that businesses take active and robust measures," she explains. "This legislation now recognises that responding to alleged incidents of sexual and sex-based harassment is critical but insufficient, and that preventative action is also necessary to create safe, respectful and inclusive workplaces."



Daniela Jaramillo

Another of our featured **Ground Breakers**, Daniela Jaramillo, Head of Sustainable Investing for Australia at Fidelity International, offers her own closely related perspective in an article appearing here that she aptly entitles, “The Underestimated Systemic Implications for Investors.” **▶ PAGE 81.**

“It is now widely recognised that weaknesses in culture, and the governance and accountability relating to culture, translate directly into financial risk,” she opens. What she calls “culture-based financial risks,” are defined by Ms. Jaramillo as “negative impacts that harmful behaviours in the workplace can have on a company’s productivity, reputation, and social license.” Jaramillo highlights that such risks may lead to negative externalities of significance for the economy and for society more broadly.

Research conducted by Fidelity suggests, however, that many companies use an “inappropriate framing of culture-based financial risks within the organization,” Ms. Jaramillo notes. They find three key elements at play in this regard: culture-based financial risks are not treated as business-critical; they lack organization-wide tracking mechanisms and aggregate metrics; and thus reflect a lack of accountability across senior leadership.

Moreover, Ms. Jaramillo notes, while there is broad recognition of the importance of culture in assessing a company’s future performance, it remains difficult for investors to assess company culture from the outside, or to quantify the potential financial impact of workplace misconduct on their portfolio.

It is now widely recognised that weaknesses in culture, and the governance and accountability relating to culture, translate directly into financial risk.

DAMIELA JARAMILLO

“Reporting standards and disclosure tools do not provide an effective way for investors to track a company’s exposure to culture-based financial risks,” Ms. Jaramillo asserts, “and do not allow investors to assess how effectively companies are mitigating these risks.” Once again, we hear of a metrics challenge. “Most metrics provided are backward looking,” Jaramillo writes. Echoing Wayne Byres, above, she notes that even these backward-looking metrics are largely input oriented rather than outcome focused.

This poses problems not only for individual firms and their investors, but for *whole industry sectors* and their stakeholders, Ms. Jaramillo contends. Company-specific issues, she suggests, can “quickly lead to sector-wide and portfolio-wide implications that can create vicious cycles and cumulative risk for investors.” Company-level incidences, such as misconduct scandals, can lead to a negative perception of other companies in the same sector, negatively effecting the license that society either extends to or withholds from all firms in that space.

This is most problematic for what Ms. Jaramillo refers to as “universal investors” — those, like Norges, and other sovereign funds, pension funds, and university endowments, among others — who own “a representative share of the entire economy.” Such investors cannot diversify away from systemic risks like climate change, she notes, and this is true also for culture-based financial risks, which can only be mitigated by effecting change across the entirety of the real economy.

“When culture-based financial risks become a systems level risk, the sector or company may receive additional scrutiny from stakeholders, including governments, consumers and civil society,” Jaramillo warns. “We believe that the extent of these impacts and the interrelated nature of these risks

are currently not fully considered or quantified by investors," she writes. But because this systemic risk is poorly appreciated, it goes effectively unpriced. "To parallel Peter Drucker's quote, 'culture eats strategy for breakfast', we would argue, 'culture can also eat shareholder value for lunch and dinner'," Ms. Jaramillo concludes.



Peter Gleason

"Culture-based financial risks impact an entire organization," Ms. Jaramillo argues, "and their management needs to be part of a CEO's, senior leaderships', and Board's accountability." This theme is picked up in another a **Peer Perspectives** article here, by

Peter Gleason, CEO of the US National Association of Corporate Directors (NACD), whose membership includes more than 1,750 corporate boards. **▶ PAGE 169**

"Companies are well aware of the importance of corporate culture in driving corporate performance," Mr. Gleason suggests. But, he asks, "what about the impact of *board culture* in driving board performance and effective governance of the enterprise?"

"While often overlooked, the board's shared norms, protocols, and practices influence each interaction, discussion, and decision of the board — and its ultimate success as a trusted steward of long-term value," Gleason argues. "If left unattended, a dysfunctional board culture may foster misunderstandings and conflict and contribute to poor board decision-making that could increase the risk of company failure."

With this in view, last year the NACD released a report produced by 'Blue Ribbon Commission' comprised of a 24-members collectively serving on more than 70 boards in the public, private, and nonprofit sectors,⁵⁹ and tasked with sounding

a call to action, "to explicitly use culture as an instrument to drive board excellence in today's complex environment."



EXPAND

Source: <https://www.nacdonline.org/all-governance/governance-resources/governance-research/blue-ribbon-commission-reports/culture-as-the-foundation/>

The Commission's final report, entitled "Culture as the Foundation: Building a High-Performance Board," argues that "companies, and the boards that govern them, are at a major inflection point in how they operate and perform." As Gleason explains here, amidst the turbulence seen in recent years, ranging from the lingering demands of the Covid pandemic, climate change, geopolitical risk, and polarizing social issues, "expectations for both overall board and individual director performance have reached unprecedented levels."

Given such demands, Gleason continues, boards must seek to create and sustain performance cultures "akin to the performance culture they expect management to create and sustain." Just as management is expected today to promote a workplace culture characterized by psychological safety, so must boards "ensure a safe environment where ideas and concerns can be shared, and mistakes can be discussed."

“Whether explicitly defined or not,” the Blue Ribbon Commission’s report observes, “each board has a culture influencing how directors interact, decisions are made, and accountability is enacted.” These cultures must be purposefully managed. “Neglecting to cultivate a purposeful board culture isn’t simply a missed opportunity,” Gleason writes here, it allows boardrooms dynamics to decay and to become “a breeding ground for misunderstandings, conflicts, and, ultimately, the erosion of good governance.”

Capitalism in crisis



Sir Keith Skeoch

Collectively, the criticisms and cautions sounded throughout our report can be heard as a call for stewardship. **Sir Keith Skeoch**, former CEO of Standard Life Aberdeen — one of the UK’s most significant active managers, with December 2023 assets under management of £495 billion —

provides another of our **Ground Breakers** essays here.

► **PAGE 93** “Stewardship should lie at the centre of financial and economic life,” he argues.

“Investors are the stewards of the assets they manage,” he writes. “Companies and boards of directors are stewards of the capital they are allocated,” he continues.

“And, finally, policymakers also need to recognise that they are stewards of the economic and financial system itself.” To underscore the responsibilities and the commensurate sense of duty that effective stewardship demands — and to inspire faith that those bearing such burdens will deliver upon them faithfully — we must craft a narrative scaffolding that supports capitalism anew.

Stewardship
should lie at the
centre of financial
and economic life.

SIR KEITH SKEOCH

“The importance of narrative and its influence on behaviours should not be underestimated,” Sir Keith contends. “Politicians have long understood this but economists are just starting to get to grip on its impact,” he complains. “We need a powerful narrative to promote the benefits of saving, investing, and building a culture of investment stewardship,” he urges. “This is the way we can rebuild and reinvigorate the risk culture that society needs and deliver the financial system fit for the social purpose that society deserves.”

“Culture and conduct risk mitigants are powerful tools,” Sir Keith argues. “They

not only influence behaviours, but the incentives they embed can have profound effects on its social purpose in capitalism — the delivery of prosperity.” And here he notes a problem; namely, that capitalism is increasingly seen to be failing in that social purpose. In large measure, Sir Keith traces this back to several perverse incentives that have been baked into the structure of the capital system, in the UK and elsewhere. These require attention and a rethink.

“There appears to be a growing lack of confidence that the economic model which has delivered such widespread prosperity over the last 400 years is now failing to do so,” Sir Keith warns. Current stewardship must come in for some questioning when sober

journalists at *The Economist* are moved to write that “the world’s economic order is breaking down,” as they did early last month,⁶⁰ or when the equally sensible sorts at the *Financial Times* run columns asking, “What went wrong with capitalism,” as they did later in the month.⁶¹

The social purpose of
the financial system is to
entrust people’s savings
to firms governed by
trustworthy people.

RANDALL MORCK
& BERNARD YEUNG

“The health of our societies depends on sustaining a delicate balance between the economic and the political, the individual and the collective, the national

and the global,” the FT’s Martin Wolf writes in one of the works featured on the **Starling Bookshelf** this year, *The Crisis of Democratic Capitalism*.⁶² ►PAGE 457

“But that balance is broken,” Wolf believes. “A big part of the reason for this is that the economy is not delivering the security and widely shared prosperity expected by large parts of our societies,” he concludes. The widespread loss of confidence in elites and institutions that has been on prominent display in recent years, Wolf argues, reflects a loss in the claim to legitimacy suffered by global capitalism and liberal democracy alike.

“Capitalism is again suffering one of its many periodic crises,” Sir Keith Skeoch continues his remarks here. “Rising inequality, both within and across generations, not only undermines confidence in the economic system but also promotes political polarisation at the very time when we need to focus on collaborating to restore shared prosperity.” He quotes economists Randall Morck and Bernard Yeung: “The social purpose of the financial system is to entrust people’s savings to firms governed by trustworthy people.”⁶³ Alas, it is precisely here where the system appears to be stumbling, and this reflects a failure of adequate stewardship.

Sir Keith argues that, in large measure, this is because the system itself is riddled with perhaps well-intended yet perversely problematic policy-driven incentives that reward behavior at odds with Morck & Yeung’s social purpose of the financial system. “These powerful effects relate not just to how well individuals and entities conduct themselves in the course of their day-to-day business but also the manner in which a system is organised and managed, to include the incentives it deploys to influence behaviours.”

By “incentives” Sir Keith refers to more than mere monetary rewards for individuals. He is concerned with institutional incentives, “deeply embedded within

regulations, codes of conduct, the prevailing economic paradigm, and social mores that ultimately define how the financial system delivers on its social purpose.”

He points to the UK experience to illustrate what transpires when these incentives go awry. When economies fail to deliver on their promise, this eviscerates a citizenship’s faith in ‘the system.’ And when that faith is sufficiently eroded, we experience a crisis in capitalism. This is where we find ourselves today, and as this report strongly suggests, continuing crises of culture and conduct are an immediate proximate cause.

Character & context

In March last year the US Department of Justice Criminal Division updated guidance for prosecutors as regards their Evaluation of Corporate Compliance Programs. That guidance steers away from ticking-boxes, as we count off inputs into compliance regimes, and towards assessing the outputs these compliance systems produce.⁶⁴

“This document is meant to assist prosecutors in making informed decisions as to whether, and to what extent, the corporation’s compliance program was effective at the time of the offense, and is effective at the time of a charging decision or resolution, for purposes of determining the appropriate (1) form of any resolution or prosecution; (2) monetary penalty, if any; and (3) compliance obligations contained in any corporate criminal resolution (e.g., monitorship or reporting obligations),” the DOJ explains.

The DOJ instructs prosecutors to ask three fundamental questions: is a company’s compliance program well designed (inputs), is it applied earnestly and in good faith (practice), and does it work (outputs)?

Where the latter proves not to be the case, the DOJ will explore how management has sought to identify and investigate “root causes” of failure. When

outputs are undesirable, we must examine the inputs and practices that produced them. “A hallmark of a compliance program that is working effectively in practice is the extent to which a company is able to conduct a thoughtful root cause analysis of misconduct,” the DOJ instructs.

“There are many approaches and models for root cause analysis,” APRA’s Chris Gower explains here. Regardless of the methodology used, APRA has observed the following key ingredients of an effective root cause analysis:

- It goes well beyond the initial reasons that gave rise to concerns, joining the dots across issues, incidents, and breaches to understand “why” these collective issues occurred;
- It goes deeper on “why” — “insufficient investment” or “inadequate oversight” are red flags that reflection has not been deep enough, as they describe symptoms, not root causes; and
- It pinpoints the underlying behavioural norms, cultural drivers and leadership mindset which shaped the environment and context for the observed failure of risk management.

Broadly speaking, two competing theories of ‘root causes’ are typically tested for when misconduct erupts: either (1) individuals of low character acted with egregious intent to do wrong, or (2) individuals of good intent somehow lost sight of structural dynamics that confounded their best efforts. To address the former, some regulators have added character assessments to their ‘fitness and probity’ regimes. To redress the latter, third parties are looked to for internal investigations and the development of remedial action and oversight plans.

Rather than asking, ‘Is this person a risk to our organization or community’ it is often more helpful to ask, ‘Under what circumstances might this person be a risk to our organization?’

DR TERRI PATTERSON



Adrienne Harris

Adrienne Harris, Superintendent at the New York State Department of Financial Services (DFS), is one of those who has opted for proactive character assessment. “DFS’s character and fitness guidance is one of several steps the Department has taken to ensure the health of the entities

we regulate and to preserve the stability of the global financial system,” she explains in an **In Focus** interview appearing here. ▶ **PAGE 183**

The Department’s character guidance,⁶⁵ the Superintendent continues, “reflects an ongoing effort to raise corporate governance and oversight standards following the banking crisis in March 2023, and to ensure confidence in the management of New York’s financial institutions.” While

this may seem a sensible and even desirable step, the problem of metrics again features. How are we to effectively assess character?



Dr. Terri Patterson

We explore this challenge with **Dr. Terri Patterson** in another **Peer Perspectives** interview captured here. ▶ **PAGE 131** A psychologist, Dr. Patterson served as Chief of the US Federal Bureau of Investigation’s elite Behavioral Analysis Unit, in the course of a 20-year career with the Bureau.

Our conversation turned on questions of character versus context.

“Because I have spent years observing and analyzing deviant behavior, I am sometimes asked about the ‘profile’ of concerning threat actors,” Dr. Patterson

shares. "It is important to remember that there is a complex combination of factors that leads one to engage in malicious activity," she cautions.

"It is always helpful in these discussions to remind ourselves that humans are complicated. We're not robots, and our daily behaviors and decisions are driven by a variety of factors, many of which are dynamic in nature," she reminds. "And when we think about deviance and why people might deviate from social norms and expectations, we have to remember that, just under the surface, there are lots of factors that interplay with one another to drive behavior."

This complexity challenges our ability to conduct character assessments in the way bank regulators might wish. "So rather than asking, 'Is this person a risk to our organization or community' it is often more helpful to ask, 'Under what circumstances might this person be a risk to our organization?'," Dr. Patterson advises. "We move from the dichotomous 'yes' or 'no' to a framework of managing the threat and mitigating risk," she explains. "This is a more productive way to approach risk management."

"For example," Dr. Patterson continues, "there are foundational, personality-related characteristics that leave a person vulnerable to the kind of deviant behavior exhibited by the malicious insider. When those foundational characteristics are present, the individual is often vulnerable to other situational factors that drive behavior," she explains. "Many of these factors are dynamic and heavily dependent upon context."



Colin Mayer

"It is not in general the character of the individuals that is at fault," in many cases of workplace misconduct, "but the system that forces them to take on guises in their workplaces that they would never dream of adopting in their

domestic surroundings," argues Oxford professor **Colin Mayer** in another of the essays from **The Academy** that features here. ►PAGE 429

Professor Mayer emphasizes the importance of corporate purpose in this connection, and a clear alignment of such with corporate culture, with a view to creating the context needed to support desirable conduct. "Everyone from the board to the shopfloor should not only understand the meaning and significance of their corporate purpose but appreciate their part in contributing to its fulfilment," Professor Mayer writes. "This requires incentives as well as cultures of organizations to be aligned with problem-solving purposes."

This is what Sir Keith would consider to be effective stewardship, at the level of the firm, and it is consistent with the calls for good governance sounded by Norges' leadership.

Establishing such a workplace context helps to bring individuals of differing character into alignment in their collective conduct. "It is only when remuneration, recognition and promotion of employees conform with the corporate purpose that employees regard it as core to the business and a genuine determinant of the corporate strategy," Mayer continues. In other words, no gas-lighting.

"Achieving that [alignment] requires *internal systems of measuring, reporting and accounting for delivery of the corporate purpose in addition to a conducive organizational culture,*" the professor advises. (emphasis added)

Culture is shaped by and reflected in character *and* context. So, when testing for the root causes of corporate misconduct, in addition to asking about individual actors, we should attend as much if not more so to whether the firm maintains internal systems by which to test for the cultural context it

allows, and to investigate whether that culture is conducive to the performance outcomes for which management is responsible.

Ethics & accountability

UBS CEO Sergio Ermotti raised eyebrows last November when he called for the imposition of tougher sanctions on negligent bankers.⁶⁶ Credit Suisse, “had repeated risk management and operational failures which undermined the credibility of its leadership and the board,” Ermotti argued. “This ineffective governance in turn led to excessive turnover in key board and management positions, further undermining individual accountability across the firm,” he said, illustrating the intimate interplay between culture, risk, governance, accountability, operational outcomes, and the investor confidence a firm enjoys — or loses.



Wim Mijs

Such conversations often take place under the banner of ethics. “The foundation of any successful business is rooted in the ethical and cultural behaviour of its employees and leadership teams,” **Wim Mijs**, CEO of the European Banking Federation (EBF) argues in another **In Focus** essay

here. ► **PAGE 289**

“High ethical standards promote a positive public image and, most importantly, also build trust and confidence in society,” he rightly adds. While regulators have sought to promote an ethical banking culture, “it is undisputed that the industry also has a vital role to play in promoting that view,” Mr. Mijs argues, in concert with Mr. Ermotti.

“In the last 15 years, EU regulatory bodies have increasingly focused on ethical banking practices, making it essential for financial institutions to stay ahead of compliance requirements,” Mijs observes. As such, “the EU banking industry has progressively adopted self-regulatory measures ... driven by the understanding that ethical banking is essential for long-term success and stability.”

Adapting to changes in culture and ethics within the sector requires a comprehensive approach that aligns with both regulatory expectations and societal values.

WIM MIJS

“Adapting to changes in culture and ethics within the sector requires a comprehensive approach that aligns with both regulatory expectations and societal values,” Mr. Mijs explains further, and “integrating ethical considerations into performance metrics and promotion criteria can reinforce the importance of ethics in achieving

business objectives.” Social values, business purpose, and performance metrics must align, as Oxford’s Professor Mayer suggests above.

“In most European countries,” the EBF’s Mr. Mij’s reminds, “professional oaths are a common practice for doctors, politicians, and lawyers. These oaths are critical to maintaining the integrity and public trust of these professions and are understood as a formal declaration by which individuals commit to upholding the standards and ethics of their profession,” he adds. “This tradition is not only ceremonial; rather, it serves as a moral anchor, reminding professionals of their obligations and the serious implications of their work.”

Mr. Mijs is proud to have introduced the Dutch Banker’s Oath in 2014/15 to help instigate a commitment to ethical intent among those in the industry.⁶⁷ “Looking ahead, the future of ethical banking may involve a hybrid model,” he suggests, “where regulatory frameworks complement industry-led initiatives.” This, Mr. Mijs believes, “could combine the flexibility and innovation of voluntary measures

with the structural support of regulation, potentially leading to more effective and comprehensive ethical practices.”

While allowing for the necessary checks and balances, such public-private partnership would betoken a refreshing departure from the dysfunctionally antagonistic stance that often prevails between the industry and its overseers.

Investigations into character and ethics may rightly feature in the root cause analyses the DOJ calls for when looking to assign accountability in the wake of risk governance failures. But questions regarding such go only to the first of the two competing theories identified above which motivate post-event inquiries: the suspicion that individuals of low character acted with egregious intent to do wrong. These avenues of inquiry are of less help when testing the second theory: the belief that individuals of good intent somehow lost sight of structural dynamics that confounded their best efforts. Here, we must explore the context behind conduct.

‘Systems intentionality’

“The brutal fact,” APRA’s Chris Gower laments, is that many post-scandal remedial efforts fail to deliver desired change, “and a common reason is failure to culturally transform,” he argues. “Remediation plans that focus on frameworks, systems, and processes but neglect leadership and cultural change rarely succeed,” he warns.

Mr. Gower continues, “Many regulators make use of third parties to monitor and oversee rectification or remediation plans as part of enforcement action.” When done right, these experts “can augment and complement the role of the supervisor,” Gower allows. While responsibility for successful transformation remains with the firm and its leadership, “the

Root cause analysis of misconduct must include the corporate ‘structures, values and practices’ through which misconduct occurred.

ELIZABETH MCCAUL

independent assurer plays a critical role in helping leadership teams and program leads by objectively assessing progress towards target states and addressing root causes.” Moreover, these “Independent assurers also help supervisors to understand if real change is taking place.”

Here, supervisors, leaders, and third-party experts are well advised to attend to *structural* elements that drive behavior in the organizational context. Doing so complements rather than conflicts with an effective inquiry into contributing cultural dynamics because, as Elizabeth McCaul observes in her opening Preamble to this report, “Risk culture is supported by structures that enable it to flourish in an organisation.”



Elise Bant

In this connection, **Elise Bant**, a Professor of Private Law and Commercial Regulation at the University of Western Australia, offers a provocative **Good Counsel** essay here. ▶ **PAGE 107**

She describes a shift in the accountability for corporate misconduct that is demanded when adopting the lens of what she calls “systems intentionality,” and she proposes this as a superior alternative to today’s legal constructs for culpability.

“Most sophisticated firms have values statements, policies and employee processes that have been poured over by lawyers with compliance and marketing alike in mind. All too frequently, these bear little resemblance to the actual practices of the firm,” she writes. “Root cause analysis of misconduct must include the corporate ‘structures, values and practices’ through which misconduct occurred.”

By use of the term “systems intentionality,” Professor Bant seeks to assert that “corporations manifest their states of mind through their de facto systems

of conduct, policies and practices.” If one wishes to assess the culture of an organization, particularly with a view to assigning accountability for the outcomes it promotes, one need only look at the system that produces such outcomes, and to those who establish and maintain such systems.

“A pattern of behaviour can be understood as an externally observable repeated way of acting,” Professor Bant suggests, noting that “Australian courts have explained that patterns of behaviour may provide evidence of a system of conduct, which is generating that pattern of behaviour.”

This model of culpability “builds on decades of outstanding work by scholars, law reformers, legislatures and courts towards developing holistic models of organisational blameworthiness,” Bant writes, “including in developing understandings of ‘corporate culture’ and the relationship between culture and corporate liability.” It is far superior to what is commonly afforded in common law jurisdictions, where “the legal toolkit for assessing corporate culpability is increasingly regarded as unfit for purpose.”

In such jurisdictions, attribution rules are largely ‘individualistic’ or ‘nominalist’ in nature, which implies that “corporate culpability depends on identifying a relevant, individual repository of fault, whose mental state can be treated as that of the corporation.” This runs headlong into the problem of “diffused responsibility,” whereby no one person seems accountable for witnessed organizational behavior, as there is no single “directing mind and will” to be found driving such.

“Faced with the clear inequity of this individuated approach, and likely personal ignorance of senior corporate officers of the details of automated

processes,” Professor Bant tells us, “courts and juries are much more likely to accept corporate pleas of ‘systems errors’ and ‘administrative mistake’.”

With reference to the Hayne Commission discussed earlier, Bant argues that the bank executives called before the Commission were only too happy to admit to “quite astounding organisational incompetence rather than dishonesty or, in everyday parlance, theft,” she writes. “Directors typically drew attention to the fact that their employees were individually honest and

hardworking, while senior leadership were personally unaware of the problems generated ‘by the system’.” Colloquially perhaps, this is the ‘shit happens’ defence.

Consistent with the systems intentionality perspective, the “adoption of corporate practices that ensure that ‘bad news does not travel upward’, may legitimately be understood as an intrinsic part of a system’s overall design and reflecting active corporate choice,” Professor Bant explains. “Systems Intentionality proposes that the everyday (real-life) systems of conduct, policies and practices of a corporation ‘manifest’ its mental states, both in the sense of revealing and instantiating them.”

In sum, systems produce the outcomes they’re intentionally designed to produce. “Lacking natural minds, corporations think through their systems of conduct, policies and practices,” Professor Bant argues. And, as such, “corporate automated systems often loudly declare the corporate values, intentions and knowledge” at work in an organization. Moreover, “Default settings of an automated system manifest corporate choices” for which corporate officers can be rightly held to account, Professor Bant concludes.

When testing for the root causes of risk governance failures, we must examine character as well as context, we must recognize that culture informs and reflects both, and we must acknowledge that

Lacking natural minds, corporations think through their systems of conduct, policies and practices.

ELISE BANT

both are manifested through the systems by which organizations operate to produce outcomes. This is true of firms and, as Wayne Byres rightly highlights here, there is no reason to believe that it is not also true of supervisory agencies.

To paraphrase Professor Bant, lacking natural minds, supervisory agencies ‘think’ through their “systems of conduct, their policies, and their practices.” Therefore, when these appear to operate perpetually from the back-foot, this may be taken as manifesting an intrinsic aspect of a supervisory system’s intentionality, and reflective of active choice. Colloquially perhaps, this is the “shit happens by design” condemnation.

Whether reflecting active choice or passive acceptance, it is precisely this ‘systems intentionality’ that so many contributors to this report appear to be calling out, and which the turmoil of ‘23 has served to highlight. The rush since to technocratic measures that emphasize capital and liquidity over the more difficult and more meaningful change implied by examining supervisory culture shows a system rushing to defend its status quo.

As cited above, Andrea Enria summarizes that status quo neatly: “All the banks that failed during the turmoil of the spring 2023 shared major weaknesses in risk management, internal governance and culture,” he writes, “and the supervisors have not always been able to promptly identify shortcomings and, especially, drive prompt remediation.” The question that must occupy us today is, why? And it is to this that we turn next.

The tone from the top may be important, but it’s faint.



Source: Dall-E

ENIGMA MACHINES

In management and supervisory circles alike, the settled view holds that the proverbial ‘tone from the top’ is of paramount importance in determining an organization’s culture. Examples of this prioritization abound. But a fascinating 2021 academic paper challenges this view, and argues that efforts to identify the cultural drivers of organizational performance should in fact run in the other direction.

In “Tone at the Bottom: Measuring Corporate Misconduct Risk from the Text of Employee Reviews,” academic researchers find that the culture of an organization is less so a matter of what the top says it is, and more so a matter of the lived experience among those lower down. As such, “inside information on the incidence of misconduct, as well as the control environments and broader organizational cultures that contribute to its occurrence, are likely to be widespread among employees.”⁶⁸ The view from the top is usually more myopic.

Certainly, this is why whistleblower hotlines have become *de rigueur* and why post-crisis investigations start with broad-based interviews among rank-and-file staff. But what is interesting about this paper is the method by which researchers sought, and found, reliable tell-tale signs of corporate culture challenges that result in supervisory smudge: using “text-based statistical methods applied to employee reviews left on the website Glsdoor.com,” the researchers found that “information extracted from such text can be used to develop measures that clearly separate high and low misconduct risk firms.”

The tone from the top may be important, but it’s faint. The echo from the bottom is both louder and of greater diagnostic value: the researchers also found that their text-based measures of misconduct risk are positively correlated with future employee whistleblower complaints. That is, the metrics these methods afford can equip us with *leading indicators* of future trouble, thus permitting for proactive corrective interventions.

Such studies excite the imagination: one could imagine IHC’s Aiden Insight, for instance, being tasked with running this sort of analysis, and thus enabling human board members and C-suite officers to identify and mitigate conduct risks before they erupt into frontpage news. There is value in this worth exploring.

But tools that afford more rapid identification and assessment of statistical correlations still don’t tell us *why* particular cultural or behavioral proclivities prevail in an organization, from whence they stem, nor how best they are to be curtailed. For this, we need a better understanding of the subject matter at hand: humans.

Looking through a behavioural risk lens means looking at an organisation as a social system.

MIREA RAAIJMAKERS

Applying behavioral science

Despite a series of high-profile replicability challenges and the alleged falsification of data that has called a number of studies into question, the last decade has seen widespread recognition that behavioral science can support improved policymaking, governance, management, and operations across a broad domain.

“Behavioural science refers to an evidence-based understanding of how people actually behave, make decisions and respond to programmes, policies, and incentives,” reads the UN Secretary

General’s Guidance Note on the topic. “It enables us to diagnose barriers preventing people from adopting a certain behaviour, understand enablers that help people achieve their aims, and design more impactful interventions.”⁶⁹

A 2021 “Behavioural Science Report,”⁷⁰ produced by the UN Innovation Network, expands: “Behavioural science places a focus on how people interact with their environment and is grounded in empirical work from a variety of disciplines, including psychology and economics. It applies rigorous scientific methods to derive insights, some of them surprising, on the common patterns and drivers of human behaviour.” The report argues that behavioral science can help to improve outcomes by facilitating a better understanding of:

- the barriers that prevent people from engaging in or following through with their intended actions;
- the enablers that assist people in establishing and achieving their goals; and
- the impact of interventions based on an understanding of those barriers and enablers.

This may benefit national security interests. A 2019 decadal survey of the behavioral science literature, from the National Academies of Sciences, Engineering, and Medicine, concludes that “Social and

behavioral science research offers a fundamental—indeed essential—contribution to the mission of the [Intelligence Community],” described as one “that requires understanding of what human beings do, how, and why.”⁷¹

Bank regulators, too, have found value in the application of behavioral science to their supervisory functions.

As we have discussed in detail throughout this series of reports, the Dutch central bank (DNB) was an early pioneer in exploring how behavioral science might help to improve supervisory efficacy. “For banks to take their role as a gatekeeper of the financial system seriously, managing behavioural risk is a must,” argues Mireia Raaijmakers,⁷² the organizational psychologist who led much of the DNB’s work in this direction.

“But behavioural risk is a rather complex problem requiring a multidisciplinary approach drawing on tools and disciplines from outside the financial industry,” Raaijmakers reminds.⁷³ “Looking through a behavioural risk lens means looking at an organisation as a social system,” she instructs.

Echoing Elizabeth McCaul’s remarks in the Preamble to this report, Raaijmakers calls attention to both the *formal* drivers of behavior, with reference to “the structural, more tangible side of the organisation — i.e., how it is set out on paper,” and the *informal* drivers of behavior, with reference to “the intangible side of an organization — i.e., how people work together in practice.”

Formal structural drivers of organizational conduct include the familiar *inputs* to risk and compliance infrastructures, captured in org-charts, job descriptions, functional hierarchies, standard operating procedures, KPIs and compensation incentive schemes. It is here that the DOJ’s guidance on root cause analysis begins.

The informal — *yet nevertheless structural* — elements that shape behavioral predilections in an organization are seen in daily *practices*. Inquiry in this direction must look to things like social relationships, perceptions of work climate, and the beliefs and values that people share with each other and with their organization.

We have far more cultural instincts, as it happens, than we do biological ones.

CHRISTOPHER COKER

With this in mind, Raaijmakers sets out four guiding principles for applying behavioral science in the context of behavioral risk management, emphasizing the recognition that: (1) behavior occurs in a social context, (2) systematic patterns of conduct are of

greater interest than individual actions; (3) successful behavior change depends on first developing an understanding of the underlying socio-structural drivers of behavior, and (4) developing such an understanding necessarily involves a mix of qualitative and quantitative measures.

Dr. Raaijmakers has successfully demonstrated the value of such an approach, in both the supervisory process she helped to design at the DNB, and in the governance context while serving as the Global Head of Behavioral Risk Management with Dutch bank ING. Yet her example remains the industry exception rather than the rule.

“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,” head of the NY Fed’s culture program James Hennessy mused in a speech one year prior to the turmoil of ‘23.⁷⁴

“Most firms have departments to address all kinds of other risks,” Hennessy noted, “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."

Ignoring evolutionary science

"Practical men, who believe themselves to be quite exempt from any intellectual influences," Keynes famously remarked, "are usually the slaves of some defunct economist." But we' be better off listening to evolutionary biologists.

"We have far more cultural instincts, as it happens, than we do biological ones," my dear friend and teacher Christopher Coker observed in his last published work, cited in the Dedication hereto.⁷⁵ As in so many other things, Christopher was right also in this. But, as he would have appreciated, these cultural instincts reflect the *natural* logic of our underlying biology.

Indeed, how could it be otherwise? The relentless efficiency of natural selection has expunged any cultural predilections that may once have run counter to our biological imperatives, as several contributors to this report highlight in remarks that ground behavioral science in the natural science upon which it is predicated.



Kevin Lala

"In recent years, behavioural science has fallen into disrepute," **Kevin Lala**, a Professor of Behavioural and Evolutionary Biology at the University of St. Andrews writes in one of the many essays from **The Academy** offered here. ▶ **PAGE 393** "There are many reasons for this," Lala suggests, "but one important consideration is a failure to build on the correct biological foundations."

You can't get the social science right without the right evolutionary theory.

KEVIN LALA

Human minds were not just built for culture, they were built by culture.

KEVIN LALA

"Scholars in fields such as economics, anthropology, and sociology have paid scant attention to evolutionary biology," Lala complains, warning "you can't get the social science right without the right evolutionary theory."

Asked to apply this thinking to the matters under reflection in this report, Lala offers us this: "To most readers, the 2023 banking turmoil will seem a million miles from the study of evolutionary biology. Yet, much like banking sector supervisory policies, evolutionary theory is currently undergoing something of a revamp, as biologists come to terms with a rush of striking findings that challenge the orthodox narrative."

Only recently has the field of evolutionary biology "matured to the point that it can do justice to the richness of human social behaviour," Professor Lala writes. "For social scientists in economics, business or management science," he laments, "current understanding remains dominated by a 'rational actor' conception of human behaviour, in which individuals are envisaged to be almost exclusively motivated by personal financial gain." This understanding is outmoded. "Personal gain remains a driver of human behaviour, but such motives are frequently overridden by the requirement to comply with institutional norms," Professor Lala argues.

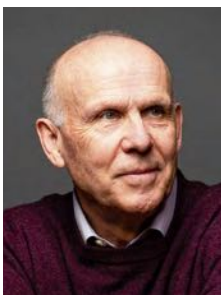
"Almost all human learning is socially guided and set in a social context," Lala explains, "and that is also likely to have been the case for our hominin ancestors for millions of years." Through such social learning — or 'culture' — groups of animals are enabled to adjust their behavior to the demands of their environment. Crucially, this includes the demands of their *social* environment.

“Culture is not something that separates humans from nature, it is a critical part of our nature,” Lala writes in *Darwin’s Unfinished Symphony: How Culture Made the Human Mind*, appearing on our [Starling Bookshelf](#).

“Human minds were not just built for culture, they were built by culture,” he argues there, as my friend Christopher Coker assuredly intended to convey with the remark cited above.

The significance of this, for Professor Lala, is profound: “Our ancestors didn’t just evolve to be suited to the world; they shaped the world,” he writes here. “The landscape of human evolution did not pre-exist us; to a large extent, we built it ourselves.” And in the course of so doing, we designed our evolutionary landscape such that it demanded compliance with social norms for behavior established by the groups to which we belong.

“At some juncture in our history, our ancestors began systematically to correct the behaviour of the individuals they taught; in the process, they shifted their society away from reliance on mere conventions and toward governance through norms,” Lala explains in *Darwin’s Unfinished Symphony*. “People stopped illustrating a way to behave and began insisting on the way to behave.” Cultural and biological evolution became intertwined.



Richard Wrangham

Some refer to this as a process of ‘self-domestication.’⁷⁶ “We can be the nastiest of species and also the nicest,” writes **Richard Wrangham**, a Harvard Professor of Biological Anthropology, in *The Goodness Paradox: The Strange Relationship Between Virtue and Violence in Human Evolution*. He

expands on this in another interview from [The Academy](#) that we feature here. **▶ PAGE 401**

Conforming socially is a survival strategy: rule-challengers and rule-breakers could all too easily end up dead.

RICHARD WRANGHAM

“To Hobbes, we are a bad species improved by experience,” Professor Wrangham reminds. “For Rousseau, we are a good species made worse by experience.” While these competing views have long seemed irreconcilable, Wrangham explains, they should instead be seen to reflect what he calls “two different scales of behavior.” We score highly on the *proactive scale* of aggression, and much lower on the *reactive scale*.

Unlike other primates, humans are far more inclined to engage in premeditated violence (Hobbesian nastiness) than we are to stumble into it reactively, when temperatures run high (Rousseauian nicety). Hence the “Goodness Paradox.” But, while seemingly at odds, these twin predilections are *complimentary capabilities* of enormous significance to our success as a species. Evolution, that is, selected for Hobbes and Rousseau both.

“Sigmund Freud labeled the primate style of male hierarchy as one based on Might, compared to the human style being based on Right,” Wrangham recalls. “For 300,000 years, then, humans have created a new kind of social world in which, at the top, Right has replaced Might.”

What Wrangham calls ‘right’ in this context reflects the power of the community over the ‘might’ that may be wielded by an individual. “Human societies are led by coalitions. Primate societies are led by single individuals,” Wrangham informs us. “The shift from Might to Right was a huge part of what gives human social groups their especially human quality,” he continues. Might alone is no longer sufficient for rule, “even for a Stalin or a Hitler,” Wrangham claims. “Human leaders cannot survive without supporters.” **▶ PAGE 421**

The ability to build and sustain such support made curtailing our past tendency towards reactive violence a matter of evolutionary priority. Even the biggest

bully can be brought low by a coalition of weaker peers, so a greater ability to coordinate behavior with co-conspirators became evolutionarily advantageous. In turn, this put a premium on conforming to group norms for behavior. Those who would deviate from such norms faced ostracism, and reduced survival likelihood. “Conforming socially is a survival strategy: rule-challengers and rule-breakers could all too easily end up dead,” Wrangham puts it starkly. And, so, we ‘go along to get along.’

“Morality might feel pure and cooperative,” Wrangham writes. “But it has a dark side that comes from a time when those who were immoral were less likely to pass on their genes, because they would have been killed for the crime of non-conformity,” he contends. “In the end, we became creatures who care immensely about belonging to our social group, both in our own self-perception as well as in the perceptions of others.”

This ancient evolutionary history has implications for the management of any modern organization. Fear of capital punishment may not operate as an obvious motivator of workplace conduct, and this may lead us to believe that the evolutionary dynamic Wrangham describes is irrelevant to contemporary social organizations. “But that idea would be wrong,” he insists. “Although execution is increasingly confined to the past, its long practice has produced a species in which the need to belong is a hugely important driver.”

As such, “managers will forever have to take the need to belong into account, if they are to successfully juggle their workers’ deep psychological needs with their company’s goals,” professor Wrangham advises.

The needs of regulatory agencies can and should help to drive future behavioral research efforts.

DR. TERRI PATTERSON

“Social belongingness is an important aspect of human behavior and drives the cultural norms on which we all rely,” former FBI psychologist Dr. Terri Patterson agrees. “When we are considering how human behavior has evolved over time, the strong drive to belong, as laid out by Richard Wrangham here, has been critical to the establishment of institutions, traditions, etc.,” she maintains.

“There are so many fascinating ways this research can inform policy and regulation — even beyond the assessment of risk,” Dr. Patterson argues. “This knowledge base should be utilized not only to inform regulatory practices,” she urges, “but the needs of regulatory agencies can and should help to drive future behavioral research efforts.”



Paul Seabright

“We don’t have to stay stuck in armchair philosophizing!” exclaims economist **Paul Seabright** in yet another interview from **The Academy** featuring here. ▶PAGE 409 “Like all group-living primates, human beings respond to explicit threats and promises in their social

environments, but also to signals of esteem,” he writes. “People will do wonderful and terrible things to achieve the esteem of others.”

People will make much bigger sacrifices for the esteem of others than for mere money.

PAUL SEABRIGHT

This realization, supported by the deeper learnings from the natural sciences recounted here, should inform our work in the social sciences, and this includes management science.

“I think of social rules as descriptions of how appropriate behavior will be rewarded by both respect and esteem,” Seabright writes, pointing to a different avenue by which to incentivize behavior than that which features in the thinking of most orthodox

economists. “The truly scarce resource is esteem, and you can’t buy that, at least not in the market,” he observes. “People will make much bigger sacrifices for the esteem of others than for mere money.”

Trust & belonging

“Life in human social groups is regulated by social norms that go beyond cooperation,” writes Harvard professor of evolutionary biology **Joseph Henrich** in another of the works featured on the **Starling Bookshelf** this year, *Why Humans Cooperate: A Cultural and Evolutionary Explanation*.

“Many behaviors are cultural in that they are socially learned by observation and interaction in a social group,” Henrich explains. “Social learning can then be understood as the foundational capacity that underpins what is typically glossed as ‘culture’,” he continues, explaining that “both purely genetic and culture-gene interactions have shaped human social psychology such that people cooperate, help, trust, and punish in highly patterned and often contextually specific ways.” Our behavioral tendencies, that is, follow social rules — predictably.

Appearing alongside Henrich on the **Starling Bookshelf** is Professor Harvey Whitehouse, Chair of Social Anthropology at Oxford’s Magdalen College. “From infancy, we copy those around us in order to be like others, to be one with the tribe,” he explains in *The Ritual Animal: Imitation and Cohesion in the Evolution of Social Complexity*. “The ritual animal longs to belong.”

“Other primates will copy behaviour that leads to transparent benefits,” Whitehouse observes, “but only humans promiscuously copy actions that have no instrumental purpose.” The principal motivator of such mimicry is “the desire to affiliate,” Whitehouse explains, “and we imitate with higher fidelity when

ostracism threats are cued, apparently as a re-inclusion behaviour.” Mutual trust is the central imperative here.

“There’s no team without trust,” Google executive Paul Santagata is quoted as observing in a 2017 *Harvard Business Review* article.⁷⁷ Key to such is a workplace culture that promotes psychological safety and a sense of belonging which both contributes to and demonstrates an atmosphere of established mutual trust.

Consider the illustration of French luxury group Hermès, which soared to the top of the 2021 *Financial Times*’ rankings for diversity and inclusion through a focus on belonging.⁷⁸ And contrast that with findings reported in a 2023 study by Deloitte, revealing that most US workers felt it necessary to ‘cover’ their identities at work.⁷⁹

Among those surveyed in the Deloitte study, 60% reported that the need to cover their identities both damaged their sense of well-being and left them feeling emotionally drained. Some 56% said that this negatively impacted their commitment to their organization

(unsurprisingly), while 58% said they felt it necessary to ‘mirror’ the behavior of certain others if they were to be perceived of as being ‘professional’ — putting testament to the evolutionary dynamics described above: conform, or else...

With this in view, Professor Seabright highlights a grave concern for leaders contending with toxic workplace cultures, and for those who have suffered by such toxicity.

“A toxic workplace culture creates a demand for protection, and those who supply that protection, even if they begin with noble motives, come to be exposed in turn to an awareness of how easy it might be to exploit the weakness of those they are protecting.” As a consequence, he warns, “It’s

Many behaviors are cultural in that they are socially learned by observation and interaction in a social group.

JOSEPH HENRICH

precisely the people that protect us from abuses by others who leave us most vulnerable to abuse at their own hands.”

“After all, in protecting us,” he explains, these same people “come to have an intimate understanding of our weaknesses.” This has troubling implications for organizations where leadership itself is seen to have contributed to the toxicity that leaves employees injured, even and perhaps especially where such leadership seeks to make amends and to lead corrective change efforts. “It illustrates how careful organizations must be when they are trying to act to clean up a culture of abuse,” Seabright cautions.

“If you’ve been a victim once, you have an entirely reasonable need for help,” Seabright warns, “And your helpers are, statistically, the people most likely to make a victim of you again.” While perhaps non-obvious at first, this makes sense once we’re made aware of it, and it returns our attention to psychological safety and workplace cultures that promote a readiness to speak out about concerns — and those that fail to do so.

“Cultures of secrecy (where some people have information that others don’t) and cultures of silence (where everyone knows what is happening, but it is taboo to talk about it) are damaging in very similar ways across a vast range of organizations in a wide variety of sectors,” Seabright regrets.

In a new book we feature on the **Starling Bookshelf**, *The Divine Economy: How Religions Compete for Wealth, Power and People*, Seabright discusses how the evolutionary drive for belonging plays out in organized religion.

Perhaps more so than almost any other organization, “Religion is about belief and about belonging,” he writes. But there is a parallel that deserves note. “Religious movements are a special kind of business—they are platforms,” Seabright suggests. Platforms, as

he describes them, “are organizations that facilitate relationships that could not form, or could not function as effectively, in the platforms’ absence.”

Once formed and once joined, we will conform our conduct so as to remain welcome among our platform peers. Notably, that may include remaining silent regarding the rules of membership: ‘the first rule of Fight Club is you do not talk about Fight Club.’ Hence the development of cultures of secrecy and silence.



Langley Sharp

Military organizations offer another profound example of platforms that compel our allegiance, and in a deeply thoughtful **Peer Perspectives** essay featured here, **Lieutenant Colonel (Retd.) Langley Sharp** offers views curated through his time directing the UK’s Centre for

Army Leadership. **▶ PAGE 141** “Having served in the British Army for 23 years, including a further 8 operational tours and almost a decade with special forces,” Lt. Col. Sharp writes, “I have reflected at length on what drives individuals and teams to high performance.”

In short, we are hard-wired to belong.

LANGLEY SHARP

“Stripped to its essentials,” he offers, “the answer so often lies in the intricate social dynamics between leaders and followers in pursuit of a shared objective, for success is a collective endeavor.”

After 400 years as a standing fighting force, the British Army decided to codify its views on leadership, and Lt. Col. Sharp was tasked with the production of that final work — *The Habit of Excellence: Why British Army Leadership Works*, another item that features on our **Starling Bookshelf** this year.

“Leadership,” he offers there, “is best understood as a human endeavour whose central concerns are to influence the individual and mould the collective in service of the ultimate mission.” It is expressed most

meaningfully through “an accumulation of countless small choices, interventions and demonstrations that set the example required to uphold standards and drive performance,” he writes.

“To set an example is both the most obvious function of leadership and one of the most important.” But this work on leadership inspired in Lt. Col. Sharp a still greater appreciation for the corollary value of *followership*.

“As defined in the British Army’s recently published Doctrine Note,” he writes here, “followership is, ‘the act of an individual or individuals willingly accepting the influence of others to achieve a shared outcome’.” Key to this idea is recognizing that followership is a choice. “But if followership is a choice, one that requires the ‘willing acceptance’ of a leader’s influence, what compels one to follow?” Sharp asks.

Here again, we are pointed to the importance of belonging. The mindset of belonging as it operates among special forces soldiers, Sharp describes, is “matched by an intense pride in their tribe and trust in one another.” This, in turn, “enables tenacity and endurance in the face of the most complex of challenges.” The result, he suggests, “is a force-multiplying effect, far in excess of the sum of its parts.”

“In short,” Lt. Col. Sharp argues, “we are hard-wired to belong.” And that belonging is experienced through our social networks. These may operate to bring out the best in us, and they may bring out the worst. Light or dark depends on the cultural commandments to which we’re compelled to conform.

So where do these come from?

Networks

“Social networks permeate our social and economic lives,” Stanford economist Matthew O. Jackson writes in another of the works featured on our

Starling Bookshelf, *Social and Economic Networks*.

“The countless ways in which network structures affect our well-being,” he writes, “make it critical to understand (1) how social network structures affect behavior and (2) which network structures are likely to emerge in a society.”

“Peers exert enormous influence on human behavior,” Jackson reminds. “It is easy to cite examples, ranging from the products we buy, whether we engage in criminal activities, how much education we pursue, to which profession we choose.” As such, the influence of our peer networks warrants attention.

“The perception of social networks begins as soon as an individual enters a new organizational context,” writes David Krackhardt, Professor of Organizations at the Carnegie Mellon University’s Heinz College of Information Systems and Public Policy, in yet another of the works on our **Starling Bookshelf**, *Interpersonal Networks in Organizations: Cognition, Personality, Dynamics, and Culture*.

To be an effective leader of a social unit, Krackhardt advises, is thus to be aware of:

- a. the relations between actors in that unit;
- b. the extent to which such relationships involve embedded ties including kinship and friendship;
- c. the extent to which social entrepreneurs are extracting value from their personal networks to facilitate or frustrate organizational goals; and
- d. the extent to which the social structure of the unit includes cleavages between different factions.

Yet, “Even as we talk incessantly about them,” the economic historian Niall Ferguson writes in another of the items on offer on the **Starling Bookshelf**, *The Square and the Tower: Networks and Power, from the Freemasons to Facebook*, “the reality is that most of us have only a very limited understanding of how networks function, and almost no knowledge of where they came from.”

“We largely overlook how widespread they are in the natural world, what a key role they have played in our evolution as a species, and how integral a part of the human past they have been,” Ferguson criticizes. He points here to the significance of this for the historian. “Often, the biggest changes in history are the achievements of thinly-documented, informally organized groups of people,” Ferguson writes. “For the historian, then, the insights of network theory, in all its forms, have profound implications.”

Also on our [Starling Bookshelf](#), in *Forging Capitalism: Rogues, Swindlers, Frauds, and the Rise of Modern Finance*, the Carnegie Endowment’s Ian Klaus explains how trust networks shaped the history of the 18th century. “If new forms of finance, commerce, and risk management were essential to [18th century] capitalism’s vitality,” he writes, “new forms of trust were needed to safeguard that vitality in a world of strangers and speed.”

“Trust, to be simple with our definition, is an expectation of behavior built upon norms and cultural habits,” Klaus stipulates, “It is often dependent upon a shared set of ethics or values,” he allows but, perhaps of greater importance, “It is also a process orchestrated through communities and institutions.” Any attempt to chronicle the history of vice and capitalism, therefore, “must also be a study of trust — or at least its absence.”

What these authors collectively emphasize and illustrate is that social and economic networks can and do form spontaneously. Once established, they serve as platforms that facilitate collective action towards the shared aims of their members, and they assert rules for membership that demand normative compliance under threat of ostracism — being ‘deplatformed’ or ‘canceled,’ in today’s common parlance.

Of critical significance here, while these platforms may feature individuals of particularly marked influence, it is regularly the case that no one single

individual ‘controls’ the platform. This presents an accountability problem for those who would seek out linear, top-down chains of command: when everyone is responsible, no one is.

And of further, critical significance, these diaphanous structures can and do challenge more concrete powers.



Emily Erikson

In another of the works pulled from the [Starling Bookshelf](#), *Trade and Nation: How Companies and Politics Reshaped Economic Thought*, Yale Professor **Emily Erikson** describes how inchoate groups of merchant-writers successfully challenged the power of the 17th century crown and ruling classes through the promulgation of competing ideas popularized by their writings. Again, this was an organic, largely leaderless phenomenon.

In the medieval era, writings that today might be filed under ‘economics’ struck an overtly religious and moral tone. In hopes of persuading the crown and 17th century nobility to adopt policies favored by the politically powerless merchant class, merchant-writers began to couch their arguments in terms of ‘productivity’ and ‘economic growth’ that would generate returns to the benefit the political classes. These writings, which in time would form the basis of today’s orthodox economics, were successful in shifting policy and practice.

“For a reader familiar with the economic literature two centuries prior to the publication of *The Wealth of Nations*,” Erikson writes, “what is most striking about Smith was his reincorporation of philosophical and moral concerns into a literature on trade that had largely left these matters by the wayside.”

More overtly so in his *Theory of Moral Sentiments*, Smith “was trying to reintroduce the moral framework of justice, equity, and benevolence that had

dominated the literature in the medieval era but had been discarded by seventeenth-century merchant authors," Erikson suggests.

Smith, that is, was pushing back on the network effects achieved by a loosely organized platform of merchant authors who successfully shifted the established political powers of their day.⁸⁰

Erikson brings this story to life fascinatingly, describing how machine learning tools and social network analytics helped to identify 17th century merchant class "influencers," as we might describe them today, and to visualize their patterns of connectedness and the 'contagion effects' inspired by their writings. It's a brilliant application of modern computing power to otherwise largely inscrutable historical forces of tremendous continuing significance: these ideas are with us still, discernably shaping contemporary economic debates.

In another of the essays from **The Academy** that features here, Professor Erikson provides further illustration of how these methodologies can make 'intangible' forces — like Smith's "Invisible Hand" — scrutable. ► **PAGE 415** "The division of labor remains a primary engine of economic growth and central to firm productivity," she writes. It is therefore important to ask, "do we have to rely entirely upon an invisible hand to bring it about?"

"Smith conceptualized the division of labor as a problem of decentralization — the original 'emergent effect' — a mysterious, heavenly harmony produced as if 'led by an invisible hand'," Erikson writes here. But with the availability of today's data and computing power, the sinews and workings of this invisible hand are made visible and, more significantly, Erikson shows that they can even be directed.

"By using our newly achieved understandings of network structure and culture, we can create environments that encourage the creation of effective and diversified teams," Erikson argues enticingly. The

invisible hand, that is, can be tipped. And this should immediately fire the imagination of anyone interested in discovering how 'invisible' and 'intangible' organizational cultural dynamics can be made visible and operable.

Emergence

"How Is Flocking Like Computing?" Cornell mathematician Steven Strogatz⁸¹ asks in an article/interview that appeared in March this year.⁸² "Birds flock. Locusts swarm. Fish school," he observes. "Within assemblies of organisms that seem as though they could get chaotic, order somehow emerges."

In yet another item that appears on this year's **Starling Bookshelf**, *Sync: The Emerging Science of Spontaneous Order*, Strogatz stirs a compelling sense of mystery. "For reasons we don't yet understand," he writes, "the tendency to synchronize is one of the most pervasive drives in the universe, extending from atoms to animals, from people to planets..." On the surface, Strogatz allows, these various phenomena may seem unrelated. But he finds in them a deeper connection — "one that transcends the details of any particular mechanism."

Perhaps unsurprisingly for a deeply studied mathematician, for Strogatz, that connection is mathematics. "All the examples are variations on the same mathematical theme," he writes, "self-organization; the spontaneous emergence of order out of chaos." These diverse phenomena are guided, as it were, by some invisible hand.

The example of a flock of birds (starlings, no less) is cited again in a 2022 article summarizing research into the nature of human behavior across online social media.⁸³ As long ago as 2010, Yale's Nicholas Christakis⁸⁴ and his co-author, the University of California (San Diego) Professor James Fowler, observed that cooperative behavior "cascades" in social networks, in another example of the spontaneous order that Strogatz describes.⁸⁵

To illustrate, even as I type, the management of the trading platform, E*Trade, is forced to contemplate 'deplatforming' so-called 'meme-stock' leader, Keith Gill — better known to his legion of followers on social news platform Reddit⁸⁶ as 'Roaring Kitty.'⁸⁷ Such is his influence that Gill appears able to move markets in a manner that E*Trade (and its owner Morgan Stanley) fear may constitute illegal market manipulation.

In yet another example, a *Harvard Business Review* article explains that "hidden teams" in the workplace, not appearing on formal org charts, may in fact have the greatest impact on company performance outcomes.⁸⁸ Depending on the degree of social connectedness and *informal* influence enjoyed across a workplace social network, even one employee can drive group dynamics in undesired directions, the authors argue.⁸⁹

Computational Social Science



Michael Muthukrishna

"The forces that shape our thinking, our economies, and our societies have become invisible to us," London School of Economics Professor **Michael Muthukrishna** laments in another of the works appearing on the **Starling Bookshelf** this year, *A Theory of Everyone: The New Science of Who We Are, How We Got Here, and Where We're Going*. "If we cannot perceive the forces that shape us, we are impotent to shape these forces."

To make these invisible forces operable, "we need a kind of corrective lens," Muthukrishna offers here in an interview from **The Academy**. ▶ **PAGE 445**
"One "that allows us to go back to first principles, understand how our societies and companies have evolved, and how human psychology, behavior, and culture work."

Fortunately, we now possess what Professor Muthukrishna calls a Theory of Human Behavior, "a set of mathematical and computational models that can explain the principles by which we operate and how our organizations and communities evolve." This can inform our efforts to make invisible social forces tractable.

If we cannot
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shape these forces.

MICHAEL
MUTHUKRISHNA

"A scientific revolution is starting to bring order to the chaotic world of human affairs," Muthukrishna offers in his *Theory of Everyone*. As a species, we may be difficult to predict, "but at least we now know the rules by which we work," he writes. "We know the rules that govern how people decide whom to trust and learn from," and

"we can use these rules to improve ourselves, our technologies, our governments, companies, schools, and societies; to develop strategies, policies, and interventions — social technologies — to chart a better future."

As science goes through what Muthukrishna describes as puberty, these newly available social technologies mature, "moving from alchemy to chemistry," as he puts it. "Norms, institutions, culture, past experience, and the way people aggregate that social information under conditions of ambiguity, different sized majorities, different prizes, punishments, other incentives and more," he writes here, "can all now be mathematically described and then used to predict overall future patterns of expected behavior."

At surface this may seem a remarkable claim. But when we recognize that human behavior follows a certain *logic* — described in the immediately preceding segments of this report, with their depiction of learnings from the natural and behavioral sciences — then it should not be too much of a stretch to imagine that these well-studied human behavioral tendencies might leave artifacts visible within easily

available data sets. Nor is it hard to imagine that these digital markers will reflect our social tendencies towards conformity with group norms.⁹⁰

“Our psychology seeks out rules and patterns and much of what we know is implicit,” Muthukrishna writes. “You don’t even realize what you know and how that shapes your behavior,” he explains, suggesting that it’s all a bit like how we learn informal rules of grammar. “In school you were taught explicit rules,” he reminds, “but those just expose some aspects of grammar,” he suggests here. “Much of the grammar you use is implicit.”

Muthukrishna offers this compelling example. “In English there is a rule about the order of words, that you don’t even know that you know,” he writes. “It goes like this: opinion-size-age-shape-color-origin-material-purpose noun. So, you can have a lovely little old rectangular green French silver whittling knife,” he offers.

“But, if you’re a native English speaker, try moving adjectives around and it just sounds off: a green French old little lovely silver rectangular whittling knife — ugh!” While perhaps ignorant of the formal rules by which the language is meant to be used, the latter formulation simply *feels* wrong to native English-speakers, for reasons they may find hard to articulate, and it is entirely *predictable* that we will shift to adopt the correct grammar without knowing why. We can’t always *explain* the rules we keep, but we keep them, nonetheless.

Computational social science now allows us to study these unconscious behavioral inclinations, cascading social dynamics, and the spontaneously emergent group properties they evoke.

Researchers have shown, for instance, that a small number of police draw the greatest concentration of public complaints, reflecting peer influence on

police misconduct.⁹¹ And whether such misconduct is called out, or simply endured, reflects discernable socio-structural dynamics that also now yield to scientific inquiry.⁹²

In another of the works featured on the **Starling Bookshelf**, Duncan Watts, Director of the University of Pennsylvania’s Computational Social Science Lab, expands on these ideas.

Our psychology seeks out rules and patterns and much of what we know is implicit.

MICHAEL MUTHUKRISHNA

“Whether we are aware of it or not, we rarely, if ever, make decisions completely independently and in isolation,” he writes in *Six Degrees: The Science of a Connected Age*. “When push comes to shove,” Watts reminds, “humans are fundamentally social creatures, and to ignore the role of social information in human decision making — to ignore the

role of externalities — is to misconstrue the process by which we come to do the things we do.”⁹³ Lurking in the background at all points is the social network, Watts emphasizes, “that ubiquitous web of signals and interactions through which the influence of one person passes to another.”

Perhaps most often, we do the things that we do in order to conform with group norms — to belong.

“We need to develop new tools and institutions for collectively perceiving and shaping these [social] forces, rather than being passively molded by them,” Michael Muthukrishna argues in his *Theory of Everyone*. “Only by making the invisible visible can we hope to steer our cultural evolution.”

“Imagine a world where we understand the intricate but ‘invisible’ rules that govern human behavior and the evolution of our companies and societies,” Muthukrishna implores. “This is no longer a distant dream, but a reality made possible by one of the biggest breakthroughs of the last few decades, achieved at the crossroads of human evolutionary biology and social science.”

Today, researchers can gather highly accurate information about likely behavioral trends and group dynamics by asking about the social circles to which we belong rather than interrogating individual beliefs, scientists at the Santa Fe Institute report.⁹⁴ And by harnessing “new computational models of human social dynamics,” we can identify trends and predict a range of outcomes. These capabilities allow us to devise interventions that “could steer social systems in different directions,” they suggest.



The science of “collective behavior,” a 2021 academic journal article explains, “focuses on the study of individuals in the context of how they influence and are influenced by others.”⁹⁵ Computational social science advances our study of collective behavior by providing us with “a framework for understanding how the actions and properties of groups emerge from the way individuals generate and share information,” the authors argue.

And these tools are set to become more and more powerful. “As our societies are increasingly instantiated in digital form, once-mathematical abstractions of social processes — networks are one prominent example — become very real parts of daily life,” they continue. “These changes present new challenges, as well as opportunities for measurement and intervention.”

“Across disciplines, a host of interrelated models of information and behavior transmission have been developed, including complex contagion

(computational social science), conformity (psychology, evolutionary anthropology), majority rule (political science, statistical physics), uses and gratifications (communication), and frequency-dependent learning (animal behavior),” the authors note.

“Virtually all of these models exhibit strong dependence on network structure,” they observe, and this renders them scrutable through machine powered network analytics and other tools of computational social science.

This line of study and innovation should be prioritized as a “crisis discipline,” these authors argue — resourced in a manner one par with the approach we bring to global challenges like climate change — “with a focus on providing actionable insight to policymakers and regulators for the stewardship of social systems.”

Predict & Prevent

“The speed of the bank runs in the spring of 2023 was unprecedented,” the Fed’s Vice Chair for Supervision fretted in a December 2023 speech.⁹⁶ “What occurred in two or three weeks or, in some cases, many months in previous episodes may, in the modern era, now occur in hours.”

Moving forward, supervisors will have to keep pace. Alas, “Broadly speaking,” NY Superintendent Adrienne Harris observes in her interview here, “financial regulators have proven to be effective at implementing policies and requirements that address yesterday’s problems.”

This sense of too-little-too-late is sounded by several other contributors to this report. Former Dubai FSA chief Bryan Stirewalt points to the backward stance that characterizes much of supervision as currently conducted. “Assessments of management should serve as a leading indicator of expected results, not a trailing indicator of obvious problems,” he writes

here. Yet “Often management is downgraded to ‘poor’ by bank examiners only after the symptoms of bad management have manifested in weak financial results.”

Stirewalt cites a 2018 speech by Andrew Bailey, then chief of the UK’s FCA, who said “As supervisors our objective is to prevent misconduct, not just clear up the messes when they happen.” Much as they might wish to guarantee good conduct across the industry at all times, this is of course not realistic. However, Bailey said, “we do expect to act to pre-empt and anticipate poor conduct, and society has a right to expect this.”

Echoing this view, former head of the Australia’s APRA and a past Secretary General of the BCBS, Wayne Byres, argues here that, “Prudential supervision is needed to fulfil the goal of being anticipative and preventative — that is, heading off small problems before they become big ones.” As such, supervision “needs to be sceptical, questioning, forward-looking, and proactive.”

Byres’ successor as BCBS Secretary General, Neil Esho, contributes his own relevant perspective and calls for data supports. “While supervisors bear the ultimate responsibility for implementing supervisory decisions directly with the bank, it is crucial that they are backed by specialist units that provide support in terms of risk analysis and early risk detection.” This places a premium on forward looking analytics. “Without confidence in the supporting analytics, taking difficult decisions under uncertainty will be even more challenging.”

“When you’re working on plans to prevent possible depositor panic and loss of confidence in the banking system,” APRA’s Chris Gower writes here, “you don’t

have time to pause and dissect the root causes.” The speed of modern finance is such that we cannot afford past proclivities that aimed to “detect & correct” for potentially systemic risks. Today, it is incumbent upon supervisors to craft capabilities that allow them to “predict & prevent” such risks from erupting into crises.⁹⁷

Prudential supervision is needed to fulfil the goal of being anticipative and preventative.

WAYNE BYRES

This is achievable only through the adoption of new technologies that may put supervisors on the front foot.

In another item from our **Starling Bookshelf**, *The Age of Prediction: Algorithms, AI, and the Shifting Shadows of Risk*, authors Igor Tulchinsky and Christopher Mason offer hope. “Today,

prediction can ascribe features and probabilities to each cell of an embryo, to each biochemical change in an astronaut in space, to each cancer patient, to each tendency in financial markets, to complex natural processes, and to social behavior,” they write.

Financial markets and biological phenomena share deep affinities that large amounts of data can sometimes reveal, Tulchinsky and Mason observe.

“Organization emerges from simple agent interactions and from bottom-up rather than top-down control,” they write, and computational social science tools have enabled us to study such bottom-up phenomena. In so doing, they “may be revealing the genesis of some elusive and stubborn

complexities of human behavior.” And this includes behavior of interest to bank supervisors.

In recent years, developments in artificial intelligence and machine learning have allowed for remarkable new predictive capabilities. London-based DeepMind shows an ability to predict almost precisely when it is going to rain within a 90-minute window.⁹⁸ Retinal scans now promise to spot early indicators

the finance industry and management science will be stronger if they pay attention to the lessons highlighted here.

KEVIN LALA

of Alzheimer's disease.⁹⁹ We can anticipate how the building blocks of life will assemble,¹⁰⁰ and forecast the likelihood of our deaths.¹⁰¹

Such tools are even capable of helping us to achieve greater social learning, maximizing the collaborative trait that has powered our species' rise to near unrivaled dominance.¹⁰² But if these technologies are to allow us to address cultural challenges in social systems such as the workplace and other organizational environments, then machine intelligences must themselves first be informed by learnings from the natural and behavioral sciences.

"I do believe," St. Andrews Professor Kevin Lala offers, "that the finance industry and management science will be stronger if they pay attention to the lessons highlighted here."

"Predicting human behaviour accurately requires the right evolutionary foundations," Lala adds, "And this has relevance to policymaking around behavioural risk." The deeper understandings of human behavior afforded by appreciating the normative constraints that allow collaborative social networks to form and operate "could underpin the development of more comprehensive risk-management strategies," Lala suggests, thus helping to ensure "more timely and ameliorating responses."

"Perhaps," Professor Lala suggests, "with a deeper understanding of risk management, with the establishment of the appropriate behavioural norms for individual and institutional behaviour, and with effective penalties for failures in management and regulatory systems, governance and supervision can be made more effective before crises erupt."

Banking supervision needs to harness the benefits that technology can offer.

ELIZABETH MCCAUL

SupTech

"Even if the behavior of starlings is a subject for biologists, the quantitative study of three-dimensional movements of individuals requires the kinds of analyses that can be accomplished only by physicists," Italian theoretical physicist Geogrio Parisi observes in another of the items on our **Starling Bookshelf**, *In a Flight of Starlings: The Wonders of Complex Systems*.

"When two systems have been well studied, it is possible to apply to one field the myriad results and techniques obtained in the other field," Parisi suggests. "In general, when the same formal mathematical system has two completely different physical manifestations," he writes "you can use physics insights from both systems to obtain valuable complementary information."

As we have seen here, mathematician Steven Strogatz, network scientist Duncan Watts, and economic psychologist Michael Muthukrishna collectively find that human social systems follow many of the 'rules' that govern other systems — "extending from atoms to animals," at Strogatz puts it.

In another item drawn from the **Starling Bookshelf**, *Computational Leadership: Connecting Behavioral Science and Technology to Optimize Decision-Making and Increase Profits*, Harvard researcher Brian Spisak applies these ideas to argue for a form of "computational leadership science."

The days of purely intuitive decisions are over," he argues. "Business and society [are] on the cusp of a shift where *all* aspects of leadership ... are overhauled through the application of computational methods, including AI, network analysis, predictive modeling, and simulations."

“In my view, a robust supervisory assessment needs to be the outcome of a balanced blend of quantitative indicators, supervisory judgment, and peer comparisons, and this applies also in the area of governance and culture,” former ECB Supervisory Board Chair Andrea Enria offers here.

“Banking supervision needs to harness the benefits that technology can offer,” his ECB colleague, Elizabeth McCaul, offers in her Preamble to this report. “Technological innovation can deliver the speed, scale and scope required to properly identify and address governance concerns in the banking sector,” she suggests. McCaul argues further that this is especially true “where technological advances make it possible to sift through vast amounts of data, potentially making it possible to rapidly detect any misalignment between management expectations for a strong risk culture and reality.”

Such is the promise of new supervisory technologies — “SupTech.”



Cecilia Skingsley

“We think SupTech is critical in supporting effective and efficient supervision, from achieving real-time risk alerts to supporting automated regulatory compliance,” Bank for International Settlements (BIS) Innovation Hub head **Cecilia Skingsley** said in an April

speech this year.¹⁰³

“We know our colleagues across the central banking and supervisory worlds think so too,” she adds, citing research conducted across 50 jurisdictions highlighting that SupTech tools have been deployed in over 90% of them. “However, the majority of these tools are at an early stage of maturity,” Skingsley observes, “We also know that they are not

being widely adopted inside institutions, as many solutions built in-house remain at proof of concept or prototype stage, thus limiting the potential value they could bring.”

“Innovation in SupTech, or technology applied to banking supervision, is essential to safeguard our financial system,” Skingsley argues in another **In Focus** article offered here. ▶**PAGE 381**

We think SupTech is critical in supporting effective and efficient supervision.

CECILIA SKINGSLEY

Describing how supervisory authorities “are wrestling with updating often manual processes, being required to ingest and analyse ever larger ranges of data, both structured (such as balance sheets) and unstructured (such as news and

social media), as well as responding to advancements that are fundamentally changing the markets they oversee,” Skingsley insists that, “As the range and complexity of supervisory demands increase, the need for SupTech is becoming more acute.”



Simone Di Castri

“The landscape of financial supervision is undergoing a profound transformation with the advent of SupTech,” writes **Simone di Castri**, Co-founder and Co-director of the Cambridge SupTech Lab, in the **Closing Comments** to our report.

▶**PAGE 451** “SupTech, short for supervisory technology, is equipping financial authorities with advanced solutions to address the need for more efficient and effective supervision in response to the growing complexity of global, datafied, and decentralized financial systems in the era of mass consumption of financial services,” he adds.

“Many new applications enhance accuracy and reliability, leading to more trustworthy datasets and advanced analytics that refine risk assessments and anomaly detection. Some solutions enable

proactive supervision through predictive analytics, allowing the identification of potential risks before they materialize,” di Castri explains. He cites some early examples of successful SupTech deployments by, e.g., Canada’s OSFI, the UK’s FCA, and the US FDIC, but notes that “we are only at the beginning of the journey toward the digital transformation of supervision, and there is still a huge untapped potential.”

SupTech has the potential to enhance human judgment and decision-making and mitigate common supervisory challenges.

TORONTO CENTER (2017)

“RegTech and SupTech could lead to major paradigm shifts,” the Center suggested, cautioning that “Paradigm shifts can only succeed with the right mindset and leadership at regulatory and supervisory authorities, since they require a profound cultural transformation.” (emphasis added)

“The most compelling use of SupTech is to enhance data analytics for both micro-and macro-prudential purposes,” the Center offered a later in a

report entitled, “SupTech: Leveraging Technology for Better Supervision.”¹⁰⁵ It offered several examples of supervisory tasks where SupTech might create efficiency, along with a laundry-list of risks involved in trialing these tools. “SupTech has the potential to enhance human judgment and decision-making and mitigate common supervisory challenges,” the report highlights, before reciting the many reasons why such benefits would likely remain unrealized for some time to come.

The Financial Stability Institute (FSI) falls under the BIS architecture, along with Ms. Skingsley’s Innovation Hub. A 2018 report from the FSI sought to capture the experience of early SupTech adopters.¹⁰⁶

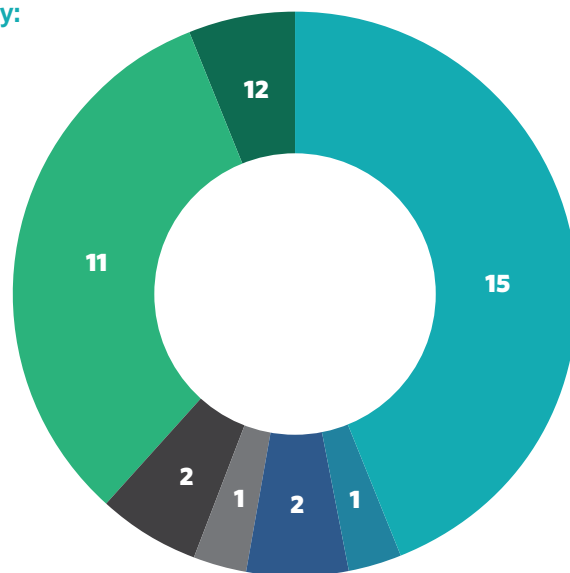
Trials & Tribulations

The last several years have seen growing interest and broader experimentation with SupTech capabilities.

“There is an emerging shift toward requiring more granular and frequent data to support more effective, intrusive and intensive financial supervision,” the Toronto Center observed in a 2017 report. SupTech offered “a path for shifting away from templates and manual procedures.”¹⁰⁴ Of particular appeal was the promise of “real-time supervision, by looking at data as it is created in the regulated institutions’ operational systems.”

Primary demand drivers for developing a SupTech strategy: No. of authorities who rank driver as most important

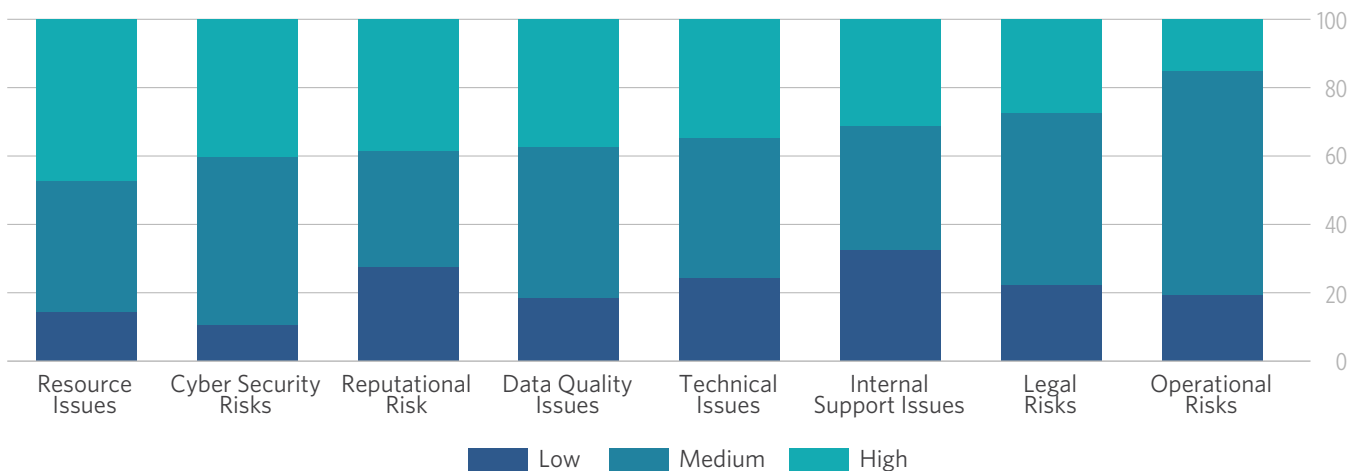
-  Enhancing efficiency and effectiveness
-  Reducing costs
-  Improving timeliness of information
-  Strengthen cyber security
-  Improving capabilities
-  Improving insights
-  Regulatory demand post-crisis



Source: FSB Survey <https://www.fsb.org/2020/10/the-use-of-supervisory-and-regulatory-technology-by-authorities-and-regulated-institutions-market-developments-and-financial-stability-implications/>

Detailed challenges/risks in developing SupTech applications

Percentage risk-severity in each category of risk / challenge



Source: FSB Survey <https://www.fsb.org/2020/10/the-use-of-supervisory-and-regulatory-technology-by-authorities-and-regulated-institutions-market-developments-and-financial-stability-implications/>

Though promising to reduce costs and to improve capabilities, supervisory agencies encountered a number of challenges in seeking to trial SupTech tools. “These include technical, data quality, legal, operational, reputational, resource, internal support and practical issues,” the FSI noted. Not a short list of challenges.

But, for our purposes here, it is important to acknowledge the equally long list of opportunities, and to note that the FSI specifically called attention to the fact that “SupTech applications for data analytics could potentially transform risk and compliance monitoring from a backward-looking into a more predictive and proactive process.”

With this in view, the FSI argued that, in the future, “supTech applications will be increasingly used to anticipate the behaviour of supervised entities or their risk exposures.” But it’s not clear how far off such a future may be, given the persistent institutional inertia that must first be overcome.

Vendors often find it challenging to engage with financial.

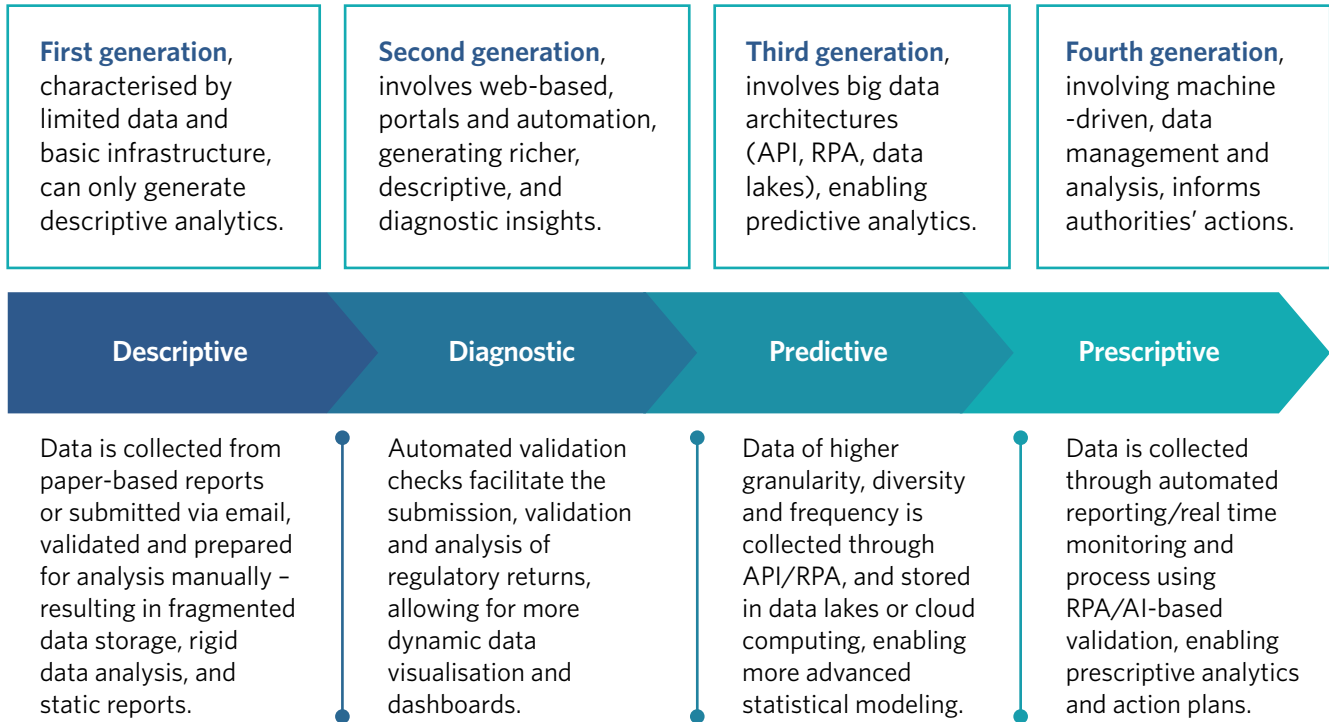
CECILIA SKINGSLEY

“SupTech is a strategic priority for an increasing number of authorities,” the FSB advised G20 Finance Ministers and Central Bank Governors in a 2020 report based on a survey of members.¹⁰⁷ The primary demand drivers identified were the increased efficiency, efficacy, and insights promised by these new technologies. (see chart)

Yet, here again, a range of risks and challenges were promptly identified to explain the slow uptake of SupTech tools. “These included, unsurprisingly, issues around skills and resourcing, data quality and considerations around integration of SupTech into internal processes,” the FSB reported.

It is also notable that the report finds regulators and central bankers to be more engaged in dialogue with one another around SupTech than they are with the community of SupTech innovators, and that the majority of early SupTech trials run thus far have been aimed at helping supervisors to do more of what they’re already doing, perhaps with a reduced manual load, rather than attempting to do entirely new things.

The four generations of SupTech



Source: <https://www.oecd-ilibrary.org/sites/d478df4c-en/index.html?itemId=/content/component/d478df4c-en>

It is perhaps therefore unsurprising that the authorities polled by the FSB reported “concern that undue reliance on SupTech tools could lead to misplaced focus on areas where risks can be easily measured,” rather than focusing attention towards “areas of concern that are not as easily given to quantifiable measurement.” Like culture, for instance.

The FSB report also notes that “The modern supervisory philosophy” deployed in most of the jurisdictions surveyed remains one based on “human judgement-based oversight of regulated institutions.”

Recognizing the promise of SupTech, yet mindful of the struggles in capitalizing on these, in 2021 the OECD issued a report on “The use of SupTech to enhance market supervision and integrity.”¹⁰⁸ There, the authors note the importance of creating a supportive SupTech ecosystem:

Going forward, co-ordination and collaboration between authorities, regulated entities and technology service providers within and across jurisdictions is crucial to:

1. ensure the compatibility of innovative systems adopted by regulators and regulated entities;
2. foster peer learning with regards to the successes and failures of SupTech uses; and
3. consider the possibility of devising common standards and taxonomies for relevant regulatory areas in order to ensure the scalability and interoperability of SupTech tools, especially with regards to reporting solutions.

By convening and fostering exchanges among a wide range of stakeholders, international organisations and standard-setting bodies can play an important role in that respect.

A 2021 report from the IBRD/World Bank, “The Next Wave of Suptech Innovation: Suptech Solutions for Market Conduct Supervision,” pointed to key benefits that might flow from such a public-private endeavor.¹⁰⁹ “Greater regulatory confidence and capacity reinforce healthier, inclusive financial markets,” the authors assert. “This is precisely where suptech can play such a critical role.”

The experience of the Covid-pandemic, where technologies played so crucial a role in allowing for remote operations, was instructive, and provided a glimpse of the future, the report concludes, “one in which data and technology become core to the operations, identity, and culture of financial authorities to enable them to achieve their regulatory mandates.”

Prioritizing progress

“Recent research with the global SupTech vendor community has allowed us to understand the range of solutions they are offering, to whom and their experience of interacting with central banks and regulators,” BIS Innovation Hub lead Cecilia Skingsley writes here. “While the breadth of this activity is encouraging, our research has highlighted that the majority of these tools are at an early stage of maturity, focusing largely on digitalisation and automation of existing workflows,” she finds.

“Vendors often find it challenging to engage with financial authorities,” Skingsley continues, “mentioning the lack of visibility of authorities’ needs, complex procurement processes and organisational siloes. The end result being that it is hard to match our problems with their solutions.”

Part of successful innovation in the banking space is promoting education and understanding for the regulators.

MICHELLE BOWMAN

Taken together, these impediments are such that “the public sector is not the most profitable one for entrepreneurs to target.”

With the sclerosis of the supervisory ‘market’ putting smaller firms off, the public sector is left to work only with larger, established vendors. “But it is often in the smaller start-up community where true innovation and cutting-edge thinking happens first,” Ms. Skingsley warns. “So, it is up to the public sector to collectively think of ways to bridge the gap between its processes and peculiarities and the private sector dynamics.”

It is precisely here where the BIS Innovation Hub looks to make a difference, by “bringing the public and private sectors closer together to accelerate SupTech experimentation and adoption.” The projects sponsored by the Innovation Hub “provide a bridge between the cutting edge of novel technologies being developed in the tech world, and the challenges faced by authorities.”

“The first reaction of regulators to proposed innovation in the banking system is often not one of openness and acceptance, but rather suspicion and concern,” Federal Reserve Governor Michelle Bowman complained in a speech last month, entitled “Innovation and the Evolving Financial Landscape.”¹¹⁰ She cites an “appeal” to resisting innovation: “it preserves the familiar and known.” But the associated cost is “stagnation and inertia.”

The turmoil of last spring suggests that such inertia is untenable. As the contributors to this report offer in unison, we must develop greater supervisory capacities if we are to safeguard the financial system, and those it intends to serve, and adopt the proactive supervisory stance that society expects and demands.

As a starting point, Bowman suggests that regulators might begin by trying to engage more directly and regularly with innovators. “Part of successful innovation in the banking space is promoting education and understanding for the regulators,” Governor Bowman counsels. “Can we shift from a reactive approach to innovation, to an active one that facilitates innovation?” she asks.



Douglas Arner

“One of the impacts of COVID has been dramatic acceleration of digitization around the world,” notes Professor **Douglas Arner** with the University of Hong Kong Faculty of Law, in yet another of the **Good Counsel** articles we feature here. ▶ **PAGE 123**

“Digitization of inputs from the financial sector, in turn, enables the application of advanced analytics, including machine learning and AI,” he adds. And with the advent of mandatory digital reporting requirements, “new datasets will be created which can enable a very wide range of analytics...”

In short, the circumstances that have provoked and facilitated the development of SupTech tools to date will accelerate going forward. This cannot be doubted. What can and must be questioned, however, is whether supervisors will benefit by these tools or stymie further progress in directions that might benefit them most.

Perhaps no technological innovation has excited more excitement and anxiety than artificial intelligence. Regulators in every sector, banking perhaps most of all, are right to approach with caution. But “even though much of the terrain here is new, and often the challenges can seem

daunting or even difficult to contemplate, that’s not an excuse for inaction,” former Fed Governor Randy Kroszner argued in a speech late last month.¹¹¹

Even though much of the terrain here is new ... that’s not an excuse for inaction.

RANDY KROSZNER

Much of the anxiety provoked by AI stems from the so-called ‘explainability problem’ — the progenitors of many AI tools cannot say how their enlivening algorithms ‘reach their conclusions.’ Fear of unregistered bias features largely here, and indeed rightly so. Better to rely on human judgement than to trust in the output of some inscrutable machine intelligence — a ‘black box’ — the argument runs.

But those raising such arguments forget that, when he popularized the term ‘black box,’ the great behaviorist B. F. Skinner was referring to the inscrutable nature of the human mind. And if the fear is that people are biased and, therefore, so must be the algorithmic models they create, then the problem of bias is not solved by shifting it from the biased algorithm back to its biased creator.

Some degree of mystery remains in either case and, for Kroszner, at least, that’s not necessarily all bad.

Kroszner cites AI expert Stuart Russell who, in Senate testimony offered last summer, remarked that: “Once trained, deep learning systems perform well, but their internal principles of operation remain a mystery. They are black boxes—not because we cannot examine their internals, but because their internals are largely impossible to understand.”¹¹² Skinner would sympathize.

Much innovation and productivity outcomes could be lost if we only permit results that come from models that we can fully interpret.

RANDY KROSZNER

But here is precisely where Kroszner finds cause for optimism. Flashes of inspiration lie behind some of the most wondrous creations in art, science, and industry, and we often cannot say how we arrived at these

moments of conception. “Much innovation and productivity outcomes could be lost if we only permit results that come from models that we can fully interpret,” Krozner cautioned. We mustn’t reject innovations “where the ‘Eureka’ moment cannot be fully explained.”

It is inherent in the very nature of innovation and exploration that we cannot say in advance just how things will play out. Had Queen Isabella required Columbus to describe precisely what route he would travel in his attempt to cross the Atlantic to India, there would have been no point in undertaking the voyage. The whole reason for the crossing was to *discover* what might be found. Notably, Columbus failed in the endeavor but, along the way, he stumbled on something that proved rather more valuable.

And what is our alternative but to prioritize progress in the wake of last year’s wake-up call? “As a creditor or lender of a financial institution, ask yourself this,” OSFI’s Peter Routledge prompted his audience during a speech delivered early last month:¹¹³

Can I truly find comfort in my financial institution’s capital or liquidity ratios, if I have concerns about its cyber risk management, third-party risk management, the integrity of its leaders, the security of its physical and information assets, its fidelity in adhering to the laws in the jurisdictions in which it operates, the culture of the organization, and the strength of governance provided by its board of directors?

Financial history is littered by companies that failed on these dimensions even though their financial indicators did not signal the severity of their problems, near to or until the last day of their existence. If you are not persuaded by this argument, please solicit the points of view of those institutions’ former creditors... or... their former shareholders.

The complaint most often heard in connection with prioritizing culture as a matter for supervisory attention is that culture is “non-quantifiable,” as the IMF moans, and thus largely inscrutable.

It would be a supreme irony if we refused to take advantage of the machine intelligence tools that now promise to make culture scrutable, because these tools themselves are deemed insufficiently scrutable, leaving us instead continually reliant on little more than the well-intentioned exercise of inscrutable human judgement.

END TIMES



“Profit derives from the Latin, *proficere*, *profectus*, to advance and progress,” Oxford Professor Colin Mayer reminds us here. “That is what profit should come from.” Too often, however, businesses leave out of their profit calculus the costs of negative externalities for which they are responsible.

This allows businesses to report misleading figures; financial statements that claim to be “true and fair” are “neither true in reporting true costs nor fair

in reporting a fair or just profit," Mayer scorns. In such circumstances, rather than marking reward for progress, firms may unjustly profit from the reverse.

"Without profit, there is no capital in capitalism," Mayer writes. But, by excluding the costs associated with the harms that firms may create, the capitalism we experience today reflects "a system that promotes self- over common-interest, ideology over pragmatism, profit over purpose, nation states over global concerns."

"We must stop measuring just the inputs that companies use and the outputs they sell," the former Dean of Oxford's Saïd Business School implores. "Rather, we must start from the question of what are the changes that the firm's activities are bringing about and the impacts they are having on others."

How, then, shall we account for the damage done to trust in our essential social institutions when misconduct scandals — "Never Events" — fill the headlines with daily regularity? How shall we account for what Fidelity's Daniela Jaramillo refers to here as the "underestimated systemic implications" of workplace misconduct?

"Trust in many institutions is declining," PwC offers, "which is why it's at a premium in business."¹¹⁴ Executives overestimate how much their firms are trusted by key stakeholders, PwC finds in its 4th annual survey devoted to the topic. While 90% think customers highly trust their companies, only 30% actually do. And though 86% think their employee trust is high, only 67% of employees say they highly trust their employer.

A wide range of liberal institutions stand accused of having lost people's trust.

MARK MALLOCH-BROWN

"Today, a wide range of liberal institutions stand accused of having lost people's trust," Lord Mark Malloch-Brown, President of the left-leaning Open Society Institute, founded by George Soros, wrote for the World Economic Forum late last year.¹¹⁵ A survey, the "Open Society Barometer," finds that "most major categories of international leadership command the confidence of under half of respondents." If this is to change, "Liberal institutions need both to deliver better results and to be widely seen and understood to do so."¹¹⁶

"Civic virtue promotes trust within a society," Arthur C. Brooks, a Professor of Practice at Harvard's Kennedy School and past president of the right-leaning American Enterprise Institute wrote two months ago.¹¹⁷ "Political trust is placed in government officials, elected and nonelected, who are assumed not to use their special access to power to enrich themselves and their friends, or to disadvantage their enemies," he argues.

Where that trust is breached, Brooks argues, civic virtue gives way to a "culture of contempt."

The decline in social, legal, and political trust has mirrored a loss of trust in business.

ARTHUR C. BROOKS

This is where we find ourselves today. The misconduct scandals that fill headlines suggest that those in whom we place political trust are not in fact trustworthy. "The decline in social, legal, and political trust has mirrored a loss of trust in business," Brooks observes. This need not reflect any increase in illegal acts of corruption but may instead come as a consequence of "various forms of 'gaming the system' for group or personal gain," Brooks writes, which is in increasing evidence. "Predictably, therefore, faith in capitalism itself is falling."

The Political Economy of Trust

“Democracy and capitalism coexist in a balanced ecosystem,” Brooks argues, “in which the ‘atmosphere’ necessary for flourishing is the trust cultivated through civic virtue. When that atmosphere is degraded,” he warns, “neither democracy nor capitalism can thrive.”

Writing in a special issue of the *Proceedings of the National Academy of Sciences*, academics in fields canvassed here — natural science, political science, and complex systems theory — explored how today’s polarization is driven “by the actions and interactions of individual voters, people in power, and various social networks.”¹¹⁸ Over time, these researchers find, such polarization leads to a system incapable of functioning well enough to provide the services critical to supporting society.

“Our core objective was to translate the American political system into a mathematical complex-systems framework that fosters participation by scholars of the natural sciences,” a lead researcher described. “The complex systems perspective demonstrates that the loss of diversity associated with polarization undermines cooperation and the ability of societies to provide the public goods that make for a healthy society.” And just as we see in natural systems, as healthy ecosystem diversity wanes, system collapse invariably ensues.



Henry Farrell

“Institutions both serve to underpin trustworthiness,” writes political scientist **Henry Farrell**, “and to communicate information about the trustworthiness of others.” In *The Political Economy of Trust*, another item on our **Starling Bookshelf**, Farrell

An organization with a culture of trustworthiness doesn’t look to comply.

HENRY FARRELL

Regulators need to think about strengthening cultures of trustworthiness.

HENRY FARRELL

continues. “While formal institutions may very clearly support cooperation on a very wide scale, they do so primarily through promoting confidence rather than trust.”

Institutions allow for collaboration among strangers who have not had reason or occasion to form bonds of mutual trust. This has created the basis for much of the prosperity we enjoy today. And it is precisely this that is at risk, for we are losing confidence in our institutions, just as we are increasingly distrustful of one another.

Farrell joins others from **The Academy** who share their perspectives here.

► **PAGE 437** “The last century of financial regulation has been a history of replacing personal trust relations between people who knew each other, were related to each other, or belonged to the same local church, with broader impersonal rules that induce confidence, and specialized officials to implement them,” he writes. “Modern society could not survive without very broad rules-based systems and regulators to implement them.”

The danger is that these regulators have largely tended to ignore what Farrell calls “the dark matter of culture and connections, trust and trustworthiness, that allow these rules to extend further than crude incentives.” Instead, regulators are more concerned with confidence in firms and the financial system — “clear expectations of appropriate behavior grounded in precise and comprehensive rules, rather than trust.”

Indeed, this may express the core mandate of prudential financial regulation. But, Farrell cautions, “Confidence only extends as far as the situation that the rules explicitly anticipate.” Trustworthiness, by contrast, “extends to situations that the rules should have covered, but did not.”

The difference is cultural. “An organization with a culture of trustworthiness doesn’t look to comply” Farrell explains, “but to anticipate and understand the intent behind the rules, asking what it ought do according to some reasonable interpretation of that intent.” No boxes to tick here.

“Regulators usually focus on things that are visible, formal and quantifiable rather than blurry, informal and qualitative,” Farrell observes. “Clear rules and formal targets are utterly necessary to the healthy functioning of complex societies,” he allows. “But they are not sufficient. When trust and trustworthiness evanesce, formal rules are at best fragile and inadequate and, at worst, actively pernicious.”

“It is impossible for regulators to completely monitor what people are doing and saying to each other,” Farrell rightly notes. “Cultures of trust and trustworthiness, then, can be invaluable in ensuring that people do what they are supposed to be doing, even when they cannot be seen or supervised.” If they are to do their jobs well, then, “regulators need to think about strengthening cultures of trustworthiness — that is, organizational cultures in which people behave trustworthily and may reasonably expect others to do the same.”

And as so many others here have argued, this implies that regulators need also to consider “the broader culture that they themselves operate in, and whether the public does or does not trust them.”

“Regulators have not thought nearly as much as they ought to about their reliance on some degree of public trust to do their work,” Farrell writes. In the past, it may have been that regulators did not need broad social embrace — confidence and passive acquiescence sufficed. “As long as people felt

confident in the financial system, they would passively assent to the rules and relationships that governed it,” Farrell suggests.

We are currently seeing an unprecedented fraying of the trust in governing bodies and institutions.

DR. TERRI PATTERSON

However, our regulatory systems have now begun to undermine the very political conditions that underpinned their previous autonomy. “If people lose trust in the system and those who run it — if they conclude that the regulators and other elites do not have their interests at heart — the space for successful regulation shrinks dramatically,” Farrell warns. And here again is precisely where we find ourselves today.

We don’t need better regulators or a tsunami of added regulation. Nor are we likely to achieve meaningful change through a focus on superior means by which to assess the character of those in the industry and a readiness to “name and shame” them in an effort to assert accountability.

Capital buffers do not provide confidence buffers when trust in an institution is eroded not by questions of liquidity but by doubts about management capability and trustworthiness. And supervisory efficacy is not a product of speed, force, and agility when supervisors are flying blind.

What we need is a new ‘systems intentionality,’ a supervisory culture and risk governance mindset that enlivens it, as well as metrics that allow us to test for it and enable us to engage proactively to course-correct when the check engine light flashes warning. We have the tools, the urgency for their deployment is in ample evidence, and it is called for unanimously by the dozens of experts from diverse fields who contribute their views here.

All that remains to be decided is whether we have the will to act — and the times are surely calling for it.

'Nero-moments'

"We are currently seeing an unprecedented fraying of the trust in governing bodies and institutions," former FBI behavioral analyst Dr. Terri Patterson observes here. "In today's polarized, 'us against them' environment," she urges, "it becomes even more important for policymakers to guard against human cognitive susceptibilities when formulating policy recommendations and regulatory requirements."

That is, it becomes important for them to factor into their designs the network effects of trust, and its absence: within financial intuitions, across the financial system, and among the global financial regulatory community.

In his *The Square and the Tower*, cited above, economic historian Niall Ferguson points to a survey, reported out in 2011, which found that a full quarter of Americans in their sample agreed with the statement that, "The current financial crisis was secretly orchestrated by a small group of Wall Street bankers to extend the power of the Federal Reserve and further their control of the world's economy."¹¹⁹

Political polarization and the appeal of conspiracy theories has only broadened in the time since.

As America heads into another presidential contest, the FT's Ed Luce argues that "the stakes in November are about the legitimacy of the system."¹²⁰ The evidence is with him. People are angry and much of this appears fueled by a sense of trust betrayed.

But "while there is consensus about the outrage, there is not about the response," Oxford's Professor Mayer suggests in *Capitalism and Crises: How to Fix Them*, pulling again from the **Starling Bookshelf**.

"The public sector has the advantage that in principle it promotes the overall wellbeing of society rather than, as in the case of the private sector, just a small segment of it." he writes. That said, "in being accountable to everybody it suffers from no effective governance by anyone." And there's the rub.

Complex human societies, including our own, are fragile.

PETER TURCHIN

In December last year the *Financial Times* reported that, in the UK, 34 of the 650 Members of Parliament had either quit or been disciplined by colleagues over allegations of bad behaviour since December 2019.¹²¹ Sir Alistair Graham,

former chair of the government's independent committee on standards in public life, is quoted as saying that voters would likely be "worried by the scale of misconduct," which would likely "undermine trust" in politicians from already "very low" base. In March this year, the FT reported that public trust in UK political parties had collapsed to 12%, making them the country's least trusted institution.¹²²

Lucky Britain is doing far better than the US. In April, *The Economist* reported that "America's trust in its institutions has collapsed."¹²³ In 2023, it ranked dead-last in pollster Gallup's league table for the first time since its relevant polling began. "Twenty years ago Americans had the highest confidence in their national government of people in any G7 country," *The Economist* reports. "Today they have the lowest."

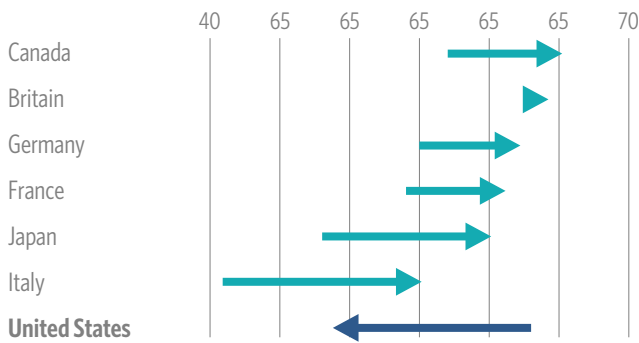
The collapse of trust in the state's institutions undermines its ability to keep internal peace and order.

PETER TURCHIN

Moreover, what little trust remains in American institutions is marked by the same political polarization that mars so much of civic life. Democrats place more faith than Republicans in journalism, higher education, and science. Republicans trust more than Democrats in religion,

the armed forces, and the police. Nothing good can come when public institutions are arrayed against one another in a world increasingly characterized by zero-sum thinking.¹²⁴

G7 countries, confidence in national institutions. %
2006 → 2023



Key national institutions: the military, the judicial system, the national government and the honesty of elections

Source: <https://www.economist.com/united-states/2024/04/17/americas-trust-in-its-institutions-has-collapsed>

The ‘us-them’ tensions that have disrupted college campuses across the globe are robbing storied academic institutions of the public’s faith — as well as alumni donations and tuition fees.¹²⁵ And in “the biggest election year in history,”¹²⁶ with voters in 76 democracies casting their ballots, businesses rightly fear that they, too, may see the kind of public protests that have disrupted the workings of academic institutions.¹²⁷ Demand for ‘political violence insurance’ is up.¹²⁸

State collapse is a common occurrence in history.



Peter Turchin

In a final item on our **Starling Bookshelf**, *End Times: Elites, Counter-Elites, and the Path of Political Disintegration*, complexity scientist **Peter Turchin**, a founder of the new academic field of

study called “historical social science,” provides a worrying perspective on the foregoing. “The collapse of trust in the state’s institutions undermines its ability to keep internal peace and order,” he warns.

The most frequent cause of state collapse is an implosion of the established ruling network.

PETER TURCHIN

Critics will accuse him of so much academic handwringing, but Turchin is nonplussed. “Because the most recent period of social and political turbulence in the United States was the 1960s, which were very mild by historical standards, Americans today grossly underestimate the fragility of the complex society in which we live,” he writes. “But an important lesson from history is that people living in previous precrisis eras similarly didn’t imagine that their societies could suddenly crumble around them.”

In a final contributed essay from **The Academy** appearing here, Turchin brings this perspective to the topics we have studied throughout this report.

►PAGE 421 “People typically fail to recognize that their society might suddenly crumble around them,” he warns, but “Political authority over complex human societies is far more fragile than a cursory glance might suggest.”

“Complex human societies, including our own, are fragile,” Turchin writes. “They are held together by an invisible web of mutual trust and social cooperation,” he notes, in agreement with many other contributors to this report. “This web can fray easily, resulting in growing social dysfunction and, in worst cases, state collapse.”

It is hard to imagine such an event occurring — surely not here, not in these times, we seek to assure ourselves. “But state collapse — the sudden and catastrophic disintegration of central authority — is a frequent occurrence in history,” Turchin tells us, warning that “It would be a grave mistake to believe that the mature democracies in North America and West Europe are entirely immune.”

“Elite selfishness and government dysfunction are entwined phenomena,” Turchin writes. According to the Pew Research Center, Turchin observes, “the proportion of Americans, who

said they trusted the government ‘just about always’ or ‘most of the time,’ declined from a peak of 77% in 1964 to just 16% in 2023.”

Most explanations point to the perception — rightly or not — that ‘the elites’ in government, business and other institutions that convey power, wealth and prestige, have rigged ‘the system’ in their favor and, worse, at the expense of those whom they are meant to serve. This feeds a mix of powerful emotions: betrayal, rage, and a perpetual sense of impotence that robs us of dignity and fuels political populism and a retaliatory agenda.

“The most frequent cause of state collapse is an implosion of the established ruling network,” Turchin writes. If the system is to blame, then the system is to be torn down. And if the elites who hold the reins are to be held to account, then they will be served with a vengeful spirit. He calls such events “Nero Moments.”

“On a summer night in AD 68, Nero Claudius Caesar Augustus Germanicus, ruler of the Roman Empire, woke up in his imperial palace in Rome and found that all his guardsmen had disappeared,” Turchin tells us, bringing the story to life. Nero’s servants had also fled his side, taking with them the box of poison he might have looked to for a painless exit from life. “As Nero’s example shows,” Turchin writes, “the emperor of a mighty empire is a nonentity as soon as he is abandoned by those who make up his power-network.”

“For years, World War II military service was the single most defining characteristic of members of Congress who otherwise hailed from widely diverse backgrounds,” Former Executive Washington Editor of the Wall Street Journal Gerald F. Seib wrote in an essay late last month.¹²⁹ But as Turchin notes here, “The elites ruling America today have no direct experience of the great challenges that shaped the Great Civic Generation.”

This is true in other democracies as well: the glue of shared hardship no longer binds us in a sense of shared fate, and selfish interests outpace collective concerns. It’s easier to ignore these macro-historical trends, or to mutter about how ‘they’ are ruining things for ‘us,’ than it is to look for and to forge common cause. And, with so much else to do, who has time for such far-fetched Cassandra-like concerns?

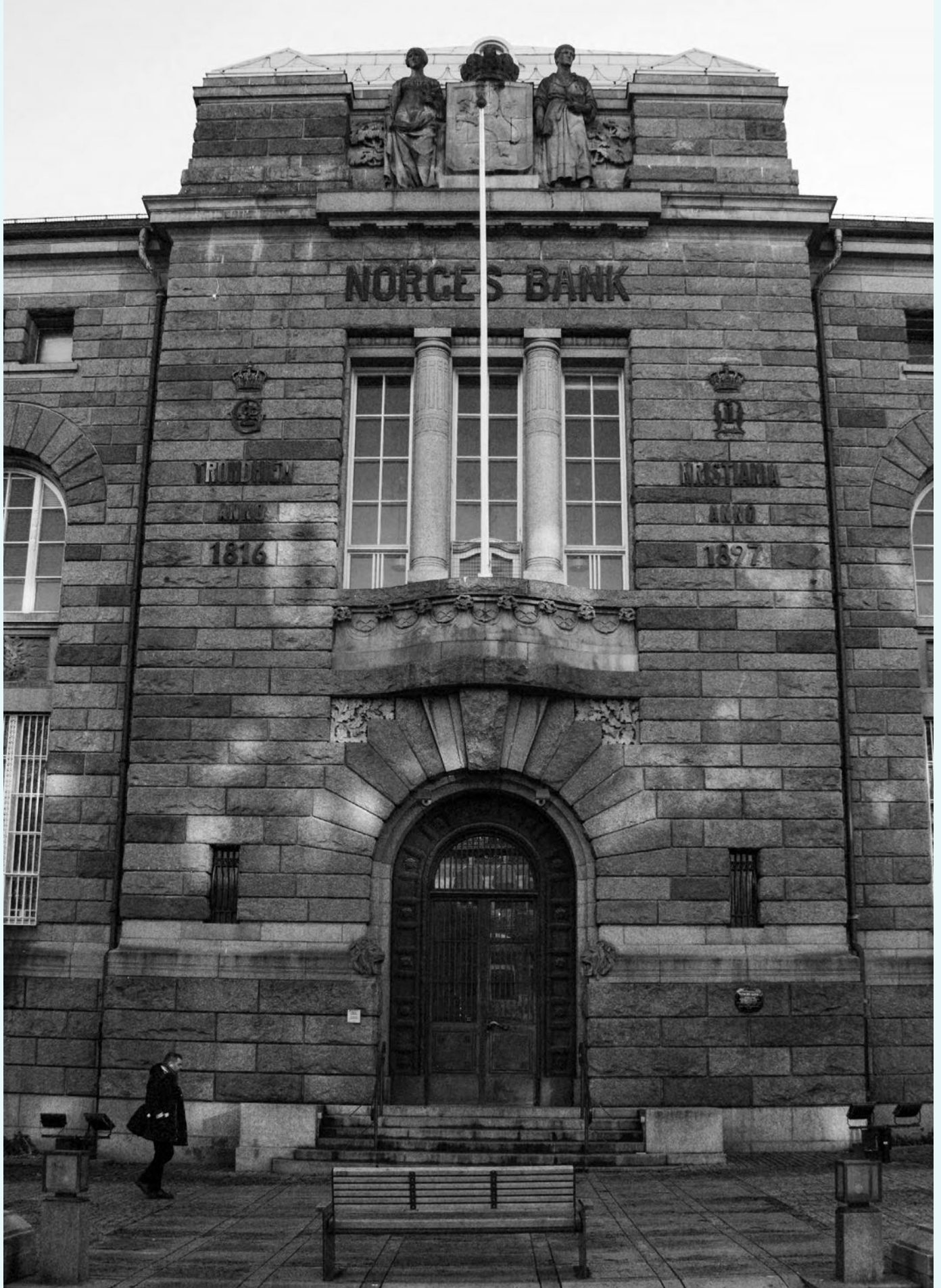
“To live in this process is absolutely not to be able to notice it,” one of the character’s explains in Milton Mayer’s classic 1955 account of 1930’s Germany, *They Thought They Were Free*.¹³⁰ “We had no time to think about these dreadful things that were growing, little by little, all around us,” he continues. “Unconsciously, I suppose, we were grateful. Who wants to think?”



GROUND BREAKERS

The task is not so much
to see what no one yet has seen,
but to think what nobody yet has thought
about that which everybody sees.

ARTHUR SCHOPENHAUER



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Ground Breakers

An Interview with Nicolai Tangen & Carine Smith Ihenacho



Nicolai Tangen



Carine Smith Ihenacho



Norges Bank
Investment
Management

Q: Nicolai, prior to your leadership of [Norges](#), you founded

and led the investment firm [AKO Capital](#) and then took time out to earn a Masters degree in Organisational and Social Psychology — and I note you studied with Professor Michael Muthukrishna, at the London School of Economics, who also contributes to this report. It's not often we see those in finance pursuing advanced studies in the social sciences, let alone when they are far along into a successful career. What prompted this? How have those studies informed your work at Norges and the performance of the fund?

Nicolai Tangen: I'm a die-hard believer in lifelong learning. I think that the historic way of learning, where you go to university and then you work for the rest of your life, is obsolete. I decided to take time off to get a degree in art history at 36, and another in social psychology at 50.

Before I studied at the LSE, I read constantly about social psychology and its impact on risk-taking. So, I just decided to study it in a more structured way. That has had a big impact on my work at Norges, because I really focused on topics that were relevant for management.

At the LSE, I studied the link between risk-taking and personality traits, how we make decisions, and how we can “un-bias” those decisions. Those learnings have clear implications for leadership and for investing alike.

Some people achieve a work-life balance by doing things in parallel. I prefer to pursue things one at a time — I work for five years, take a break for a few years to pursue other interests, and then work again. Now, I'm working.

Q: You are a big believer in that improving culture and leadership will improve results. You have brought a sports psychologist and mental coach in to Norges and built a program working on individual and team performance. What results are you seeing?

Nicolai: I worked with a sports psychologist for many years in my previous job, and I just saw how incredibly useful it is. The funny thing is, when you ask your colleagues to work with a psychologist, they think that you feel they're ill. But when you ask them to work with a sports psychologist, they think they're heroes. And the exercise has really helped change how we think.

Carine Smith Ihenacho: In 2021 we launched our internal “Human Performance Program.” The purpose was to enhance psychological safety and resilience within the organization. The program has absolutely improved the organization, both regarding individual performance and how we work together in teams. It's been rolled out in various stages. First, they worked one-to-one with people, to improve performance at the individual level, and then they worked with teams, to help them perform and communicate better.

Even in the Leader Group, we found that this exercise has allowed us to work much more effectively. We have more open discussions and we're more likely to take problems head-on. We are also much more willing to speak up in meetings when we disagree, rather than waiting to discuss things afterward.

Q: You also recently [published the results](#) of a study of Norges, conducted by an anthropologist, Dr. Tone Danielsen, with a view to obtaining external validation around culture questions. The report offers a candid account of successes and identifies areas for improvement. Again, this is atypical — why bring an anthropologist into Norges? How was that received, internally? What did you hope to learn? Any big takeaways?

Nicolai: When you bring an anthropologist into an organization, people are happy that someone wants to listen to them.

Before we brought her into Norges, Dr. Danielsen had done some groundbreaking work with the Navy SEALs. And I thought, "Well, we are high-achieving individuals in high-performing teams, so why not."

The important thing for me was to discover if there were things I wasn't aware of in the organization, or problems I hadn't seen. It was all upside. If everything is going well, great. If there are problems, then great, because now we can fix them. I'm a big believer in the truth, and that we must be able to face the truth.

We published Dr. Danielsen's findings so that the entire organization could read them and, thereafter, we discussed the study in a townhall meeting. I didn't want this to be a secret report, which would be leaked in the media and taken out of context. So, we also published it publicly on LinkedIn for the whole world to see. Clearly, there were issues identified in the report and lessons to

I'm a big believer in the truth, and that we must be able to face the truth.

be learned. However, I think a lot of our findings would be valid for all institutions, including your own.

Q: Norges recently launched a research project into the significance of psychological safety and resilience among employees, working with the Stockholm School of Economics' Martin Carlsson-Wall and Harvard Business School professor Amy Edmondson. In a relevant illustration of Norges' culture, the [Financial Times has reported](#) about your response to a mistake that cost the organization \$92 million. The employees involved owned up to the mistake immediately, and the FT reports that you didn't punish them. Why is it important to handle mistakes in this way? How do you work to build psychological safety, so employees feel safe to admit to such mistakes?

Nicolai: It starts by admitting mistakes in public. It's a tough thing to do, and you need to be confident to do it, but it's very powerful. The interesting thing is, if people think you are competent, then when you admit mistakes, they will trust you more rather than less. That trust is completely key. As soon as you have any confidence in your job, start to admit mistakes. That really accelerates the building of trust.

Carine: Nicolai is championing a "no-blame" culture within Norges. We have a system for recording every mistake that occurs, but the follow-up is focused on moving forward and learning from them, not assigning blame. Nicolai also sets an example here. He is the first to admit to a mistake, and that willingness to say, "OK, maybe I shouldn't have done that," permeates down through the organization.

Now, we are seeking knowledge on how we can further develop our performance program. The aim of the new research project with SSE and Harvard is therefore to understand the mechanisms behind psychological safety and resilience among employees and how

sports psychology can contribute to strengthening the fund's performance culture. By taking a scientific approach to the evaluation of our work we can understand better WHY things are effective. This allows us to be even more targeted in our approach to human and financial performance — or put differently; to take our internal deliveries from “good to great”.

Q: This series of reports is principally concerned with the governance and supervision of non-financial risks, most particularly those believed to be driven by firm culture and the conduct it promotes. As such, we are very much focused on the “G” in ESG. At a time when many institutional investors have stepped back from a public focus on ESG issues, Norges has doubled down. In fact, Carine, you recently relocated to New York to become more actively involved in the US market. Why? And why now?

Carine: On my relocation to New York, the motivation was three-fold. First, NBIM has long had a NY office. But our team there has grown lately, and Nicolai wanted someone from the Leader Group to be there to serve as a conduit between our headquarters and the NY Office to help facilitate communication and establish more of a presence.

Second, almost half of the fund's equity investments are in the US markets. So, we thought it would be helpful for the stewardship team to be closer to those companies and to engage more actively in the US market.

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And, finally, we've seen the ESG backlash in the US. We think the issue has been too politicized, and there is so much noise around it. We wanted to be a clear voice that, for us, as a long-term investor, ESG is about managing long-term risks that have financial consequences.

By taking a scientific approach to the evaluation of our work we can understand better WHY things are effective.

ESG is about managing long-term risks that have financial consequences.

Nicolai: More broadly, we try to spend time in different places to engage with the local market. I frequently spend time in New York and London, for example.

Q: Norges has been prominent in demonstrating a readiness to hold portfolio company leadership accountable when they fail to evidence good governance practices. I note, in this regard, that you are leading a class action lawsuit against SVB, its auditor, and its Wall Street advisors, arguing that they worked to conceal “rampant weaknesses” in risk controls. I believe this is a first for you. Again, why this issue, why Norges, and why now?

Carine: Norges has taken companies to court for alleged securities fraud for decades. Litigation is not a new tool for us, but being a lead plaintiff is. This means that we represent all investors and not only ourselves. The sheer

scale of SVB's mismanagement, rapid collapse and investors' losses make this an important case for all the affected investors.

In making the decision, we conducted an overall assessment of the best litigation strategy for the case. Some of the factors we considered were that the holding company is bankrupt, that we have an extremely large loss as a result of the failure, and that we have the resources and expertise necessary to bring this case forward, which is not true of all investors.

We also wanted to take a visible stance against the huge corporate governance failures seen in this case. Hopefully, we can also create a legal precedent and raise the bar

for governance among both companies and what we call the “gatekeepers,” which includes the auditors and advisors.

Q: I believe that Norges is [the largest investor in UBS](#), and that it was one of the top 10 investors in Credit Suisse before it failed. It's been said that Credit Suisse [scandalized itself](#) out of existence. What do you expect companies to do to prevent such failures? What is the role of the board versus the role of the C-Suite and trying to manage these kinds of intangible risks?

Nicolai: There are some industries where culture is extremely important because you can't see the risks from the outside, and banking is perhaps the most important one. There is no way you, as an investor, can really understand what's going on inside a bank. You saw that in the extreme with Silicon Valley Bank and Credit Suisse. In those situations, you need to understand corporate culture more than anything else.

We recently recorded an episode of our podcast "[In Good Company](#)" with James Gorman, CEO of Morgan Stanley. He has a rule: "Do the right thing." We asked him, "Isn't that a pretty obvious, banal kind of rule to have?" But, the thing is, it is just not that obvious in the banking sector.

This is important because the consequences of banks doing the wrong thing are disproportional. If you don't have proper control systems and a sound culture in a bank, there can be humongous consequences.

We discussed this in another recent podcast with Sergio Ermotti, CEO of UBS. Super successful and lucrative mergers can only be achieved in wartime. The Credit Suisse and UBS merger is an example, which is why we have invested so heavily in UBS since.

Ultimately, culture is more important than anything else in banking, and you really need to attend to it.

►READ MORE ON STARLING INSIGHTS

Ultimately,
culture is more
important than
anything else
in banking.

Q: Some have argued that AI has the potential to be transformative for governance. I know you have been [outspoken](#) on the potential risks and benefits of AI. Norges has also sought to drive [increased transparency](#) among companies in its portfolio regarding their use of AI and how they are seeking to manage the associated risks. What are the opportunities for AI in improving governance? And how can we maximize that value and minimize the inherent risks?

Nicolai: AI can certainly help you understand corporate culture, but it's not easy. We've tried in the past. I worked with Tom Reader **►READ MORE** and Alex Gillespie **►READ MORE** at the LSE on how we could gauge corporate culture from the outside in. Even using all sorts of metrics — Glassdoor reviews, the size of the CEO's picture in the annual report, you name it — it's a tough one.

We do believe that AI needs regulation and we have also published a view on responsible AI. We have highlighted the following three key elements of responsible AI: board accountability, explainability and transparency and robust risk management. But we also think that AI has potential to have a phenomenal impact on society and productivity. We are really, really optimistic about AI.

Nicolai Tangen is the Chief Executive Officer of Norges Bank Investment Management, Norway's \$1.5 trillion sovereign wealth fund. Tangen was previously Chief Executive Officer and Chief Investment Officer of AKO Capital, which he founded in 2005.

Carine Smith Ihenacho is the Chief Governance and Compliance Officer of Norges Bank Investment Management. Prior to joining Norges, Ihenacho was Vice President Legal and Chief Compliance Officer of Statoil ASA.

Ground Breakers

Workplace Misconduct: The Underestimated Systemic Implications for Investors

By: DANIELA JARAMILLO



Daniela Jaramillo



Introduction

Company culture has been in the spotlight for a number of years, with growing recognition of the importance of culture within an organisation, and its contribution to an organisation's risk profile. It is now widely recognised that weaknesses in culture, and the governance and accountability relating to culture, translate directly into financial risk.

Traditionally, investor engagement on these issues has been focused on human resources-related strategies that can be leveraged to improve company culture. These strategies include appropriate diversity and inclusion practices, creating a 'speak up' culture, survivor-centric grievance mechanisms, among others. We fundamentally support and encourage these initiatives and believe they are a critical way to improve workplace culture.

In parallel, this article seeks to add another lens to understanding culture and focuses on the risk elements associated with a poor company culture.

'Culture-based financial risks' refer to the probability of negative impacts that harmful behaviours¹ in the workplace can have on a company's productivity, reputation, and social license. They can also lead to externalities in the economy and society.

In this article, we seek to cover three key objectives:

1. Highlight the challenges of assessing culture-based financial risks for investors;
2. Provide a framework to begin assessing these risks across portfolios; and
3. Outline recommendations to companies on how they can address these risks.

We have developed a framework to help investors understand these risks and the potential financial implications. While putting a value on the total cost of culture-based financial risks is challenging, we outline examples below of some of the financial consequences when these risks are mismanaged.

While this framework focuses on the financial implications of culture-based financial risks, it should be considered within a broader human rights context. Fundamentally, as investors we have responsibilities to respect human rights in our own operations and supply chains, as well as in our direct and indirect investments. This framework is meant to help guide investors to conduct greater due diligence into human rights breaches in the form of harmful workplace incidents and play a role in remediation.

THE CURRENT CHALLENGE: WHY ARE CULTURE-BASED FINANCIAL RISKS UNDERESTIMATED BY INVESTORS?

While there is broad recognition of the importance of culture in assessing a company's future performance, it is still difficult for investors to:

1. Assess company culture from the outside; and
2. Quantify the potential financial risk posed to an investment portfolio by harmful workplace behaviours.

Difficulty with assessing company culture from the outside

Currently, there is little information in the public domain that gives investors insight into how boards and management assess key measures of corporate culture. A key challenge is the intangible nature of culture and the subjectivity that surrounds it.

Reporting standards and disclosure tools do not provide an effective way for investors to track a company's exposure to culture-based financial risks and do not allow investors to assess how effectively companies are mitigating these risks. Most metrics provided are backward-looking, show an aggregate view of the health of the company's workforce and are input oriented.

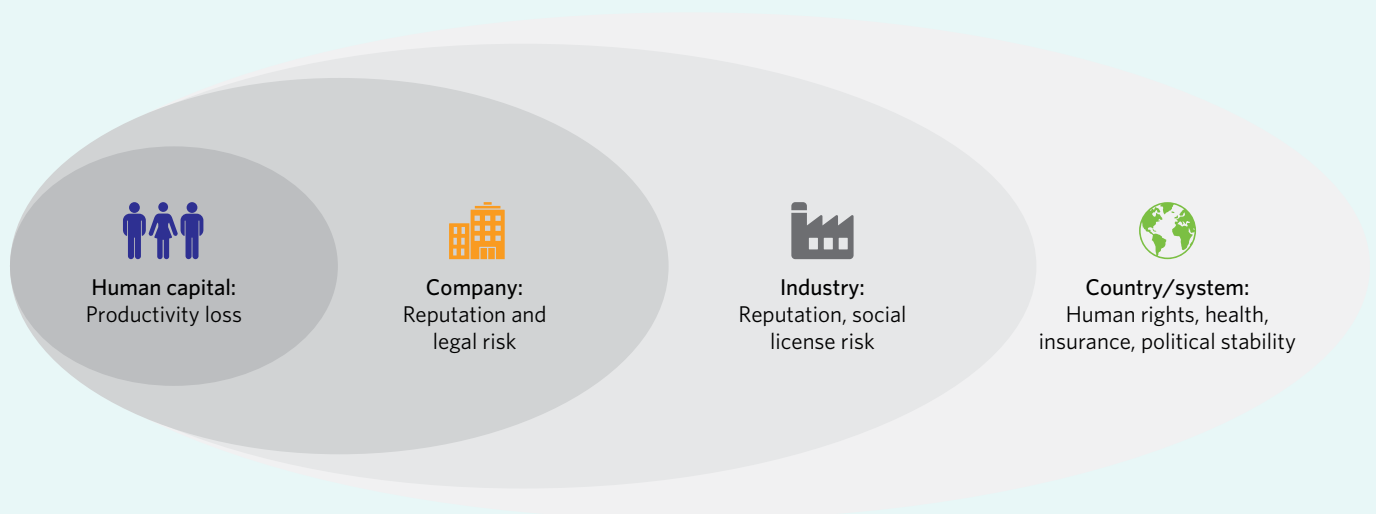
A key challenge is the intangible nature of culture and the subjectivity that surrounds it.

Difficulty with assessing a portfolio's culture-based financial risk exposure

Historically, the majority of culture-based financial risk analysis has been focused on company level implications. Investors have viewed the risks in isolation and only assessed the impact of these risks to the company's productivity and financial performance. However, when taking a universal investor lens to culture-based financial risks we realise that harmful behaviours in the workplace can have much wider reaching implications than initially thought.

For the purposes of this article, we define 'universal investors' as diversified asset owners such as pension funds, university endowments, and sovereign wealth funds that own a representative share of the entire economy and therefore have an interest in the long-term health of the financial system. Universal investors cannot diversify away from systemic risks

Figure 1. Layers of culture-based financial risks that impact investors



Source: Fidelity International, October 2023

such as climate change and culture-based financial risks and can only mitigate whole-system threats by effecting change in the real economy.²

We posit in this article that company specific issues can quickly lead to sector-wide and portfolio-wide implications that can create vicious cycles and cumulative risk for investors.

We believe that the extent of these impacts and the interrelated nature of these risks are currently not fully considered or quantified by investors.

A framework to understand culture-based financial risks for investors

For investors to holistically assess culture-based financial risks, we have developed a framework (see Figure 2) that captures the three categories of risk that can lead to the most

material financial implications. These three types of risks include: operational, societal gap and systems-level.

Company specific issues can quickly lead to sector-wide and portfolio-wide implications.

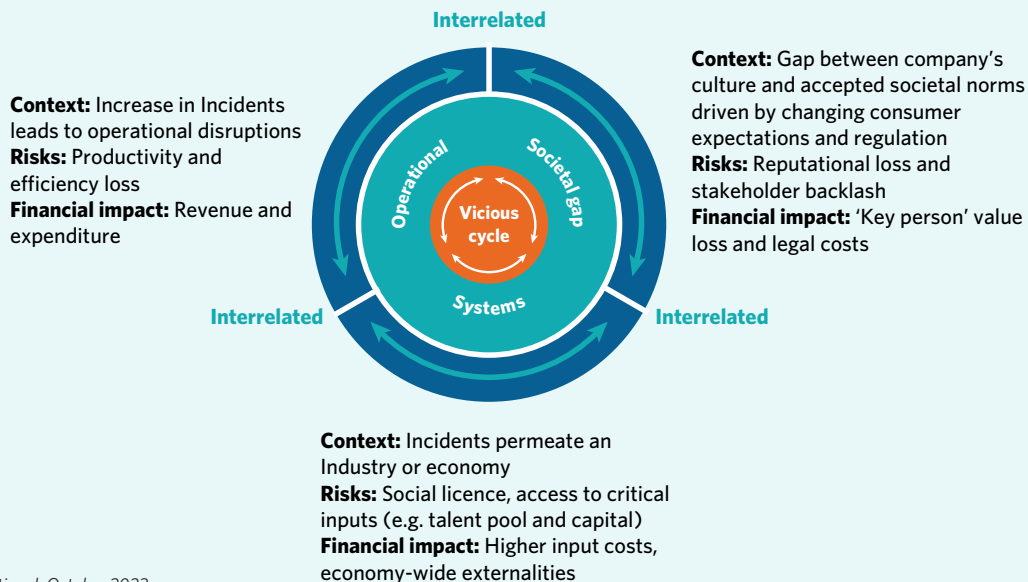
Investors familiar with frameworks used to assess the financial risks of climate change, such as the Taskforce for Climate-related Financial Disclosure (TCFD), will notice that we have borrowed

elements of these disclosures when thinking about culture-based financial risks.

As highlighted in Figure 2, the majority of current financial analysis conducted on culture-based issues largely sits in the 'operational' risk category which describes unilateral risk at the company level. With this framework, we can now assess the broader risk categories of 'societal gap' risk as well as 'systems-level' risk to develop a fuller picture of the potential risk exposure for investors at the portfolio level.

In addition, investors can also better understand the connection between these interrelated risks and the potential contagion effect.

Figure 2. Types of culture-based financial risks and the interactions between them



Source: Fidelity International, October 2023

For example, company-level incidences (operational) can lead to negative perceptions of a sector (societal gap), which in turn impact the sector's social license to operate (systems-level). They can then lead to long-term and material impacts on economic productivity. The interconnected and additive nature of these risks can then form a vicious cycle for communities and economies.

OPERATIONAL RISKS — COMPANY-LEVEL IMPACTS

From an operational perspective, incidents of harmful behaviour in the workplace, such as sexual harassment or bullying, impact a firm's operating productivity and efficiency. These incidents can absorb an organisation's time and resources and lead to higher levels of absenteeism and lower presenteeism. These conditions also lead to higher turnover and disengagement across the workforce. All of which directly impact productivity.

As Deloitte highlighted in their Economic Costs of Sexual Harassment in the Workplace report, the estimated annual cost of sexual harassment to workplaces in Australia is A\$2.6 billion in lost productivity.³ Staff turnover costs, absenteeism, and manager time largely drive these losses. These incidents can also lead to higher workers' compensation premiums. Companies may also need to provision for additional capital expenditure to improve their workspaces to enable a safe working environment and speak up culture (e.g. surveillance and security and training programs).

While the financial impacts of culture-based operational risks may be hard to fully quantify, investors are able to use proxies such as absenteeism and turnover rates to approximate the direct impact to the company. A good example of this type of financial impact analysis is recent research published in the *Journal of Business Ethics* investigating the extent to which sexual harassment impacts a company's value.

The authors of "How Much Does Workplace Sexual Harassment Hurt Firm Value?" highlight that the sample of companies with unusually high sexual harassment (SH) scores exhibit significant reductions in future stock performance and profitability. For example, firms with a top 2% SH score earn a value-weighted risk-adjusted stock return of -17% in the one-year period after the high-SH classification. Furthermore, these firms experience a decline in operating profitability and an increase in labour costs during a five-year period around the high-SH classification.

The evidence in the report suggests culture-based financial risks, such as sexual harassment, can cause greater damages to firm value than previously documented.⁴

SOCIETAL GAP RISKS — COMPANY CULTURES FALLING BEHIND

Societal gap risk describes the risk that emerges following evolving societal expectations, shifting consumer preferences and regulatory and legal developments. Social movements, such as the #MeToo, #TimesUp and #BlackLivesMatter movements, which started in the US but spread around the world, have exposed companies to this risk. These movements highlight a change in social values and norms, which make previous behaviours, actions, and internal company cultural norms no longer acceptable.

Stakeholders are now holding companies accountable for their social license to operate, demanding greater alignment between management and boards and broader society. Furthermore, these social movements have in turn become part of the political agenda in many countries and have influenced legislative change, such as the Respect@ Work Bill in Australia, the Worker Protection Bill in the UK, and the Ending Forced Arbitration of Sexual Assault and Sexual Harassment and Speak Out Acts in the US.

As a society becomes more progressive, the societal gap risk increases for companies whose cultures are lagging, thereby creating the potential for ‘stranded asset’ risk. We characterise stranded asset risk in this context as the experienced individual who was originally seen as valuable to the company and a potential contender for a senior leadership position, but as societal norms changed and historical incidents came to light, management decided to unexpectedly or prematurely ‘write-down’ the individual’s value to the company. In this case, the individual’s value could no longer be fully realised, as promoting and retaining the individual would pose too much risk to the company and its reputation. The value and investment put into the individual may be lost or ‘stranded’, which can also result in loss of company value. Later in this article we offer a company case study of this ‘culture-based stranded asset risk’.

Societal gap risks, much like climate transition risks, are somewhat unpredictable and, given the scale of the impacts, they are hard to calculate. For investors, we can use indicators that assess changes in consumer preferences as well as shifting societal norms. Still, there are no consistent methodologies, and it is hard to predict the direction and impact of future social movements.

These risks can manifest in many ways, including reputational loss and consumer and employee backlash. Other material financial impacts occur when there is ‘key person risk’ and the individual is either involved in the incident or its mismanagement. These instances can result in the removal of senior company leadership such as the CEO, board members, and senior management.

Recent academic research showcases the financial impact of societal gap risks for companies, with a specific focus on sexual harassment incidences. In the #MeToo: Sexual harassment and company value report, the authors identify that the average effect

of a sexual harassment scandal on company value is around a 1.5% abnormal share price decrease over the event day and the following trading day.

SYSTEMS RISKS — CUMULATION OF COMPANY-LEVEL RISK

The accumulation of company-specific risks can lead to systems-level risks which manifest in two ways: social license to operate and cost to society.

When harmful behaviours are prevalent across several companies in the same sector this can impact a sector’s social license to operate.

► **SEE DAVID ROUCH ON STARLING INSIGHTS** The loss in social license can mean that an entire sector will face increased barriers to accessing critical inputs for production. Human capital resource is one such example, but other inputs can also become challenging to obtain such as access to financial capital and regulatory approvals.

When culture-based financial risks become a systems-level risk, the sector or company may

receive additional scrutiny from stakeholders, including governments, consumers and civil society. ► **PAGE 421**

Cumulative culture-based financial risks across a sector can lead to externalities for an economy.

In addition to social license considerations, cumulative culture-based financial risks across a sector can lead to externalities for an economy. The costs following from harmful behaviours in the workplace are borne not only by individuals and companies but also by governments and society. A recent report by Deloitte estimates that approximately 30% of the annual cost of sexual harassment in workplaces in Australia is borne by the government and society.⁵

The externalised costs of culture-based financial risks may include costs to the legal and justice system, increased healthcare costs as well as higher government spending on welfare payments and reduced tax revenue from affected individuals and

companies. These externalities have deeper impacts for investors that are invested across multiple companies and sectors, and the subsequent systemic risks cannot be mitigated through divestment or diversification.

CASE STUDY OF THE THREE LEVELS OF RISK: THE AUSTRALIAN MINING SECTOR

Mining in Australia has long been, and continues to be, a significant contributor to the Australian economy. Despite its importance, in recent years the sector has come under increasing scrutiny around its 'social license to operate', particularly its management of culture-based financial risks.

In the 2018 Australian Human Rights Commission's report, mining was called out as one of the top five industries with the highest prevalence of workplace sexual harassment. The release of Rio Tinto's "Everyday Respect" report, conducted by Elizabeth Broderick & Co, and the Western Australian Parliament's "Enough is Enough" report, further highlight that harmful workplace behaviours have long been and continue to be prevalent across the mining industry. ►PAGE 153

We chose the Australian mining sector as a case study for the impacts of culture-based financial risks as there are clear examples across the sector of the manifestation of the three levels of risk.

Operational risks in the sector

According to the Australian Productivity Commission, when comparing the mining sector to other industries such as manufacturing and business services, labour productivity has remained largely flat in recent years.⁶ While the weakness in productivity can be attributed to lower investment in the sector and challenges with securing talent, we posit that culture-based issues may have also played a role in the improvement of operational productivity. In the last few years, the sector has seen higher absenteeism levels and

turnover rates driven by several sector-specific issues, which may have been contributed to by culture-based issues.

In addition to lower productivity levels, miners have also had to allocate additional capital towards improving their facilities and ensuring safe working conditions. For example, after defining sexual assault and harassment as a safety risk, BHP allocated A\$300 million in FY22 to implementing security upgrades across their sites. These improvements included guards, CCTV, and lighting to reduce the incidents of misconduct and ensure the safety of their female workforce.

Societal gap risk in the sector

Public perception of Australian mining is catching up with the sector, highlighting the disconnection between company cultures and the changes in societal norms and expectations. An example of this dislocation was when Newcrest Mining's CEO Sandeep Biswas came forward in February 2022 and conceded that his leadership style had been too 'autocratic' in his early tenure as CEO and needed to change to suit modern standards.⁷

He vowed to make Newcrest a more inclusive, respectful and 'psychologically safe' workplace. However, less than twelve months after the initial comments, Mr Biswas made a sudden departure which led to increased turnover across Newcrest's senior leadership team. While this incident did not have a material impact on the company's share price, the implications are likely to be seen in operational performance and reputational impacts, off the back of societal gap risk and 'key person' value loss.

Systems level risk in the sector

Systems level risk has potential implications for issues such as labour shortages and talent retention, as adverse coverage could impact the attractiveness of the sector as a career choice. While we do see

positive steps being taken, it's important that the sector keeps moving forward collectively. Companies need to focus on building a purposeful brand that aligns with today's societal values in order to attract and nurture talent for the future.

Recommendations for investor portfolio level culture-based financial risk assessment

To assess portfolio-level risk exposure to culture-based financial risks, we believe there are three leading indicators for these risks, namely: country, industry, and workplace conditions.

On country level risk, the social and regulatory landscape in a particular jurisdiction increases the potential for societal gap risks to occur in an organisation. Example jurisdictions would include Europe, United Kingdom, Ireland, United States and Australia. Recent research by the Criterion Institute showcases the high correlation of culture-based financial risks, particularly gender-based violence data, with political risk analysis. Their research provides evidence that rates of violence against women are a better indicator of state stability than many traditionally used measures, such as wealth and the strength of institutions.⁸ As a result, for universal investors, understanding social movements, consumer preferences and gender inequalities are likely to be critical tools to assessing country level risk.

At the industry level, certain sectors are associated with higher prevalence rates of culture-based issues, including workplaces that are hierarchical, male-dominated, client-facing and have 'high-value' or 'indispensable' workers.

High-risk industries include mining, construction, media, technology, financials, retail, healthcare, and hospitality.

Finally, certain workplace structures or conditions lead to a higher risk profile. For example, workplaces with a higher contracted workforce, lack of diversity, that operate in isolated and remote areas or allow higher levels of alcohol consumption activities tend to have a higher prevalence of culture-based issues.

As a result, investors can use these three indicators to assess the culture-based financial risk across their portfolios, highlighting potential areas of concentrated risk, and begin to quantify the financial impacts of the cumulative risks. In addition to risk assessment, investors can use engagement and public policy advocacy to encourage appropriate disclosure and action from companies that go beyond policies and self-assessments.

Bridging the gap between companies and investors: recommendations for companies

Here we share our key recommendations on the asks and expectations of companies, which include appropriate governance mechanisms, senior oversight, as well as proper incentive structures.

THE COMPANY CHALLENGE: FRAMING CULTURE-BASED FINANCIAL RISKS APPROPRIATELY

This article has largely focused on the challenges investors face when assessing culture-based financial risk. Nevertheless, we also wanted to highlight the current challenges that companies face when seeking to manage these risks. While there are a range of factors, we believe the fundamental challenge companies face is the inappropriate framing of culture-based financial risks within the organisation. Through our research, we have identified three key elements that impact the consideration of these risks:

- Not treated as business-critical risks;
- Lack of organisation-wide and aggregation of workforce tracking mechanisms; and
- Lack of accountability across senior leadership.

Currently, culture-based financial risk incidents are not generally treated with the same level of priority as other business risks, such as physical safety. While workplace safety is often a key constituent of a company's enterprise risk management framework, most companies do a poor job of capturing psychological safety and culture-based risks in these mechanisms. We believe this omission makes it more challenging for companies to holistically manage these risks.

While many companies have adopted organisation-wide tools to track human capital metrics, the extent of their use and sophistication varies materially. We understand from companies that many don't have the necessary tools or structures to track the data or are only beginning to collect the data. Without having useful and granular organisation-wide human capital information, managing culture-based financial risk can be challenging and uncovering potential risk areas nearly impossible.

Culture-based issues have traditionally been managed by human resource departments and are often handled with a legalistic response.

We believe this narrowcasting of the risks constrains a company's ability to manage them appropriately.

Finally, culture-based issues have traditionally been managed by human resource departments and are often handled with a legalistic response. We believe this narrowcasting of the risks constrains a

company's ability to manage them appropriately. Culture-based financial risks impact an entire organisation, and their management needs to be part of a CEO's, senior leaderships', and Board's accountability.

RECOMMENDATIONS FOR COMPANY-LEVEL ACTION AND DISCLOSURE TO HELP ASSESS CULTURE-BASED FINANCIAL RISK

We believe that assessing companies across the three levels of risk — operational, societal gap and systems level — offers a more holistic way to assess a company's exposure to, and management of, culture-based financial risks.

Again, borrowing framing from the Taskforce on Climate-related Financial Disclosures, we outline in Table 1 our recommendations for these three levels of risk across governance, strategy, risk management and metrics and targets. The recommended actions and disclosures outlined are by no means exhaustive, though we believe them to be fundamental to appropriately manage culture-based financial risks.

Table 1. Summary recommendations for company-level action and disclosure on culture-based financial risks

	Governance	Strategy	Risk management	Metrics and targets
Culture-based financial risk	Disclose the organisation’s governance around culture-based financial risks	Disclose the actual and potential impacts of culture-based financial risks on the organisation’s businesses, strategy, and financial planning where such information is material	Disclose how the organisation identifies, assesses, and manages culture-based financial risks	Disclose the metrics, targets and milestones used to assess and manage relevant culture-based financial risks where such information is material
Operational	<ul style="list-style-type: none"> Board and management oversight Clear accountability across senior leadership Remove sole responsibility in HR and broaden scope Incentive structure Link culture-based issues and psychosocial safety to remuneration Design Incorporate culture- based considerations into design of all policies and strategies 	<ul style="list-style-type: none"> Curation Foster a ‘speak up’ culture and reduce characteristics of high-risk cultures Training Robust training and awareness programs Partners Ensure outside organisation stakeholder inclusion (e.g. contractor workforce) 	<ul style="list-style-type: none"> Risk register Elevate culture-based financial risk to company Enterprise Risk Management (ERM) framework 	<ul style="list-style-type: none"> Disaggregation Disaggregated human capital data Engagement Employee engagement survey results detail Incorporate ‘speak-up’ content Remediation Complaints, incidents, and disciplinary actions
Societal gap	<ul style="list-style-type: none"> Gap assessments Remain informed of emerging social movements and how they might impact operations and business strategy, including gap assessments between societal expectations and company culture 	<ul style="list-style-type: none"> Transformation Cultural transformation strategies and milestones 	<ul style="list-style-type: none"> External audits Third-party culture assessments 	<ul style="list-style-type: none"> Seniority Level of seniority of the incidents Severity Assessment of the level of severity of the incidents Use of NDAs Policy on the use of NDAs and disclosure of historical agreements and settlements
Systems		<ul style="list-style-type: none"> Collaboration Industry-wide initiatives to elevate culture-based financial risk considerations 	<ul style="list-style-type: none"> Benchmarks Develop sector-wide framework/ benchmark and best practices to elevate risk management 	<ul style="list-style-type: none"> Capacity building Programs, activities, benchmarks as well as funding for sector-wide initiatives

Conclusion and call to action for investors and companies

As outlined in this article, culture-based financial risks can extend past an investee company and have implications at the systems level, leading to long-term and widespread risk for universal investors.

While an organisation may be a leader on culture-based risk management, if a sector has lost its social license to operate then that organisation may still be impacted by association. To parallel Peter Drucker's quote, 'culture eats strategy for breakfast', we would argue, 'culture can also eat shareholder value for lunch and dinner'. Therefore, in our view, it is important that investors do not solely look at culture as an HR issue that is value additive to a company, but also consider the broader financial implications of culture-based financial risks.

Similar to climate change risks, culture-based financial risks are also materialised and exacerbated by the fast and often unpredictable shift in societal norms and regulatory changes. These risks are increasingly moving beyond reputation and are becoming compliance and legal risks for companies. Investors can use engagement to encourage appropriate disclosure and action from companies that go beyond policies and self-assessments.

At the same time, companies should consider the broader impacts of harmful behaviours in their workplaces. These incidents can have long-term implications for their relevant sectors, and can potentially lead to significant impacts on the societies and economies where they operate. The framework

and recommendations provided in this article can help companies understand these risks from a different lens.

Finally, it is critical to acknowledge that a safe and respectful workplace is also a matter of human rights. All workers have the right to physical and psychological safety at work, and managing culture-based financial risks will help companies to better protect these human rights. Our framework sits in the broader context of human rights management, and we hope that this framing will help bring the investor voice to these conversations and enable better communication and action from all stakeholders involved.

This is an excerpt from a Fidelity International report, which can be found [here](#).

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With thanks to:

Sue Lyn Stubbs is a Sustainable Investing Analyst at Fidelity International, where she works closely with Fidelity's Investment and global Sustainable Investing team to integrate sustainability into Fidelity's investment processes.

ENDNOTES

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Ground Breakers

Financial Sector Culture, Conduct Risk, and Prosperity: Lessons from the UK

By: SIR KEITH SKEOCH



Sir Keith Skeoch

Capitalism is again suffering one of its many periodic crises.

This time, however, it's not the result of economic consequences stemming from a major financial market crash or panic. Rather, there appears to be a growing lack of confidence that the

economic model which has delivered such wide-spread prosperity over the last 400 years is now failing to do so, despite the economy recovering from the deep recession caused by pandemic-induced lock downs.

The improvements in prosperity that normally follow such a period of recovery is not only narrowly distributed but, for the first time in living memory, it appears also not to be delivered across the generations. Those just entering the workforce, or early in their careers, face the historically unusual prospect of being much worse off than their parents. Rising inequality, both within and across generations, not only undermines confidence in the economic system but

There appears to be a growing lack of confidence that the economic model which has delivered such wide-spread prosperity over the last 400 years is now failing to do so.

also promotes political polarisation at the very time when we need to focus on collaborating to restore shared prosperity.

The function of finance

What on earth, you may be thinking, has this to do with financial services, regulation, and the behaviours of those involved? A great deal, I would argue, a great deal.

Right at the heart of the capitalist system are two key functions: the ability to collectivise savings and then to transform them into capital that finances economic activity and generates growth. Sustained growth delivers rising incomes, either through increased employment or productivity (sometimes both), and increased wealth for savers through the returns on their investments. The combination of all three helps to determine the pace of prosperity. Put simply, turning savings into successful investments powers future prosperity.

What could be a more important social purpose for financial services? Indeed, according to Morck & Yeung, "The social purpose of the financial system is to entrust people's savings to firms governed by trustworthy people."¹

While by no means perfect, our financial systems do appear to be a lot safer than they were in 2008. Barriers to entry for firms and individuals are robust, prudential solvency and supervision of providers and individuals are much improved. There have been some notable bumps in the road; the liquidity issues in lockdown, the failure of SVB, etc. But, by and large, financial markets have suffered only temporary disturbances. However, while the system is arguably "safer" for

savers, that doesn't mean that financial services are doing the second and arguably most important part of their role well.

The outlook for GDP growth is universally acknowledged to be poor, relative to history, with trend global growth dropping by around 1%.² In part, this has been driven by a slowdown in business investment, which is now well below the pre GFC trend. Compare and contrast these worrying trends with the \$122 trillion increase in world-wide non-bank financial assets between 2008 and 2022, rising from around 150% to 200% of GDP.³ These are largely the assets of insurance companies, pension funds and investment managers, and so should be available to finance investment.

It's clear from this data that the current system has been very successful, and increasingly successful, in developing the mechanisms for collectivising savings from simple bank or mutual savings accounts to highly leveraged, risk-seeking vehicles, or "hedge" funds. At a very superficial level, then, there has been no apparent shortage of money available to be invested to finance future prosperity. But it is one thing to collect savers' money on a well-governed balance sheet to make capital available, and it is an entirely different thing to invest it well and generate a robust return.

Embedded incentives

As Keynes rather poetically pointed out, "the social purpose of *skilled* investment is to defeat the dark forces of time and ignorance which envelop our future."⁴ Or, as Jean Tirole put it a bit more formally, the purpose of investment "is to mediate between badly informed savers and the users of capital."⁵ So

why, if ample capital is available, is it not being utilised to finance *productive* capital? And why is conduct an important part of the solution?

The social purpose of the financial system is to entrust people's savings to firms governed by trustworthy people.

RANDALL MORCK & BERNARD YEUNG
"AGENCY PROBLEMS AND THE FATE OF CAPITALISM"

The standard response will identify here uncertainty in the outlook for the economy and business, and possibly some structural impediments. These are undoubtedly powerful forces that can dominate the short-term, and indeed have done so over the last five years. But behaviours driven by embedded

incentives can also have very powerful effects over the long term, though their role is often less well recognised and understood.

These powerful effects relate not just to how well individuals and entities conduct themselves in the course of their day-to-day business but also the manner in which a system is organised and managed, to include the incentives it deploys to influence behaviours. To quote Charlie Munger, "show me the incentive and I'll show you the outcome."⁶ But understood rightly, incentives are far, far broader than just monetary rewards for individuals. They are also deeply embedded within regulations, codes of conduct, the prevailing economic paradigm, and social mores that ultimately define how the financial system delivers on its social purpose.

The UK provides an interesting case study of why culture, conduct, and incentives are important for the financial system beyond the banking sector. It's the country with the lowest investment rate per capita, despite having the second largest pool of investible capital in the G7. It also ranks at the bottom of Edelman's 2024 Trust Survey and, so, is one of the places where the need to start rebuilding trust is most pressing.⁷

Why, if ample capital is available, is it not being utilised to finance *productive* capital?

Structural shifts

While the need may be pressing, there are no quick fixes to rebuilding trust.

The UK's modern financial architecture, infrastructure, and regulation are the result of a host of well-intentioned policies put in place over the last forty years. Some have been very beneficial for the banking system and — beyond prudential solvency, stress-testing, resolution regimes and supervision — individual behaviours among those operating in the industry are much improved, leading to much greater resilience across the system.

However, some of the policies put in place have had unfortunate and unintended long-term consequences. At best, they have fostered the impression of perpetual change rather than stability, reducing confidence in the financial system. At worst, their interaction has put in place a set of long-term incentives that represent a potentially toxic impact on the supply of funds available for long-term, riskier investments. I would single out four as having had the largest impact:

1. The scrapping of Advanced Corporation Tax and Pension fund tax credits on Dividends in 1997, which not only signalled the end of the “cult of the equity” but also removed the tax advantage of owning equity and receiving dividend for long term institutions. Some estimates have put the total loss as high as £250bn over the last twenty years. This came in the same Budget that introduced the very successful tax-free Individual Savings Account and, with hindsight, signalled the start of the transfer of investment risk from corporates and institutions to individuals.
2. The introduction of Financial Reporting Standard 17 in 2001, an accounting change that forced companies to mark to market the assets of their defined benefit pension schemes appearing on

their balance sheets. This created a massive incentive for company sponsors to shift the liability off their balance sheet, and for trustees to transfer investment and payment risk to insurance companies as the schemes matured and members retired. This really accelerated the transfer of investment risk to individuals.

3. The introduction of risk-based solvency in 2001 for insurance companies, and for pension schemes in 2004. While this delivered a significant improvement in prudential solvency, it also increased the pro-cyclicality of insurance assets, particularly in the UK. It also led to the creation of the market for Liability Driven Investments (LDI) for pension schemes.

Each of the above has a strong intellectual foundation and had a strong case for its application in its own field. However, the unintended consequences of combining all three has had a toxic effect on the supply of funds available for long-term riskier investments.

In part this was a consequence of unfortunate timing; the measures were already starting to show impact, just as the global financial crisis took hold and was followed by over a decade of exceptionally low inflation, with interest rates close to zero. In this environment, the valuation of liabilities soared, as did the demand for risk free assets that the new solvency regimes had placed in such high regard. In so doing, this created the pre-conditions for profound instability in the bond markets, witnessed in September 2022 during the “dash for cash” that triggered the LDI crisis.

4. Matters were not then helped by the introduction of an aggressive consumerist agenda at the Financial Conduct Authority, in 2013, marking a very different tone and a far heavier emphasis on consumer protection. While understandable and popular, in the wake of the financial crisis, there was little focus on the needs of savers who provide capital to finance investments.

The difference between consumers' needs and savers' needs may be subtle, but it's incredibly important when it comes to risk and the risk cultures.

Culture and consequence

In extremis, it's a question of risk appetite. Commoditised financial products with reasonably certain outcomes suit low risk appetites and warrant high levels of protection. Those exposed to longer term, financial market outcomes require an increased risk appetite and accept much lower levels of protection. However, a higher risk appetite requires a stronger risk culture, where the values, beliefs, knowledge, attitudes, and understanding about risk is shared by groups with a common purpose.⁸

An effective risk culture enables and rewards groups for taking the right risks in an informed manner. It is precisely this risk culture that should allow the financial sector to display the skill and intermediary prowess that Keynes and Tirole identify as vital to its social purpose.

While impossible to prove, my own sense is that the aggressive approach did have an impact on risk aversion, and especially not so for ordinary savers rather than professional investors. One consequence of this, probably at the margins, was that most individuals chose not to top the employer contributions into DC pension schemes, reducing the flow of funds available for long term investments. A more concrete example was the campaign against investing institutions using commission to pay for investment research and corporate access, due to perceived conflicts of interest and its effective ban from 2014. This generated a significant deterioration in the quality of UK-based independent investment research and, more importantly, it killed off the flow of research on smaller companies so critical for IPOs.

The impact on the supply of UK long-term capital for domestic risky assets has been devastating, particularly for equity. Life insurance and pension funds, back in 1997, owned around 46% of the domestic equity market. By the end of 2002, they owned 4.2%.

Beneath these already shocking statistics are a number of deeper structural concerns: The large-scale mechanisms for pooling investment risk for the average person have virtually disappeared, and are fading ever faster. For individual savers, access to and connections with the markets that turn savings into capital available to be invested have become increasingly fragmented and complex. While the stock of investible assets based in the UK today is high, unsurprisingly given the above, not enough is being saved, flows into pension and investment funds remain depressed, and are far too low for self-funded retirements for many. At a time when there are many calls on the public purse, the cost of state pension provision is likely to remain burdensome. The UK

equity market has now become very dependent on overseas capital and the once leading market is in danger of becoming an 'also-ran.'

Finally, much of the post-crisis debate was about the need for long term investors and effective stewardship to help to reinforce the social purpose of

the financial system. The mechanism for doing that is equity ownership. Sadly, however, at the very time demand for action was increasing, the UK was taking away ammunition from its front-line troops. The UK's Governance and Stewardship codes once led the world, and still aspire to do so, but the requisite firepower available through domestic institutions and ownership is much reduced.

An effective risk culture enables and rewards groups for taking the right risks in an informed manner.

New narratives needed

Culture and conduct risk mitigants are powerful tools: they not only influence behaviours, but the incentives they embed can have profound effects on its social purpose in capitalism — the delivery of prosperity. It is abundantly clear from the UK's experience that seemingly modest, well intentioned, and sometimes technical changes to incentives in the financial system have powerful effects on behaviours, but it may take a long time before their full force is felt and impacts are understood.

Long here is measured in terms of decades, not years or parliaments. Policymakers and politicians should take note when embarking on change or a seeking a quick-fix. The complex and deeply interlinked relationships that characterise financial systems suggests the full systematic impact of any proposed change to incentives needs to be assessed before change is put in place. This should include a full consultation with those likely to be affected and serious consideration given to their views.

The importance of narrative and its influence on behaviours should not be underestimated. Politicians have long understood this but economists are just starting to get to grip on its impact.⁹ The power of narrative will surely only increase as AI and social media take an even firmer hold on popular attention. We need a powerful narrative to promote the benefits of saving, investing, and building a culture of investment stewardship.

Stewardship should
lie at the centre
of financial and
economic life.

Stewardship should lie at the centre of financial and economic life.

- Asset gatherers are the stewards of savers' funds and need simple, transparent, and cost-effective propositions to deliver returns that allow the vast majority of individuals, not just the privileged few, to cope financially with life's trials and tribulations.
- Investors are the stewards of the assets they manage, and they have fiduciary responsibilities to their clients regarding their ability to deliver a return to help meet savers needs.
- Companies and boards of directors are stewards of the capital they are allocated, the assets they acquire with it, and the returns delivered to investors and their ultimate clients, savers.
- And, finally, policymakers also need to recognise that they are stewards of the economic and financial system itself, and should take a long run approach to its sustained health rather than seeking out shorter-run fixes.

This is the way we can rebuild and reinvigorate the risk culture that society needs and deliver the financial system fit for the social purpose that society deserves. It will take a long time.

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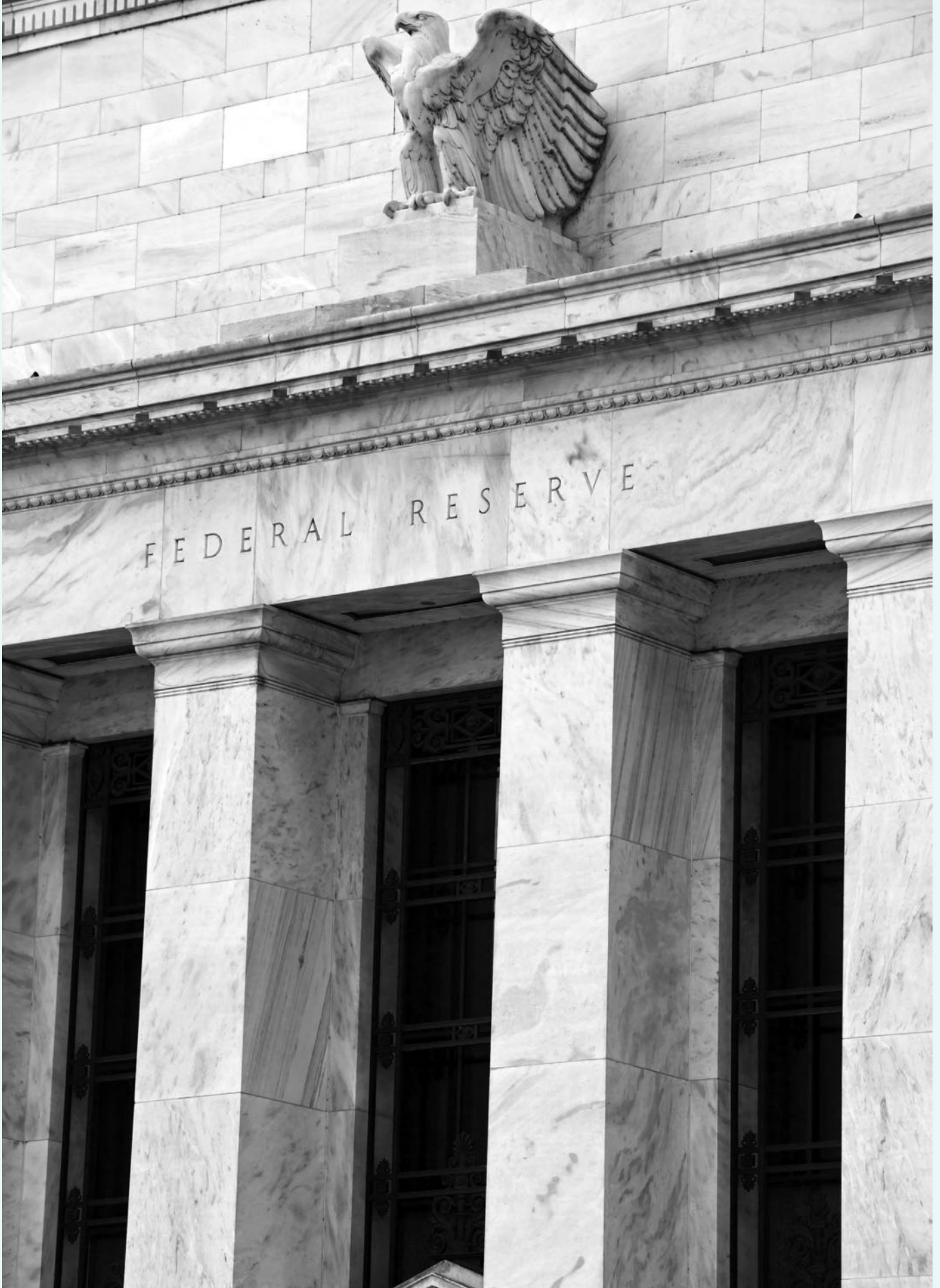


GOOD COUNSEL

Science is built up of facts, as a house is built of stones;
but an accumulation of facts is no more a science
than a heap of stones is a house.

HENRI POINCARÉ

SCIENCE AND HYPOTHESIS (1905)



Good Counsel

The Supercycle: Where Regional Bank Boards Should Focus

By: MARGARET E. TAHYAR



Margaret E. Tahyar

Davis Polk

of new regulations, revised guidance, enhanced supervision and uncertainty created by litigation against the agencies.

Based on interactions with dozens of mid-size and regional banking organizations since March 2023, a few themes around these non-financial risks have emerged. These themes are especially important for growth-minded banking organizations for which the industrial logic of consolidation is inexorable. Senior Management and boards should focus now so as to be ready to take advantage of any future opportunities for growth or merger.

Introduction

It is widely recognized that the fallout from the banking turmoil of March 2023 has created a challenging environment for mid-size and regional banking organizations. In addition to the pressures from the credit cycle and interest rate changes, banking organizations have been dealing with a “supercycle”

Many banking organizations find themselves in situations where they must clean up enforcement actions or other supervisory smudges before the organization can grow or merge.

This article first sets out the context of the supercycle, then suggests what a banking organization can do to keep its house in order, including by avoiding formal or informal enforcement actions and maintaining strong, healthy community and supervisory relationships.

Alas, in this imperfect world, many banking organizations find themselves in situations where they must clean up enforcement actions or other supervisory smudges before the organization can grow or merge. For those organizations, the focus must be on working their way out of those problems constraining growth or preventing a merger.

The Context of the Supercycle

The pace of change has accelerated in multiple aspects of the regulatory, supervisory and litigation environments.

The sheer number of proposed and finalized regulatory changes is enormous. If one looks at the Federal Reserve, OCC, FDIC, CFPB and SEC, there is a tsunami of proposed and finalized regulatory changes since the beginning of the Biden Administration. To understand the scale of changes being proposed, consider the sheer number of new pages of proposed or final regulations in the Federal Register. Since 2021, the

Federal Reserve, OCC, FDIC and CFPB have proposed or finalized regulations that account for 3,192 pages in the Federal Register. If one includes the SEC, there are 4,697 additional pages, for a total of 7,889 pages.

These numbers do not capture guidance from the agencies, a few examples of which include: proposed bank merger guidance, proposed changes to corporate governance, climate guidance, third party guidelines and limits on novel activities. It also does not capture the breakdown of the technocratic consensus at the

agencies, increasingly revealed by the strong uptick in dissenting votes and public spars between agency principals on key topics of the day.

Another fundamental change is the increase in litigation, both against the agencies and in the private sector. In the Davis Polk Financial Institutions Group, we have been tracking 17 litigations affecting the banking sector, six of which are at the Supreme Court. The historical run rate is about one or two per year.

The increase in litigation reveals that something major has changed in the banking sector, which historically has been reluctant to sue its regulators. At the moment, we are tracking five suits by the banking sector against the CFPB, two suits against the Federal Reserve and one suit against the OCC, FDIC and Federal Reserve jointly. Of course, the suit on the jointly proposed Basel III Endgame is only threatened, not active.

Moreover, there are also suits by general trade associations and others challenging the SEC's climate rule and the FTC's noncompete rule. Some of these suits are driven by direct costs to the bottom line imposed by the regulations, such as the interchange fees and late fees, and other suits are driven by the intense increases in regulatory complexity, such as the climate rule and the noncompete rule. The increase in litigation also shows the fragility of the collaborative relationship between the regulators and the regulated.¹ **▶ PAGE 187**

The enhanced supervisory environment of "speed, force, and agility" since the banking turmoil has also led to a sharp increase in enforcement actions whether informal, such as a nonpublic memorandum of understanding, or formal, such as a public consent order.²

There is a tsunami of proposed and finalized regulatory changes since the beginning of the Biden Administration.

In today's environment there is a high risk of a supervisory smudge, such as an adverse exam finding.

In today's environment there is a high risk of a supervisory smudge, such as an adverse exam finding, matter requiring attention or matter requiring immediate attention. According to the Federal Reserve's May 2024 Supervision and Regulation Report, only about one-third of banks with total assets of \$100 million or more had satisfactory ratings across all three components of the Federal Reserve's rating system as of December 31, 2023.³

Supervisory findings related to weaknesses in liquidity and interest rate risk management have been on the rise, but the majority of the large bank outstanding findings relate to governance and risk control shortcomings. The number of supervisory findings for banks with less than \$100 billion in assets have also increased. The most common supervisory issues for these banks relate to IT/operational risk, market/liquidity risk, credit risk and management weaknesses.

So, with this context, where does a growth-minded bank focus its attention to prepare for a merger?

Keep the House in Order

To prepare to grow into a larger, more complex organization and to be integration ready, a banking organization must keep its house in order. It is optimal to avoid a consent order or a memorandum of understanding because banking organizations with enforcement orders are often discouraged or prohibited from acquiring another bank. Sometimes even adverse exam findings or downgrades lead to discouragement of growth or acquisition.

On the target side, since memoranda of understanding, like CAMELS ratings, are confidential

supervisory information, that information cannot be shared with the acquiring entity. There are often enough clues in the diligence materials to raise concerns about mysterious redactions, such that experienced readers will know there is a problem but not what the problem is. It is unfortunate that there is not a limited exemption from confidential supervisory information for mergers given that no banking organization wants to buy the risk of a material supervisory smudge or downgrade from another.

The public release of Silicon Valley Bank's confidential supervisory information, including the draft memorandum of understanding and matters requiring attention or immediate attention, have revealed a path forward to keep the house in order.⁴ These are:

- **Senior Supervisory Relationships.** A good relationship with the on-site regulators is critical. If that relationship is not healthy, nothing will go right. It is almost impossible to overcommunicate. There should be no surprises to the regulators—don't hold back bad news. The time to invest in senior supervisory relationships, at the regional and national level, is before there is any trouble. Many regional banking organizations do not pay enough attention to relationships in Washington, which is a mistake because, more and more, decisions are made or heavily influenced there.
- **Board Effectiveness.** Do the regulators view the board as effective? In particular, is the board actively managing the information provided to it by management? Has the board reviewed its composition, skill set and committee structure lately? Expect an enhanced focus on big bank or other commercial banking experience, especially in a rapidly growing organization.

The majority of the large bank outstanding findings relate to governance and risk control shortcomings.

Compliance is about how the whole bank operates, not just the compliance function.

- **Senior Management Accountability.** There is a renewed focus by supervisory staff on insisting that boards hold senior management accountable for its actions in strategy, risk and more broadly.
- **Risk Governance.** It is important for boards to exercise strong oversight of the risk function, starting with stature, budget and authority. Risk should be fully embedded in the first and second lines and set at a standard for where the bank aims to grow, not where it is today. If the first line is not managing the risks effectively, all the second line can do is point it out. But, the problem in the first line must be fixed. Historically, business units have sometimes outsourced management of non-financial risk to the second line. With growth, this breaks down. Clearly and properly delineated roles and responsibilities are critical, particularly as a banking organization grows.
- **Audit.** Is the audit function strong with the stature, budget and authority it needs? Does it have large bank experience in its talent pool?
- **Legal.** Since the passage of the Dodd-Frank Act, the legal environment has become much more complicated. At the same time, banks' business models have become more complex. The legal function has, in many regional banks, not always been given the independence, stature and authority that it needs to keep up with these developments. At the same time, risk and compliance have grown a great deal, creating more internal clients for the legal function.
- **Compliance.** Compliance is about how the whole bank operates, not just the compliance function. Is compliance in good shape, especially with respect to consumer laws and regulations? Other hot spots are BSA/AML and BaaS.

- **Community Relations.** Any acquisition minded bank needs to keep its CRA rating, engage in local philanthropy, keep up its relationship with community groups and consider community benefit agreements. None of these actions guarantee that there will not be adverse comments, but it lessens the risk. As a result, there should be board level line of sight into these areas.
- **Talent Management.** Is your senior management up to the task of running a larger organization? Hiring should focus on where you aim to be, not where you are now.
- **IT and Cybersecurity.** How up to date is your core technology? Are you complying with cybersecurity requirements and best practices? Failure to invest in adequate technology can increase cybersecurity risk and lead to supervisory findings.
- **Models.** One of the lessons from the release of confidential supervisory information about Silicon Valley Bank is how necessary it is that there be in-house expertise on model risk management. As noted in the report by Vice Chair Michael Barr, a model for interest rate risk was implemented, largely by consultants, but it output the wrong information.⁵
- **Proper Use of Consultants.** Fresh eyes can be very effective in spotting problems and examining the effectiveness of risk management. But, ultimately, the bank has to address these issues itself. Third parties are tools to help the bank fix its own problems. If the balance is not right, the changes driven by the third party will be superficial and not embedded. The supervisory staff will notice.

Nobody wants to be subject to a public naming and shaming.

It is a rare situation where the supervisory staff is completely wrong.

The bottom line here, especially for those who are acquisition minded, is to make sure the banking organization is preparing now to be a larger, more complex organization. For those who are thinking a sale, keeping the house in order decreases the regulatory risk for approvals.

From Supervisory Smudges to Consent Orders

Banking organizations are too complicated and too highly regulated to never have any material problems.

Things will go wrong. It's risk mitigation, not risk elimination.

Two points for when the inevitable breakdowns occur: (1) If a bank has been systematic in working to address risks, it will be credible when it puts the breakdown in context; and (2) Nothing is more important than fixing identified problems. Banks that can do so are in one category with supervisory staff, banks that can't are in another. Once a bank gets into the latter category it can be very hard to recover.

Supervisory smudges will not necessarily stop growth or an acquisition but a memorandum of understanding or a consent order will. This limit on expansionary activities, including new branches or new lines of business, and acquisitions is often a shock to senior management or the board. The need to work through the five stages of grief is especially acute in banking organizations where senior management or board members have not previously experienced an enforcement action.

It is critical that both the board and management work together when there is an enforcement action. Enforcement actions are often signed by the board members and often contain explicit tasks for the board, both in terms of

heightened oversight and in terms of actions that the board must take to hold senior management accountable for fixing the identified issues.

It is common for board members to worry about their fiduciary duties and whether they will be personally liable should the issues not be fixed. Personal liability or fines against board members are exceedingly rare and unknown outside of situations where the board member is personally engaged in some kind of fraud. But the implicit threat is always in the air, and most board members are worried about their hard-won reputations. Even absent the exceedingly rare case of personal liability, nobody wants to be subject to a public naming and shaming. The best way for a board member to view an enforcement action is that it, alone, does not change fiduciary duties, but it is deliberately designed to increase the pressure on boards.

A banking organization must work its way out of a consent order, memorandum of understanding, adverse finding or other supervisory criticism.

There is an escalating stair step and wise banking organizations find a way off the staircase at the stage of adverse exam findings by taking these adverse examination findings seriously and building a program office to deal with them efficiently and effectively. It is possible to appeal adverse examination findings or to work through them with the ombudsman if a banking organization believes that the supervisory staff is mistaken. It is a rare situation where the supervisory staff is completely wrong. Instead, management of the affected part of the banking organization is often at the denial stage. When senior management or the board steps in and forces the issues to be fixed, it is possible that the situation is remedied.

Deficiencies
require a material
change to cure.

Deficiencies require a material change to cure. Problems escalate when, for a variety of reasons, senior management or the board does not engage in a meaningful, strategic assessment of the problem and implement material changes. It is at that stage that the supervisory staff will escalate by announcing that a memorandum of understanding, often to be signed by the board, will be forthcoming. At that point, it is wise for the board to form an *ad hoc* committee to begin the heightened supervision that will be required by the memorandum of understanding.

The eight-month lag between the time that the supervisory staff notified Silicon Valley Bank that it would receive a memorandum of understanding and the actual sending of the draft to management and the board on the eve of its bankruptcy is only slightly longer than the norm of around six months. For a

healthy institution, this lag time is an opportunity to begin to fix the issues already identified in the adverse exam findings, matters requiring attention and matters requiring immediate attention.

A banking organization with a memorandum of understanding or a consent order should anticipate at least two years, and possibly three, before it can work its way into a situation where it can engage in expansionary activities.

Conclusion

There is a way to avoid or work through supervisory problems, but it takes time, resources and the willingness to face up to sometimes uncomfortable and meaningful changes. Growth-minded banks should focus now on avoiding or working through these problems to be ready to take advantage of any future opportunities for growth or a merger.

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ENDNOTES

- 1 Jamie Dimon, "Annual Report — Letter to Shareholders," *JPMorgan Chase & Co*, 2023. [LINK ▶](#)
- 2 Michael S. Barr, "Supervision with Speed, Force, and Agility," Speech at the Annual Columbia Law School Banking Conference, New York, Feb. 16, 2024. [LINK ▶](#)
- 3 Board of Governors of the Federal Reserve System, "Supervision and Regulation Report," May 2024 [LINK ▶](#)
- 4 Board of Governors of the Federal Reserve System, Memorandum of Understanding By and Among SVB Financial Group, Silicon Valley Bank, Federal Reserve Bank of San Francisco & California Department of Financial Protection and Innovation, Apr. 2023. [LINK ▶](#)
- 5 Board of Governors of the Federal Reserve System, "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank," Apr. 28, 2023. [LINK ▶](#)

Good Counsel

‘Systems Intentionality’: A New, Work-Ready Model of Corporate Responsibility

By: ELISE BANT



Elise Bant



This article explains a new model of corporate responsibility entitled ‘Systems Intentionality’. This posits that *corporations manifest their states of mind through their de facto systems of conduct, policies and practices.*¹

The model builds on decades of outstanding work by scholars, law reformers, legislatures and courts towards developing

holistic models of organisational blameworthiness, including in developing understandings of ‘corporate culture’ and the relationship between culture and corporate liability.

The ‘value-add’ of the model is that it is practically workable as a regulatory and litigation tool: in particular, it readily enables fact-finders to assess specific corporate mental elements, such as knowledge, general and specific intention, mistake,

In common law jurisdictions, the legal toolkit for assessing corporate culpability is increasingly regarded as unfit for purpose.

and more complex normative assessments, such as recklessness, dishonesty and unconscionability, which underpin many important civil and criminal doctrines and rules.²

As will become apparent, the model also has powerful implications for responsible corporate governance. While full explication of the model cannot be attempted here, the aim is to give a useful snapshot of its distinctive features and operation, sufficient to encourage those at the coal-face of corporate governance, regulation and enforcement to engage with Systems Intentionality in their practices.

Why do we need Systems Intentionality? The ‘Where’s Wally’ problem.

In common law jurisdictions, with their roots in English courts, the legal toolkit for assessing corporate culpability is increasingly regarded as unfit for purpose. This is because, notwithstanding decades of judicial and legislative development, corporate attribution rules remain largely ‘individualistic’ or ‘nominalist’ in approach. This means that corporate culpability depends on identifying a relevant, individual repository of fault, whose mental state can be treated as that of the corporation.

This game of ‘Where’s Wally’ (or ‘Where’s Waldo’ for North American audiences)³ may be well-suited to small corporate players with tight and hierarchical structures. Here, identifying the responsible agent (whether in the ‘directing mind and will’ of the Board of Directors, or other key decision-makers) may be both straightforward and entirely appropriate. But it makes little sense where corporate conduct operates through teams of individuals, across departments and time, often including through corporate agents. Here, no

one individual may possess relevant knowledge or intention regarding their part in the overall corporate misbehaviour. This is the problem of 'diffused' responsibility.⁴

The problem is well-illustrated by the Arthur Andersen obstruction of justice trial, part of the litigation fall-out from the Enron scandal.⁵ Faced with impending investigation of the firm by Federal authorities, its employees had embarked on a concerted process of identification and destruction of relevant documents. It might have seemed a straightforward business to find that Arthur Andersen had 'knowingly ... corruptly persuad[ed]' its agents and employees 'with intent to cause' them to destroy evidence. But defence counsel Rusty Hardin emphasised throughout the trial the need to identify an individual Waldo-influencer within the firm, subjectively holding the requisite corrupt mindset and intentions. This included commencing his examination of key witnesses with the amusing, but loaded, question: 'Are you Waldo?' These tactics clearly impacted the jury's deliberations.⁶

The same Where's Wally/Waldo emphasis has worked effectively, if not consistently, to defeat attempts to prosecute individuals (often middle managers or employees with limited decision-making authority) for their roles within corporate systems of misconduct.⁷ Jurors, in particular, are rightly cautious of sacrificing individual scapegoats for what seems like corporate wrongdoing.

In other cases, however, relatively junior employees have borne the brunt of carrying out corporate malpractices.⁸ In the UK Rolls-Royce bribery scandal,⁹ for example, senior executives were implicated in some transactions: in these cases, Rolls-Royce was charged with bribery on its own account. But in others, individual, lower-level employees were charged with responsibility for bribery transactions, even though they were carrying out well-established practices, performed by generations of employees working across different teams, departments, and jurisdictions.

Further, employees had not engaged in corrupt activities for their own, personal profit, except to the extent that adherence to the practice resulted in career advancement and reward, which rather makes the point. These were Rolls-Royce's practices and a large part of how it then did business. Nonetheless, in these cases, Rolls-Royce was charged with the separate, and less serious, offence of 'failing to prevent' the employees' bribery. This was because senior officers comprising its 'directing mind and will' were not directly implicated in these bribery events.

While some corporate responsibility might be considered better than none, the result arguably remains problematic. Most evidently, it seems to mischaracterise endemic¹⁰ corporate corruption as organisational ineptitude, thereby undermining the expressive, deterrent and retributive aims of the law.

The position only gets worse once automation and algorithmic processes come into play. Here, the attribution game of 'Where's WALL-E' loses all credibility.¹¹ Even a simple automated fee deduction process may swiftly degenerate into an ad hoc and unprincipled search for a human fall-guy: is Wally/Waldo the coder, some coding team, or series of coding teams, or software engineer, or employee who presses a button, or manager of the department in which the software is notionally situated...?

Faced with the clear inequity of this individuated approach, and likely personal ignorance of senior corporate officers of the details of automated processes, courts and juries are much more likely to accept corporate pleas of 'systems errors' and 'administrative mistake'. Here, executive ignorance whitewashes the corporate conscience very effectively. Thus, in Australia, senior officers of banks caught charging fees for no services, carried out through automated fee deduction processes, often over very long periods of time, have been all too happy to admit to quite astounding organisational incompetence rather than dishonesty or, in everyday parlance, theft. Directors typically drew attention

to the fact that their employees were individually honest and hardworking, while senior leadership were personally unaware of the problems generated 'by the system'.¹²

As more sophisticated machine learning and artificial intelligence systems become embedded in corporate business practices, a Where's WALL-E approach may even support corporate sleights-of-hand that falsely seek to blame a non-sentient tool, the AI, as being 'responsible' for the deploying corporation's wrongdoing.¹³ Directors may well testify to ignorance of the innately harmful tendencies of 'off the shelf' programs (the 'black box' problem), blame 'legacy systems' or argue that different computer systems 'did not speak' to one another.¹⁴ In all of these narratives, the corporation (through its officers) presents itself as an unknowing and hence innocent, or mistaken, participant — at worst a bumbling incompetent in a complex world of evolving technologies.¹⁵

Lacking natural minds, corporations think through their systems of conduct, policies and practices.

What is Systems Intentionality?

Unlike these individualistic games of Where's Wally, Systems Intentionality is a holistic and 'realist' approach to organisational responsibility. It sees corporations as more than the sum of their natural parts and, hence, looks beyond 'responsible agents' in all their variety to understand the anatomy of corporate minds.

In sum, Systems Intentionality proposes that the everyday (real-life) systems of conduct, policies and practices of a corporation 'manifest' its mental states, both in the sense of revealing and instantiating them. Another way of putting this is to say that,

lacking natural minds, corporations think through their systems of conduct, policies and practices. By assessing the objective features of these systems, it becomes readily possible to determine important corporate states of mind, such as intention and knowledge, as well as related concepts, such as dishonesty and recklessness. The core ideas underpinning the model are simple, intuitive and rest on common understandings: all useful attributes, particularly in jury contexts.

A 'system of conduct' is a method, process, or plan of procedure, a coherent set of steps that combine in a coordinated way in order to achieve some aim (whether conduct or, additionally, result). The inherently purposive nature of systems is obvious from these common meanings, a point to which we return below.

'Practices' are systems of conduct that often arise organically, from the ground up. They typically occur where patterns of behaviour become habitual or customary in nature, so that the practice becomes the default response to repeated events or circumstances.

Corporate 'policies' are also guides to behaviour, and so related to systems and practices, but tend to operate at a higher level of generality. These manifest a corporation's (or some corporate section's) overarching and high-level purposes, beliefs and values. Policies operate to influence, nudge or direct the development and deployment of everyday systems and practices at more granular and event- or conduct-specific levels.¹⁶ In these ways, 'policies' are closely associated with conceptions of corporate culture, or ethos, which also operate to nudge employees' decision-making and behaviours in their daily work.

How does Systems Intentionality work to shed light on the corporate mind?

INTENTIONS AND KNOWLEDGE

We know that natural persons routinely use systems of conduct to support their decision-making and, hence, conduct.¹⁷ Common examples are recipes, maps and notations. These 'extended mind' supports enable a person to achieve their purpose without having to solely rely on memory, intuition or happy accident. Thus, when I am observed deploying a cake recipe, this recipe-system of conduct both reveals and instantiates ('manifests') my intention to bake (my generally intended conduct) in order to make a cake (my specifically intended result of my deliberate conduct). Further, some of my knowledge is patent from my successful application of the recipe: I must know what flour is, the process of beating eggs and so on, in order successfully to apply the recipe-system of conduct. In these ways, I manifest my intentions and knowledge through my recipe-system of conduct.

Similarly, corporations utilise systems of conduct to enable them to achieve their organisational ends. Systems are inherently purposive, in that they exist to achieve some end(s), such as coordinated conduct (general intention) or some specific outcome from that conduct (specific intention).

Importantly, corporations also must be taken to know the core features of their practices, patent on the face of those systems, and essential to their successful operation. In this way, Systems Intentionality readily captures the basic building blocks of responsibility: general and specific intention, and knowledge.

Corporations utilise systems of conduct to enable them to achieve their organisational ends.

It is the coordinated set of processes taken as a whole that constitute intended conduct.

As we will see from the case examples below, with these simple ingredients, it becomes possible to assess a range of important, related doctrinal concepts, such as unconscionability, dishonesty and recklessness.¹⁸

IGNORANCE IS NOT BLISS

These propositions have some further, profound ramifications. For example, the model refutes that corporations are 'ignorant' (and therefore innocent) of their own systems of misconduct, simply because

Boards members are oblivious to them. Boards form the baseline decision-making systems required to transform passive corporate shells into purposive actors, but they hardly exhaust the range of systems typically required to achieve a corporation's ends.

Examples are legion, but embedded 'standard operating procedures' are common forms of corporate systems of conduct. These guide and coordinate otherwise diffused individual employee conduct to achieve some end(s), and so remove or reduce unpredictability associated with employee mistake and turn-over. Automated systems arguably lie along the same spectrum, and are subject to the

same analysis. Returning to my cake example, my states of mind are manifested equally clearly whether I use an automated food processor or bake solely by hand. So too with corporations. Indeed, as we will see below, the default settings and key design features of corporate

automated systems often loudly declare the corporate values, intentions and knowledge.

Further, systems of conduct will often comprise both positive and negative, and proactive and reactive, elements. What may look like a primary system (for example, a marketing strategy or automated

fee deduction system) itself necessarily entails the adoption of certain steps *and omissions of others*. It is the coordinated set of processes taken as a whole that constitute intended conduct. This means that the omission of audit and remedial mechanisms relating to a primary system of conduct, or adoption of corporate practices that ensure that ‘bad news does not travel upward’, may legitimately be understood as an intrinsic part of a system’s overall design and reflecting active corporate choice. This analysis is both necessary and appropriate, given that systems of conduct are generally intended to roll out repeatedly over time.

As systems of conduct generally involve repeated behaviours, any allegation of error needs to be tested against the organisation’s reaction to its repeated behaviours.

MISTAKES AND ‘SYSTEMS ERRORS’

The model also challenges the common corporate narrative that harm resulting from some system of conduct was a ‘mistake’.¹⁹ Of course, it is possible for an organisation’s intentions to be vitiated through a genuine ‘systems error’, for example where an employee presses a wrong button, initiating a system of conduct in circumstances for which it was not designed. Or a human coder may make an error in transcribing a proposed system of conduct into code.²⁰ Or a rogue employee (the notorious bad apple) may deliberately undermine or sabotage the operation of an otherwise entirely appropriate system of conduct. In this last case, Systems Intentionality operates in a powerful exculpatory or mitigatory way, to show that the corporation was operating as an ethical and prudent corporate citizen. However, where a corporate system of conduct is adopted and deployed according to its terms, the analytical starting point is that the conduct is intended. The evidential onus then lies on the corporation to substantiate any allegation of mistake or accident.

As systems of conduct generally involve repeated behaviours, any allegation of error needs to be tested against the organisation’s reaction to its repeated behaviours and, importantly, the outcomes from its system.²¹

► **SEE COMPENDIUM 2023 PREAMBLE** To return to my cake analogy, suppose that even though, formally, my recipe is one for cakes, I produce pancakes. I may claim I was mistaken in producing pancakes: there was an error in deploying the system-recipe. While this might initially seem plausible, the credibility of this claim

radically reduces as the system is rolled out over time and its effects become clear. After I have produced pancakes on multiple occasions, and certainly once I have served them up to customers for profit, the conclusion becomes irresistible that this is what was intended. Although I was purporting to use a cake recipe, in fact I was intending to make pancakes. So too with firm malpractices: Systems Intentionality suggests that their deployment over time stands important testament to the firm’s ongoing intentions, which must be assessed in light of that longevity.

CORPORATIONS AND CONFLICTING MENTAL STATES

Finally, just as for natural persons, the model leaves room for conflicting mindsets and values within the one organisation. I may be a diligent and trustworthy member of my school parent committee while cheating on my taxes: so too corporations may manifest through their daily practices honest and law-abiding traits in one activity or section, and dishonest and predatory mindsets in another.²² The question for liability (and rehabilitation) purposes concerns the mindset with which the relevant act occurred through the particular system of conduct: broader issues of corporate character may properly go to mitigation, or prospects of rehabilitation.

Systems Intentionality Applied

CASE STUDY 1: DECEPTIVE VIRTUE-SIGNALLING

I have elsewhere described in detail how to identify, and prove, systems of conduct, policies and practices.²³ Evidence 'internal' to the corporation may include employee testimony (including that of whistle-blowers), internal emails and other communications, internal 'scripts' given to employees for dealing with third parties (such as customers and regulators), training-as-delivered, remuneration/reward/promotion criteria, complaint processes and internal audit records, amongst others. Evidence 'external' to the corporation may include patterns of harm or commonality between victims, email and other communications (e.g., telephone, chat exchanges) with customers or other third parties, incentives and disincentives provided to external participants, records of contract or transaction terms, evidence of complaints and corporate responses, and, of course, external audit records. The important point for present purposes is that corporations manifest their states of mind through their real-life, instantiated systems, not the purely formal, paper-based, glossy website versions.

Corporations manifest their states of mind through their real-life, instantiated systems, not the purely formal, paper-based, glossy website versions.

Most sophisticated firms have values statements, policies and employee processes that have been poured over by lawyers with compliance and marketing alike in mind. All too frequently, these bear little resemblance to the actual practices of the firm. Examples are again legion. Every employee knows, for example, that corporate declarations that they care for and value their employees' wellbeing must be discounted by reference to the true daily employment practices. Where, for example, employee rewards and recognition depend on practices such as working late, not claiming overtime, missing scheduled breaks such as for lunch or rest, not taking sick leave or

holidays, then those practices manifest a corporate decision to value other ends (for example, profit) over employee wellbeing. The recent spotlights on deficient audit cultures likewise suggest disturbing shifts in organisational mindsets from prudence towards profit-maximisation, manifested in their daily practices.²⁴ ►SEE SARAH RAPSON ON STARLING INSIGHTS

A more detailed and specific example drawn from the Australian Victorian Casino Royal Commission, concerns Crown Casino's 'responsible gambling policies'. In the words of Commissioner Finkelstein:

*Crown Melbourne had for years held itself out as having a world's best approach to problem gambling. Nothing can be further from the truth.*²⁵

For example, the Commission considered that Crown's 'Red Carpet' program appeared targeted at older members of community (including culturally and linguistically diverse) groups. Participants in

these groups were offered a range of incentives (such as free buffet lunch, and free bus travel to and from the Casino) to sign up for the scheme.

In order for their community organisation to qualify for a Crown subsidy for these activities, and for participants to

get the free bus-trip home, visitors were required to stay for four to six hours. Entirely predictably, many participants went on to gamble extensively, and suffered gambling harms. One independent (non-Crown) study found that 42 per cent of participants spent more than they had planned gambling at the casino and almost a quarter planned to return to win back their losses. Some participants reported overspending so that they could not purchase medications. There was no evidence of any Crown audit or review of this program, to determine its fit with its formal responsible gambling policies. The

program was eventually stopped in 2021, some two decades after its inception and in the face of mounting casino inquiries.

Through the lens of Systems Intentionality, a number of the program features stand out as eloquent to Crown's state of mind: the patent (and therefore corporate-known) vulnerabilities of members of the targeted community groups; the nature and conditions of the program incentives, which manifested an intention to keep participants, including vulnerable participants, at the Casino to encourage spending, including on gambling activities; the omission of any oversight, audit or research by Crown into the impact of its program on participants in light of these features; and failure to react to published concerns about the schemes, over an extended period.

These combine to suggest a mindset far from the prudent and responsible corporate citizen represented through its formal responsible gambling policies. Rather, Systems Intentionality suggests that Crown took knowing advantage of members of a vulnerable class for profit. Such misconduct would likely contravene Australia's fair-trading prohibitions on 'unconscionable conduct,' and reflect a specifically 'predatory' mindset.²⁶ The longstanding and rank divergence between the formal policy and the reality of Crown's deliberate practices is also indicative of organisational 'dishonesty'. These assessments would be highly relevant for regulatory and liability purposes.

Beyond casinos, the case study illustrates the real liability risks associated with misleading virtue-signalling through formal policy and marketing publications. Green-washing, false 'fair trading' and modern slavery statements are all potentially related forms of misconduct. Through the lens of Systems Intentionality, these become directly and powerfully actionable as a form of deceptive conduct in trade or commerce, designed to mislead investors, future

employees, regulators and customers amongst others into thinking that they are dealing with a relevantly ethical corporate citizen.

CASE STUDY TWO: FEES FOR NO SERVICES AND 'SYSTEM ERRORS'

The second case study arises from the 'fees for no services' scandals outlined earlier, and which remain of continued concern to Starling Insights' contributors.²⁷ Many cases involved banks' automated fee deduction systems, which unlawfully took money from deceased customers' accounts for (ironically) life insurance. Commonly, banks pleaded 'systems errors' or mistake. But from the perspective of Systems Intentionality, a range of corporate knowledge is patent on the face of even the most basic elements of such systems.²⁸ Most obviously, (1) any automated 'takings' from customer accounts must be authorised; and (2) being humans, the customers' circumstances might change, affecting existing authorisations. On (2), the key circumstance of which banks were always, necessarily aware is that their customers may die — that is why, after all, they sought life insurance.

Taking a broader and integrated perspective, which encompasses audit and remedial functions, further insights emerge. Here, it is open to characterise the banks as having deployed 'set and forget' automated systems, the default settings for which manifested a corporate purpose to 'keep taking fees until manual intervention'. However, in that context, the *omission* of any functioning manual audit or oversight systems becomes highly significant: it means that there was no means to correct the (inevitable) consequence that, given customers would (inevitably) die, the authorised fees would (inevitably) degenerate into unlawful takings. This is precisely what occurred. This broader angle of focus to capture audit and remedial systems is necessary and entirely appropriate, given that the automated fee deduction systems were designed to roll out over a long period of time, with respect to many customers, to the substantial benefit of the corporations.

Finally, Systems Intentionality places the burden on banks to substantiate any allegation of ‘mistake’ affecting their otherwise deliberate and knowing conduct. In one case, involving automated fee deductions for other forms of financial service, Justice Mark Moshinsky of the Federal Court of Australia accepted a director’s evidence that a human coding error had caused the unlawful takings.²⁹ However, his Honour expressed concern about the paucity of evidence on how the error arose.³⁰ Systems Intentionality explains why further explanation was appropriate and, indeed, necessary to justify the allegation of corporate mistake. Default settings of an automated system manifest corporate choices: after all, an individual coder is unlikely accidentally or randomly to exercise that kind of substantive discretion, at a critical functional juncture, on behalf of the corporation, unaided by direction or guidance.³¹ In any event, as the judge further observed, any human mistake did not explain why there were no audit or remedial systems in place to identify and address the error as the system played out in practice.³²

Seen from this more holistic perspective, Systems Intentionality suggests that where an organisation deploys positive elements of a system that are objectively apt, or indeed guaranteed, to produce a harmful outcome, and omits audit or remedial processes, this omission can be understood as a matter of corporate choice. Such a system may manifest recklessness or ‘callous indifference,’³³ in that it evinces a choice not to care about the inevitable harm that will result. The same conclusion may be open where an adopted system repeatedly results in harms, brought to the attention of the organisation, yet no steps are taken to investigate and correct the deployed system. Further, in some cases, it will be open to conclude that the

Systems Intentionality places the burden on banks to substantiate any allegation of ‘mistake’ affecting their otherwise deliberate and knowing conduct.

Systems Intentionality focuses attention on the features of the practice deployed-in-fact.

specific harmful outcome is intended (in the sense of chosen, rather than desired), so that the system manifests a predatory mindset.

CASE STUDY 3: REVISITING ARTHUR ANDERSEN

We have seen that the Arthur Andersen obstruction of justice trial centred on a practice of destroying documents relevant to Federal authority investigations. On the face of it, through the lens of

Systems Intentionality, that looks like a corporate-intentional act that could readily be put to jurors, for consideration in relation to the mental elements of the offence. What was not mentioned previously, however, was that this practice was performed pursuant to repeated ‘reminders’, including by in-house counsel for Arthur Andersen, that now was a good time to adhere strictly to the firm’s general document retention policy. Could this make a difference to the analysis?

The Supreme Court rightly emphasised that, as a general matter, a direction by in-house counsel or a senior officer, to follow a formal and lawful policy cannot itself be unlawful or corrupt. But Systems Intentionality focuses attention on the features of the *practice deployed-in-fact*, which resulted in the destruction of relevant

documents, rather than either assuming the conduct aligned with the formal policy, or that the formal policy had always been deployed in practice. In both respects, there may have been important differences between the formal policy and the actual practice, relevant to the jury’s deliberations. Most obviously, the very fact that employees were repeatedly ‘reminded’ to apply the policy suggests that the formal policy was not normally strictly

followed. This suggests that the instantiated document destruction practice, purporting to apply the policy, was something new.

Further, the sudden shift to an active practice was indubitably deployed in the face of and by reference to the impending investigation. The evidence of individuals who observed the practice as it rolled out was that it targeted a specific range of documents, relevant to the investigation. Thus, in one instance, a document was destroyed that was labelled 'smoking gun'. This suggests a process, as part of the overall practice, of first identifying and then destroying salient evidence. Prosecutors adopting this approach could clarify the nature of the practice (and hence Arthur Andersen's state of mind) not only through the testimony of observers, but also from employees who carried out the directions, as to what they were told, and what they did. This would not be in order to incriminate them, but to gain valuable insight into the practice-as-deployed.

In Australia, employees embedded within unconscionable systems of conduct are frequently recognised as reliable sources of information on key features of their roles, enabling courts readily to assess the corporate culpability manifested by those systems.³⁴ Not infrequently, employees draw attention to email correspondence, discussions in meetings, and with supervisors for example, which are extremely enlightening on the true nature of the practice-as-deployed. Even where the employee has embraced their role within the corporate practice, as seemed to be the case in the 'smoking gun' example, it is still the corporation's own practice under the spotlight, and employees can and should be encouraged to speak to the process in which they were (more or less wilfully) embedded.

Systemic and sustained change is needed for a culpable corporation to reform its character, as revealed through its systems, policies and processes.
Commissioner Finkelstein

CASE STUDY 4: REHABILITATING CORPORATE OFFENDERS

Finally, the model offers some interesting lessons for corporate governance and rehabilitation.³⁵

As will hopefully be apparent by this stage, the widespread and embedded bribery practices in issue in the Rolls-Royce scandal outlined earlier are revealed through the lens of Systems Intentionality to be Rolls-Royce's own intended conduct. On this analysis, rather than a mere failure to prevent individual employees' misconduct, Rolls-Royce was arguably liable, in all instances, for the offence of bribery on its own account.

Equally importantly, however, Systems Intentionality also explains why cultural change, or 'corporate rehabilitation,' was rightly recognised in that case, as it was in the Australian Crown Casino inquiries, as very difficult, costly and time-consuming, requiring many years under independent oversight to achieve. The problem is that 'Board renewal', replacing layers of management, and writing beautifully ethical formal policies and training manuals will not suffice to change a corporation's character. As Commissioner Finkelstein stated, adopting Systems Intentionality: 'systemic and sustained change is needed for a culpable corporation to reform its character, as revealed through its systems, policies and processes.'³⁶ This assertion challenges firm responses that concentrate on leadership renewal.³⁷

Root cause analysis of misconduct must include the corporate 'structures, values and practices' through which misconduct occurred. Systems Intentionality provides the toolkit for that job.

Of course it is then necessary to develop, test and embed ethical, systemic reform, which includes audit and remediation processes. Rehabilitation also requires that both leaders and employees embedded in the system adopt ethical and compliant practices, including candour in dealing with regulators and other relevant authorities. Finally, where toxic or criminogenic corporate cultures have been longstanding, it may be necessary for reforms to be overseen by external monitors, often over an extended period.

These steps require considerable corporate resources and regulatory infrastructure. But we have long known that 'heads on sticks' are not enough to effect meaningful reform of corporate wrongdoers. Systems Intentionality provides a principled and practical way forward to provide a better 'Future of the Corporation'.³⁸

CASE STUDY FIVE: AUDIT MALPRACTICES

Of course, serious organisational misconduct is not restricted to corporations. Recently reported malpractices by members of 'the Big Four' in Australia, for example, implicate firms that are sometimes (but not always) organised as partnerships.³⁹ Beyond differences in executive remuneration, this means that the organisations' liability mechanisms may differ, as a matter of law. But as social facts, large partnerships generally look, act and sound just like corporations. For this reason, one of the reform options under serious contemplation in Australia is simply to make all large firms incorporate, or otherwise subject to

corporate law, obliterating gaming of organisational forms and taking a strongly functional approach to their regulation.⁴⁰

Whether or not that eventuates, because Systems Intentionality builds on moral and legal theories of *group* responsibility, the model applies perfectly well to partnerships (and indeed other associations, such as governments⁴¹) to determine the group mindset, as a matter of social fact. This is very useful for governance and regulatory purposes,⁴² as well helping to express and condemn appropriately firms' blameworthiness in the court of public opinion. The last is often of primary interest to firms: protecting reputation is 'mission critical', as Australian firms have been powerfully reminded.⁴³

Root cause analysis of misconduct must include the corporate 'structures, values and practices' through which misconduct occurred.

The PwC Australia tax scandal illustrates this well. The saga merits book-length treatment. But the most basic reported facts, drawn from the key inquiries to date, are these.⁴⁴ The Commonwealth of Australia sought advice from certain PwC Australia partners, including a Mr Peter Collins, in relation to confidential and important anti-avoidance tax reforms. Details of these reforms were then shared by Mr Collins with other partners and clients on repeated occasions, with the object of helping clients to avoid the very reforms PwC Australia had helped design. While Collins was a lead character in the misconduct, his behaviour was condoned and even applauded by senior colleagues with whom he shared the information. Further, PwC Australia initially responded to queries into the misconduct by the Australian tax office by inappropriately claiming legal professional privilege in respect of tens of thousands of potentially incriminating documents, and did not report the conduct, in breach of its legal obligations, over many years. Throughout, PwC Australia aggressively asserted its ethical credentials. Eventually, PwC Australia blamed Collins as an

isolated, 'bad apple', before responding to increasing government and public outrage, and emerging evidence in the press, by relegating more and more senior rotten apples to the barrel.

As this threatened to overflow, PwC Australia commissioned an external review by Dr Ziggy Switkowski into the firm's culture.⁴⁵ However, expressly excluded from the scope of the review were the specific matters, systems and practices at the heart of the taxation scandal.

From these reported facts, and through the lens of Systems Intentionality, PwC Australia's scorecard is a massive 'Fail,' assessed against PwC's published core value to 'act with integrity'.⁴⁶

Consider Mr Collins. Even if he was at the root of all breaches, Systems Intentionality explains that repeated misuse of taxation reform information may constitute a 'pattern of behaviour'. A pattern of behaviour can be understood as an externally observable repeated way of acting. Australian courts have explained that patterns of behaviour may provide *evidence* of a system of conduct, which is generating that pattern of behaviour.⁴⁷ In PwC Australia's case, then, repeated instances of misuse of confidential taxation reform information by Mr Collins should have been seen by PwC Australia partners as red-flags, providing evidence of a broader, potential firm malpractice requiring immediate investigation. The fact that partners instead applauded his acumen supports the view that Collins' behaviour was not isolated, but rather consistent with a group practice, participation in which was seen to support firm objectives. There is little doubt that such a practice was objectively apt to garner PwC Australia competitive advantage and profit. This is

A pattern of behaviour can be understood as an externally observable repeated way of acting.

Formal compliance policies and standard operating procedures are not mere puffery, the protective progeny of marketing and legal teams alike, white-washing the corporate conscience.

consistent with the 'shadow culture' of privileging 'rain-makers' within PwC Australia at the expense of compliance identified by the Switkowski report.⁴⁸

Seen as 'practices', Systems Intentionality also provides independent and principled support for the Commonwealth parliamentary committee's withering assessment of PwC Australia's repeated misuse of legal professional privilege and reporting failures: 'Taken together, PwC engaged in a deliberate strategy over many years to cover up the breach of confidentiality and the plan by PwC personnel to monetise it.'⁴⁹ Indeed, through this lens, a strategy of concealment may provide further support for concluding that the initial misconduct was organisationally known and approved. 'Reactive corporate fault' is a powerful indicator of corporate-intentionality, because systems of conduct are necessarily repeated over time. This possibility must also be assessed in light of PwC Australia's inherent and longstanding structural conflicts: on the one hand, providing confidential tax reform advice while on the other hand, advising clients on tax-minimisation and, it seems, -avoidance strategies. Given PwC Australia could hardly be unaware of the inherent risks of its fundamentally conflicted position, its repeated leveraging of those conflicts to its considerable financial benefit, and evasive and sustained patterns of response, suggest a mindset that is at least highly reckless as the risks of unlawful conduct: a decision 'not to care' about the real risks involved.⁵⁰ A more damning conclusion, also open on the facts, was that its practices reflected an organisational readiness to facilitate repeatedly dishonest (individual) conduct in the pursuit of group profit. That is itself group-dishonest, particularly in a specialist firm of very considerable experience.

Finally, it will be recalled from Case Study 1 that misleading virtue-signalling to the market and its regulators may be assessed as deceptive, when made in the face of organisational knowledge of the firm's true, and contrary, practices. Appreciation of this point arguably sits behind the parliamentary and government outrage over the repeated assertions by PwC of its ethical character.⁵¹ If Collins' behaviour was part of a broader practice, not only was the Commonwealth deceived initially into consulting with PwC Australia on its reforms, but the subsequent conduct of PwC has repeated, and deepened, that wrongdoing. Through the lens of Systems Intentionality, this sort of misconduct becomes itself directly and powerfully actionable as a deceptive trade practice. The liability risks of this misconduct, including through maintaining generic value-branding on the firm's websites, are obvious. More broadly, it is a salient reminder to firms that glossy values-statements, formal compliance policies and standard

operating procedures are not mere puffery, the protective progeny of marketing and legal teams alike, white-washing the corporate conscience. Through the lens of Systems Intentionality, they provide a ready and just means to assess and condemn firms engaging in deceptive trade practices: hoisted by their own petard.

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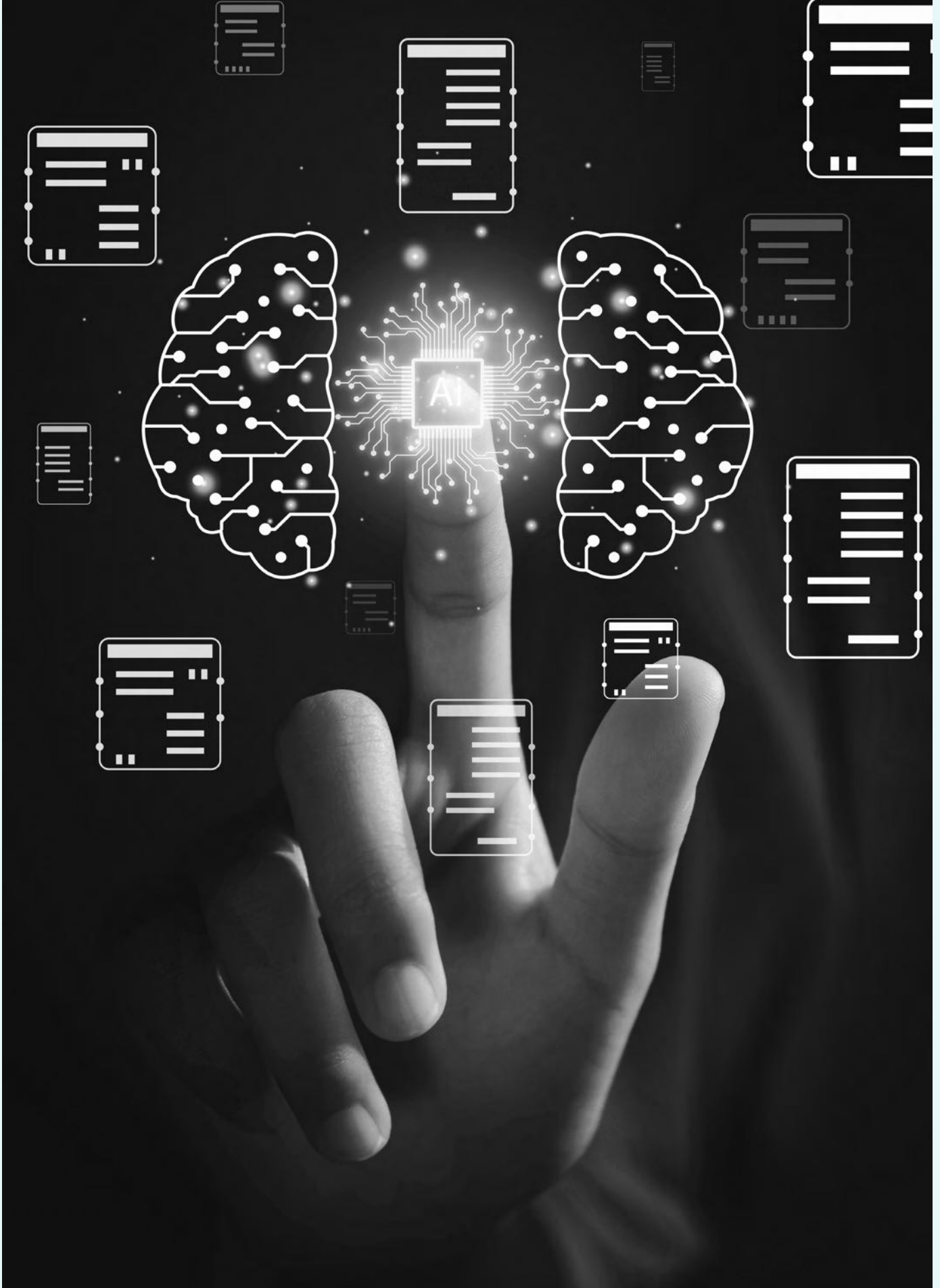
ENDNOTES

- 1 See <https://unravellingcorporatefraud.com/> for publications and other materials and (from most recent) Elise Bant and Rebecca Faugno, 'Corporate Culture and Systems Intentionality: part of the regulator's essential toolkit' (2024) *Journal of Corporate Law Studies* <https://doi.org/10.1080/14735970.2023.2292837> n.2.; Elise Bant, 'The Culpable Corporate Mind: Taxonomy and Synthesis' (ch 1), 'Systems Intentionality: Theory and Practice' (ch 9), Modelling Corporate States of Mind through Systems Intentionality' (ch 11) and, with Jeannie Marie Paterson, 'Automated Mistakes' (ch 12), all in Elise Bant (ed) *The Culpable Corporate Mind* (Hart Publishing, Oxford 2023); Elise Bant, 'Reforming the Laws of Corporate Attribution: "Systems Intentionality" Draft Statutory Provision' (2022) 39 *Company & Securities Law Journal* 259; Elise Bant, 'Catching the corporate conscience: a new model of 'systems intentionality' (2022) *Lloyds Maritime and Commercial Law Quarterly* 467; Jeannie Marie Paterson, Elise Bant and Henry Cooney, 'Australian Competition and Consumer Commission v Google: Deterring Misleading Conduct in Digital Privacy Policies' (2021) 26(3) *Communications Law* 136; Elise Bant and Jeannie Marie Paterson, 'Systems of Misconduct: Corporate Culpability and Statutory Unconscionability' (2021) 15(1) *Journal of Equity* 63; and Elise Bant, 'Culpable Corporate Minds' (2021) 48(2) *University of Western Australia Law Review* 352; Forthcoming are Elise Bant, 'Where's WALL-E? Corporate Fraud in the Digital Age' in Hans Tijo and Paul S Davies (eds) *Fraud and Risk in Commercial Law* (Hart Publishing, Oxford 2024); Elise Bant, 'Corporate Mistake' in Jodi Gardner et al. (eds), *Politics, Policy and Private Law* (Hart Publishing, Oxford); Elise Bant, 'Corporate Evil: A Story of Systems and Silences' in Penny Crofts (ed) *Corporate Evil* (Routledge, 2024).
- 2 See, for example, its use in the Australian casino inquiries: State of Victoria, Royal Commission into the Casino Operator and Licence (The Report, October 2021) vol 1 (VCCOL Report) 174-8 [87]-[102], 58-9 [19]-[25]; State of Western Australia, *Perth Casino Royal Commission* (Final Report, 4 March 2022) 50-51 [1.61]- [1.64] and State of New South Wales, Review of The Star Pty Ltd: Inquiry under sections 143 and 143A of the Casino Control Act 1992 (NSW) (Report, 31 August 2022) Chapter 6.3.
- 3 A creation of English illustrator Martin Handford, published as a series of children's puzzle-books from 1987.

- 4 Brent Fisse, 'Reconstructing Corporate Criminal Law: Deterrence, Retribution, Fault, and Sanctions' (1983) 56 *Southern California Law Review* 1141, 1189.
- 5 See the excellent discussion in George R Skupski, 'The Senior Management Mens Rea: Another Stab at a Workable Integration of Organizational Culpability into Corporate Criminal Liability' (2011) 62 *Case Western Reserve Law Review* 263, 288. See also Jonathan Weil and Alexei Barrionuevo. 'In the Balance: As Trial Nears End, Andersen Proves Surprisingly Tough — Once Seen as a Slam Dunk, The U.S. Case Must Show A Tricky Chain of Events — The Proper Spelling of `Y'all'" *Wall Street Journal*, Eastern edition; New York, N.Y.. 04 June 2002: A.1.
- 6 Jonathan Weil et al., Dramatic Question from Jury Could Shape Andersen's Fate, *Wall Street Journal*, June 14, 2002, at A1. The jury's eventual decision to convict was overturned due to inadequate jury instruction on the issue of knowledge: *Arthur Andersen LLP v. United States*, 544 U.S. 696 (2005).
- 7 Peter J Henning, 'S.E.C. Gets Encouragement, but Needs Something More' *New York Times* August 6, 2012, available at <https://archive.nytimes.com/dealbook.nytimes.com/2012/08/06/s-e-c-gets-encouragement-but-needs-something-more/>
- 8 Law Commission of England and Wales, *Corporate Criminal Liability* (Discussion Paper, June 2021) Appendix case studies, critically analysed in 'Catching the Corporate Conscience' (n 1).
- 9 *Serious Fraud Office v Rolls-Royce plc* [2017] *Lloyd's Rep FC* 249 and full discussion in 'Corporate Culture and Systems Intentionality' (n 1).
- 10 *ibid* [45] (Lord Leveson).
- 11 The full analysis is contained in 'Where's WALL-E' (n 1).
- 12 Commonwealth of Australia, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Final Report, February 2019) vol 1 (FSRC Final Report) 138-139; see also <https://www.sbs.com.au/news/article/nab-says-fees-for-no-service-not-dishonest/u838rxy95>; <https://www.afr.com/companies/financial-services/banking-royal-commission-where-nab-went-wrong-on-fee-for-no-service-20190205-h1avui>; <https://www.afr.com/opinion/cba-the-gold-medallist-of-the-big-five-for-charging-fees-for-no-service-20180418-h0yxvj>.
- 13 The false narrative of 'algorithmic agents' is discussed critically in 'Automated Mistakes' (n 1) 267.
- 14 See, eg <https://www.investordaily.com.au/markets/40308-banks-blame-legacy-systems-for-advice-failures>.
- 15 See further 'Corporate Evil' (n 1).
- 16 'Modelling' (n 1) 245-46. In this way, policies are closely associated with the corporate culture or 'ethos': see further 'Corporate Culture and Systems Intentionality' (n 1).
- 17 Mihailis Diamantis, 'The Extended Corporate Mind: When Corporations Use AI to Break the Law' (2020) 98 *North Carolina Law Review* 893.
- 18 The analysis uses definitions drawn from Australian doctrinal contexts, but can be readily adapted to suit alternative requirements: see further 'Modelling Corporate States of Mind through Systems Intentionality' (n 1).
- 19 For detailed discussion, see 'Corporate Mistake' (n 1).
- 20 *Australian Securities and Investments Commission v AMP Financial Planning Proprietary Limited* [2022] FCA 1115 [47] (Moshinsky J).
- 21 Reactive corporate fault: see Brent Fisse, 'Reactive Corporate Fault' in Bant (ed), *The Culpable Corporate Mind* (n 1) 139.
- 22 A point explicitly recognised in Australia's corporate culture provisions: see Criminal Code Act 1995 (Cth) s 12.3(6).
- 23 Systems Intentionality: Theory and Practice (n 1).
- 24 See Case Study 5.
- 25 VCCOL (n 2) 3 [12].
- 26 Cf *Australian Competition and Consumer Commission v Cornerstone Investment Aust Pty Ltd (in liq)* (No 4) [2018] FCA 1408 [751] (Gleeson J) and *ACCC v Australian Institute of Professional Education Pty Ltd (in liq)* (No 3) [2019] FCA 1982[80]-[84] (Bromwich J), examined in 'Systems of Misconduct' (n 1) 88-90.

- 27 https://insights.starlingtrust.com/content/observations/have-australia-s-banks-improved-their-behavior?utm_medium=email&hsmi=287889522&hsenc=p2ANqtz-fqXKJcZAD_ND6U-6ev3E7E4rdwJuVDrOb1dH5XqZHZPF1YFhPB5D8hyB8D2wo_W3ei2bQ1gqD4LDRJ4tsuZ8T9CV2Q&utm_content=287889522&utm_source=hs_email ; see also analysis in Commonwealth of Australia, *Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry* (Final Report, February 2019) vol 1 (FSRC Final Report) 138-139 and discussed in 'Culpable Corporate Minds' (n 1) 385; 'Catching the Corporate Conscience' (n 1) 487 and 'Corporate Evil' and 'Where's WALL-E' (both n 1).
- 28 The same analysis readily applies to other, egregious examples of flawed automated processes underpinning very serious organisational blameworthiness, such as that involved in the UK Post Office Horizons Scandal: see, eg, the facts detailed in *R v Josephine Hamilton and others* [2021] EWCA Crim 577 and the Court's conclusions on the Post Office Limited's related prosecution practices.
- 29 *ASIC v AMP* (n 20) [47] (Moshinsky J). This analysis is taken from 'Where's WALL-E' (n 1).
- 30 *Ibid*, *ASIC v AMP* [52]-[53].
- 31 See K Low and E Mik, 'Lost in Translation: Unilateral Mistakes in Automated Contracts' (2020) 136 *Law Quarterly Review* 563, 567-568, distinguishing between the coder's technical task of writing the program and the client's commercial judgment in setting the transactional parameters; see also As S McConnell, *Code Complete* (2nd ed, Washington, Microsoft Press, 2004) 112-13 on the 'myth of stable requirements', when reality requires recurrent consultation with clients to achieve their ends as systems evolve: see also at 217.
- 32 *ASIC v AMP* (n 20) [54] (Moshinsky J). See further McConnell, *ibid*, Chapters 22 and 23 on the unavoidable testing and debugging required for even the most carefully conceived automated system.
- 33 'Systems of Misconduct' (n 1) 88-90.
- 34 The cases are identified and discussed in detail in 'Systems of Misconduct' and 'Systems Intentionality: theory and practice' above n 1.
- 35 The natural fit with developments in directors' responsibility for business systems such as *Marchand v Barnhill*, 212 A3d 805 is clear. The model provides means to support and advance these developments, including in the context of automated and algorithmic processes: see Christopher M Bruner, 'Managing Fraud Risk in the Age of AI' in *Fraud and Risk in Commercial Law* (n 1).
- 36 VCCOL Report (n 2) 178, para 6.101.
- 37 From the audit context, see for example, <https://www.pwc.com.au/media/2023/pwc-australia-exits-eight-partners-for-professional-organ-governance-breaches.html> ; <https://www.pwc.com.au/media/2023/pwc-australia-appoints-new-ceo-kevin-burrowes-intent-to-divest-government-business-to-allegro-funds.html> ; <https://www.pwc.com.au/media/2023/open-letter-from-pwc-australia-acting-ceo-kristin-stubbins230529.html> ; <https://www.pwc.com.au/media/2023/pwc-announces-further-actions-230529.html> and <https://www.reuters.com/business/finance/uk-watchdog-fines-kpmg-24-mln-over-carillion-regenersisaudits-2022-07-25/>. This strategy drew the ire of Parliamentary commissions of inquiry: see Case Study 5.
- 38 <https://www.thebritishacademy.ac.uk/programmes/future-of-the-corporation/>
- 39 See, e.g., <https://insights.starlingtrust.com/content/observations/australian-auditors-still-under-scrutiny> .
- 40 See, eg, the submission of corporate culture and responsibility emeritus Brent Fisse 27 August 2023: https://www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/ConsultancyFirms/Submissions .
- 41 See, eg, submissions by Elise Bant to the Commonwealth of Australia Robodebt Royal Commission <https://robodebt.royalcommission.gov.au/>, re-published at <https://unravellingcorporatefraud.com>

- 42 It was the Tax Practitioners Board finding of Code of Professional Conduct Breaches that led to full investigation, and Government, parliamentary and public outcry, over the misconduct: see <https://www.tpb.gov.au/tax-practitioner/tax-agent/16226000> . The Senate Standing Committee's further investigation and report, revealingly entitled 'PwC: A Calculated Breach of Trust,' contains a valuable account of salient facts and PwC's exculpatory narratives: https://www.aph.gov.au/Parliamentary_Business/Committees/Senate/Finance_and_Public_Administration/Consultingservices/PwC_Report . The third and ongoing parliamentary inquiry is found at www.aph.gov.au/Parliamentary_Business/Committees/Joint/Corporations_and_Financial_Services/ConsultancyFirms . Other potentially interested parties include the Australian Federal Police, repeat clients and peak financial services regulator the Australian Securities and Investment Commission.
- 43 See, eg, <https://www.smh.com.au/business/companies/westpac-dumps-pwc-after-20-years-in-wake-of-tax-scandal-20231108-p5eie2.html>.
- 44 Above n 42.
- 45 The report and PwC response are found at <https://www.pwc.com.au/about-us/commitments-to-change.html> .
- 46 <https://www.pwc.com/gx/en/about/purpose-and-values.html> .
- 47 Detailed treatment of how to identify and prove patterns and practices is contained in 'Systems Intentionality: Theory and Practice (n 1).
- 48 Above n 42.
- 49 PwC Report, above n 42, Chapter 1 - PwC: A calculated breach of trust [1.82].
- 50 The 11th-hour divestment and eventual rebirth of the government advisory business in the shape of corporate entity, Scyne Advisory, is a very late acknowledgement. Largely staffed by ex-PwC partners and their teams, it has been approved as a tenderer for future government business: see <https://www.finance.gov.au/sites/default/files/2023-10/Finance-Report-on-Scyne-Advisory.pdf>.
- 51 PwC Report, above n 42. This includes attempts by PwC Global to badge the tax scandal as isolated to Australia, arguably a corporate form of the bad apple narrative: see, eg: <https://www.themandarin.com.au/236738-the-big-fours-revelations-insenate-estimates/> .



Good Counsel

Looking Ahead: What Next for FinTech, RegTech and SupTech?

By: DOUGLAS ARNER



Douglas Arner



Over the past fifteen years, the world has gone through a period of dramatic financial, technological, and regulatory transformation in the context of what we now refer to as “fintech”.

In a new book, *FinTech: Finance, Technology and Regulation* published in 2024 by Cambridge University Press, we analyse the intersection of finance, technology and

regulation, focusing on five main themes.¹

First, we consider the co-evolution of finance, technology, law and regulation over the history of human civilizations and show patterns that are important today. The process of electrification and digitization over the past 150 years, beginning with the first trans-Atlantic telegraph cables providing for the first time instantaneous communications between Europe and North America, has taken finance from an analogue paper-based industry to one which is almost entirely digitized, while at the same time being both one of the most

Over a billion people —
mostly concentrated in
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still do not have access
to a bank account.

globalised and regulated sectors. This period of technological transformation underpins the eventual evolution of fintech over the past fifteen years, in the aftermath of the 2008 global financial crisis.

We also highlight the evolution of the use of technology for regulation and supervision of finance across this period — what is now thought of as “RegTech” and “SupTech.”

Second, we analyse experiences with the interaction between emerging technologies, particularly over the past fifteen years, and the appropriate regulatory approaches to these. We consider experiences with data, with artificial intelligence, with blockchain and distributed ledger technology, and with the emergence of digital platforms.

From this, we argue that the most appropriate response to these rapid technology-led shifts combines mechanisms of test and learn (including innovations hubs, regulatory sandboxes, pilot schemes and bespoke FinTech licenses) — to develop an appreciation of the opportunities and risks implied by these new technologies — with the application of graduated and proportional risk-based approaches to regulation. While easier said than done, this approach is now emerging as best practice internationally.

Third, we draw lessons from the incredible digital financial transformations which have taken place in countries including China, India, and Brazil. During this period, almost 1.5 billion people have gained access to finance for the first time, almost entirely as a result of the application of a range of new technologies, mobile communications most particularly.

Yet we also note that, at the same time, over a billion people — mostly concentrated in low income countries — still do not have access to a bank account, mobile money account or digital wallet.

Central elements of success

In looking at these experiences, we highlight the central elements which have underpinned success around the world, broken down into three levels: infrastructure, regulatory approaches, and ecosystem development.

Infrastructure is fundamental, beginning with digital access, through mobile phones and smart phones. Costs of handsets and data have come down dramatically around the world, increasing accessibility. At the same time, mobile penetration rates in many low income countries are still below 40%. Lack of access to communications-enabling technologies prevents access to the opportunities and benefits of the digital economy and digital finance, while also presenting a major barrier in disaster and crisis response.

Beyond digital access, the next levels — particularly reflecting the India Stack strategy — focus on key elements of digital public goods and digital infrastructure: digital ID, account or wallet access, and interoperable electronic payment systems. This combination is central to financial and economic empowerment as well as to wider sustainable development and reduction in costs of customer acquisition to support innovation and wider, sustainable development.

The second level — as highlighted above — focuses on regulatory approaches, combining test and learn frameworks with proportional, graduated, risk-based regulatory frameworks and the use of RegTech and SupTech. The third and final level focuses on the role of data and the role of research and development support and funding.

Next, we highlight the risks that have also evolved with digitization and datafication: “TechRisk.” In addition to cybersecurity, digital crime, and data protection, we focus in particular on the challenges of scale. As the network effects of technology combine with the economies of scope and scale of finance,

we are seeing the evolution of ever-more dominant platforms. While the opportunities have indeed been tremendous, so are the evolving risks.

Fifth, we look forward, and identify five key themes, for 2024 and the rest of the decade:

1. DIGITAL ASSETS AS A REGULATED INDUSTRY

During 2024-2025, in a significant number of major jurisdictions, digital assets (including cryptocurrencies) will become — for the first time — a regulated industry. As a regulated industry, digital assets will not only be subject to oversight but also will be increasingly integrated with the traditional regulated financial services sector. This is likely to be transformational, in many ways.

What does this look like? Over the 15 year evolution of crypto and digital assets, a number of international regulatory processes have emerged, as despite the underlying promise of the technology, human involvement has resulted in the usual sorts of crime, mismanagement, hysteria resulting in risks to consumers.

The responses to the series of crises in the sector over its history now constitutes a comprehensive framework for digital asset regulation in a core and growing group of jurisdictions, including the EU, UK, Hong Kong, Singapore, Japan, Switzerland and Japan. This framework addresses market integrity and money laundering (in the context of a series of Financial Action Taskforce standards), regulation of intermediaries and custodians (framed by the IMF, Financial Stability Board and IOSCO), enforcement, and stablecoins (under G20 / FSB standards).

Looking forward, we are now seeing the increasing entry of traditional institutions, investors, and intermediaries into the sector, with very interesting developments particularly in the context of debt capital markets, foreign exchange, and early stage equity.

2. CROSS BORDER PAYMENTS

Today's incumbent cross-border payments structure has evolved over centuries; in many ways, the framework of correspondent banking is one which emerged from the 19th century technological horizon that replicated centuries-old models of trust and family relations.

One of the impacts of COVID has been dramatic acceleration of digitization around the world.

It is clear, though, that today's technological horizons, social and economic preconditions are very different, and that the technology to build better cross-border payment systems exists.

This results from a technological revolution in payments over the past 50 years, with the development of communications technologies such as the fax and internet, the development of communications systems and standards such as SWIFT, the implementation of RTGS systems in over 120 countries from the early 1980s to the present, the spread of mobile payment from mPesa and Alipay, the evolution of crypto since 2008, the very rapid adoption by over 70 countries of fast payment systems (FPS) in the last decade, and now regulated stablecoins and central bank digital currencies (CBDCs).

These technological developments have utterly transformed domestic payments in many countries. As highlighted by the Libra proposal in 2019, they also offer the possibility to transform cross-border payments. In looking ahead, three of these look to hold the most promise at present and are also experiencing the most rapid development:

- The BIS and a number of ASEAN and other central banks in the context of Project Nexus have developed a system to link domestic FPS to enable instantaneous cross-border retail payments. From the standpoint of middle income and above countries — where we find almost all FPS systems — this may be transformational.

It is certainly likely to be transformational in the context of ASEAN. While the technology is not difficult (particularly as most FPS are quite new and based on similar architecture), the legal and governance arrangements are complex when dealing with multiple countries, multiple systems, and multiple currencies. But the possibility of making a cross-border payment instantaneously on the basis of a mobile phone or email address would indeed be transformational.

- The BIS and a number of central banks in a variety of jurisdictions are engaged in a series of projects focusing on linking wholesale CBDC and RTGS systems for cross-border foreign exchange transactions. Once again, the technology is not proving the major barrier; rather it is the legal and governance arrangements. While slightly less advanced than FPS linkages, it seems likely that one or more of these projects will launch in the near future.
- Finally, as major jurisdictions put in place regulatory frameworks for stablecoins, this is likely to present a very attractive framework for major currency cross-border transactions, particularly for countries which lack FPS or RTGS or are not willing to integrate into such cross border frameworks.

3. REGTECH / SUPTECH / INFRASTRUCTURE

One of the impacts of COVID has been dramatic acceleration of digitization around the world. One of the best examples of this can be seen in the context of central banks and financial regulators: COVID dramatically increased their use of and familiarity with digital technologies and data analytics.

This is driving large numbers of central banks and financial regulators around the world to pursue their own digital transformation strategies. These typically begin with digitizing their internal processes and data operations. From this, they extend to data collection, generally via digital regulatory reporting requirements. In many cases — particularly in securities markets disclosures and ultimate beneficial ownership reporting — regulators are also developing infrastructures such as the EDGAR system of the US SEC or the EU's planned European single access point (ESAP).

Digitization of inputs from the financial sector, in turn, enables the application of advanced analytics, including machine learning and AI. The digitization of regulation and supervision, in turn, drives digitization of compliance processes in the financial sector.

Going forward, this transformation is accelerating and can be seen across all levels of country development. In particular, experiences with the intersection between digital finance and communications, banking, and regulation and supervision became very clear in the context of the failure of Silicon Valley Bank (SVB) in 2023. This has served to significantly accelerate processes towards real-time supervision and responses.

4. SUSTAINABILITY

In the same way that digital assets are becoming a regulated industry, sustainability disclosure requirements and risk management systems are becoming mandatory

Digitization of inputs from the financial sector, in turn, enables the application of advanced analytics, including machine learning and AI.

The digitization of regulation and supervision, in turn, drives digitization of compliance processes in the financial sector.

in an increasing range of major jurisdictions from 2024-2025. Mandatory disclosure frameworks for listed companies in major jurisdictions is not only driving their own data collection and compliance efforts but also driving those of their business partners around the world.

With mandatory digital reporting, new datasets will be created which can enable a very wide range of analytics, ranging from impact on profitability to specific forms of sustainability impact, supporting differing investment, support, and transition strategies. The increase in related stress testing for the financial industry — particularly insurance and reinsurance — is likely to be even more significant going forward.

5. STRATEGIES TO SUPPORT MAXIMIZATION OF THE BENEFITS OF AGGREGATE DATA AND ANALYTICS, ESPECIALLY AI, WHILE BALANCING THEIR RISKS.

Finally, we highlight emerging efforts in major economies — including the EU, China, US and India — to seek to develop strategies to maximize the value of aggregate data for competitiveness and sustainable development. At this point, very different approaches to data, its control and use are emerging, with major challenges for cross-border operations. These also relate directly to similar considerations around AI: how to maximize training data while seeking to understand and address the risks which are arising alongside the opportunities.

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With thanks to:

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Dirk A. Zetzsche holds the ADA Chair in Financial Law (inclusive finance) and leads the House of Sustainable Governance & Markets at the University of Luxembourg.

ENDNOTES

1 <https://www.hkufintech.com/book>

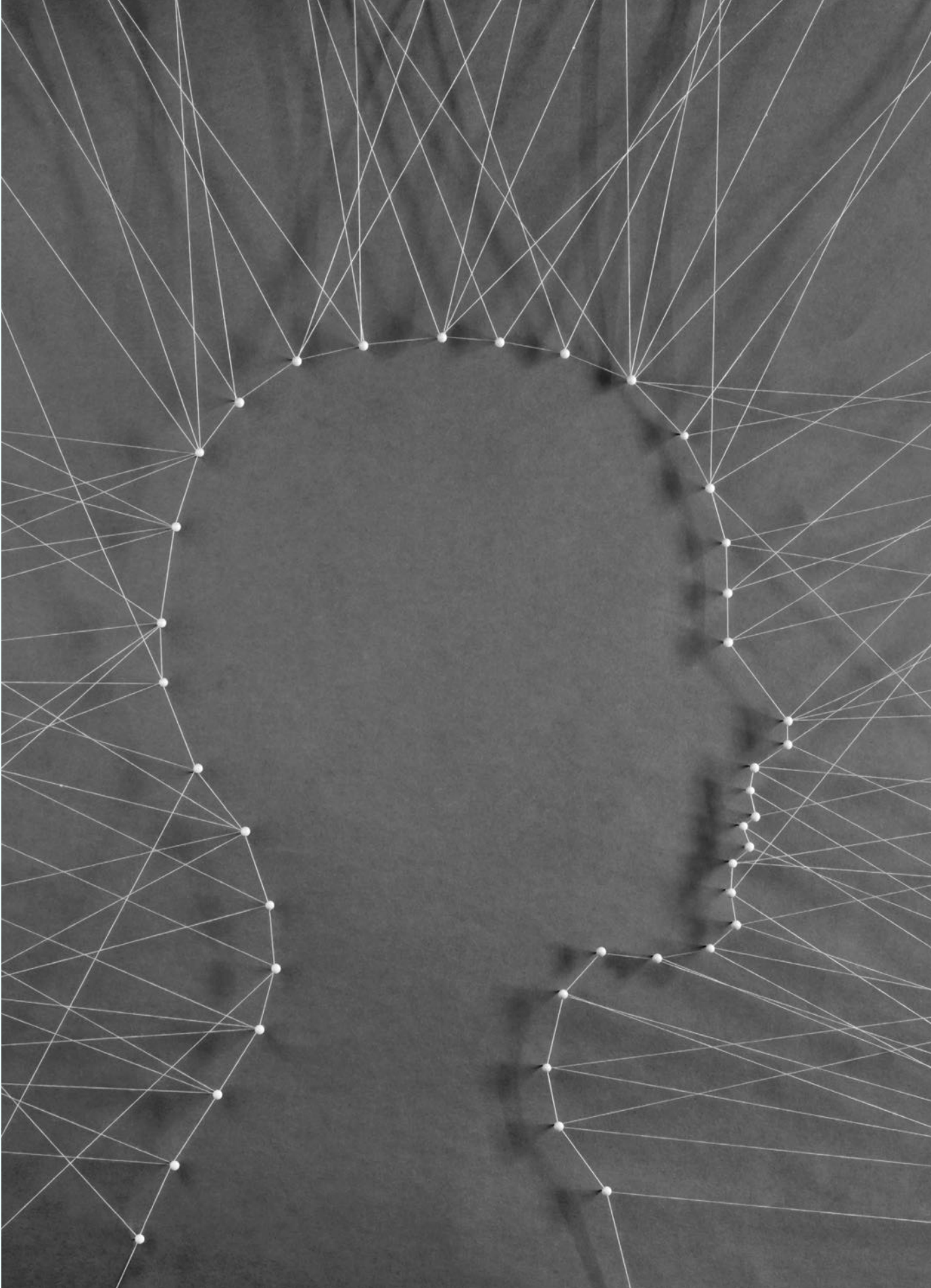




PEER PERSPECTIVES

The intuitive mind is a sacred gift and the rational mind is a faithful servant.
We have created a society that honors the servant and has forgotten the gift.

ALBERT EINSTEIN



Peer Perspectives

An Interview with Dr. Terri Patterson



Terri Patterson



Q: A common topic in this series of reports is the application of behavioral science to risk management challenges. In that context, your story is especially interesting: a psychologist who spent 20+ years with the FBI, ultimately leading its elite Behavioral Analysis Unit. Can we start with a bit

about your fascinating career history and ask you to share any key life-lessons?

A: I have had the benefit of many interesting and rewarding experiences over the course of my career. After completing new agents training, I was assigned to the Miami field office where I investigated a variety of violent crime matters, eventually specializing in the investigation of human trafficking, child exploitation and child abductions. I had long admired the work of those assigned to the Behavioral Analysis Unit (BAU) at Quantico and was honored to eventually become a part of that team and its mission, where I supported criminal and national security investigations.

The BAU has the benefit — and perhaps curse — of assisting with some of the most challenging matters facing law enforcement and the intelligence community. The cases that came through

We constantly asked the question: How can we manage risk and potential threats to our communities through prevention rather than reaction?

the door had generally been thoroughly reviewed without success and often had unusual or even bizarre elements. Consulting on individual cases was only one element of the work at the BAU. It had long been recognized that gathering data around challenging cases could be exceedingly helpful in future efforts to prevent and solve what were often low-likelihood/high-stakes incidents.

The research component of the BAU was born out of this curiosity and desire to add an empirical data to behavioral “profiling” and analysis. And finally, an important aspect of the BAU’s mission is to “pay it forward” through training. So, we spent a significant portion of our time providing briefings and training to fellow law enforcement around the trends, patterns, and behaviors we observed through case consultation and research at the Unit.

I learned some valuable lessons at the BAU. I learned the effectiveness of an elite team when each member brings a different skill and approach to a challenging problem. I also learned the importance of fostering an intellectually trusting environment to encourage productive debate. Relatedly, I learned how easy it can be for a group to succumb to the “groupthink” trap, and how to best inoculate a team against it.

Some of the most urgent work of the BAU involved the early identification and mitigation of threats to the community. We constantly asked the question: How can we manage risk and potential threats to our communities through prevention rather than reaction?

Psychologists have long struggled with identifying risk in a way that differentiates between those who will and will not engage in violence. Are there variables that serve as pointers to assist in that identification? Are those variables or factors static in nature or are they dynamic and constantly shifting? Do some have a stronger influence on behavior than others? Is

violence more likely to occur when certain factors appear together in a “clustering” effect? And, if we have the answers to these questions, would we be better positioned to prevent violent acts of terror from occurring?

These are some of the questions that operational psychologists seek to answer. And these questions led to another lesson I learned at the BAU — while prevention is the goal, it is very hard to measure your success in achieving it. When we succeed, nothing bad happens, so there’s nothing to see. But when we fail, the evidence abounds. As such, success in prevention wins little attention or public recognition, while failures are rightly studied for months and sometimes years.

Q: Can we turn attention to the kind of work you’re doing today? Are you able to share some of that? What kinds of behavioral or conduct risk issues are you seeing and what do you expect to see going forward? What’s driving this?

A: Currently, I am a Principal at Control Risks, where I help clients address a variety of challenges and risks that are largely driven by human behavior. Some of this risk is caused unintentionally and some is based on malicious conduct on the part of actors, both internal and external to an organization. Regardless of the cause, our job at Control Risks is to do what our name suggests — help our clients to identify and manage risk.

My experience at the BAU continues to strongly influence my current approach to behavioral threat management at Control Risks. It is a ‘three-legged stool’ of sorts. We focus on robust program development, training that incorporates empirical data and is informed by operational experience, and developing strategy that goes beyond a strictly compliance-based approach to risk management.

Social belongingness is an important aspect of human behavior and drives the cultural norms on which we all rely.

Across sectors and markets, we continue to see concerns around employee resilience and well-being. We are also seeing clients’ response to new legislation around workplace violence prevention and response and, for our U.S.-based clients, there continues to be concern about active assailant situations. Those very low instance but incredibly high stakes scenarios are often on the minds of security professionals. Corporate leaders are interested in balancing employee wellness with structure and productivity. And risk managers continue to ask for guidance around processes to help ensure that risk is mitigated through early identification and management.

Going forward, I anticipate we will see an increased focus on social and political unrest, and subsequent challenges posed to the operational cadence and reputation of organizations that find themselves dealing with these sensitive and extremely volatile situations. From global financial uncertainty to geopolitical volatility, I expect we will deal with continued challenges going forward. And these challenges mean that organizations will have to be vigilant and nimble in their readiness posture, and thoughtful in their response to these crises.

Q: May I ask for your views on some of the thoughts offered here by those working in the evolution of human behavior? Richard Wrangham, for instance, suggests that we evolved to become “creatures who care immensely about belonging to our social group, both in our own self-perception as well as in the perceptions of others.” You’ve done a lot of work looking at “insider threats” and “rogue actors.” How should we think about such people? Do they not wish to “belong” in the sense Wrangham describes?

A: Social belongingness is an important aspect of human behavior and drives the cultural norms on which we all rely. When we are considering how human behavior has evolved over time, the strong

drive to belong, as laid out by Richard Wrangham here, has been critical to the establishment of institutions, traditions, etc. Without that drive, the systems that we have built would be useless as mechanisms by which to control behavior — in both its productive and deviant forms.

It is always helpful in these discussions to remind ourselves that humans are complicated. We're not robots, and our daily behaviors and decisions are driven by a variety of factors, many of which are dynamic in nature. And when we think about deviance and why people might deviate from social norms and expectations, we have to remember that, just under the surface, there are lots of factors that interplay with one another to drive behavior.

For example, there are foundational, personality-related characteristics that leave a person vulnerable to the kind of deviant behavior exhibited by the malicious insider. When those foundational characteristics are present, the individual is often vulnerable to other situational factors that drive behavior. Many of these factors are dynamic and heavily dependent upon context.

Even the foundation of our human experience, such as our interpretation of events around us and our basic memories, are not static in nature. For example, in the process of recalling an event, we reconstruct our memory of the incident in a dynamic manner that can be influenced by a variety of social and cognitive factors. So, whether we are talking about a process as primitive as recalling an event or as complex as social deviance, these processes are greatly influenced by both environmental context and individual experience.

Because I have spent years observing and analyzing deviant behavior, I am sometimes asked about the "profile" of concerning threat actors. It is important

to remember that there is a complex combination of factors that leads one to engage in malicious activity. So rather than asking, "Is this person a risk to our organization or community" it is often more helpful to ask, "Under what circumstances might this person be a risk to our organization?" We move from the dichotomous "yes" or "no" to a framework of managing the threat and mitigating risk. This is a more productive way to approach risk management.

Q: Wrangham argues that "Conforming socially is a survival strategy" because, in the course of our evolutionary history, those who went their own way might literally have been "killed for the crime of non-conformity." What has to be true for someone to act in utter disregard of common social expectations?

A: My professional experience in dealing with non-conformity is somewhat narrowly focused on individuals who have not only disregarded social expectations but who have victimized and targeted others in the process. So, I will start with some thoughts on that type of deviance.

When polarization moves from healthy debate to demonizing the other side, we see fertile ground for mass movements.

Psychologists have long argued that a complex psychosocial foundation explains why some individuals deviate from the norm and engage in violent or exploitive behavior. In my experience, a critical factor contributing to

the pathway often includes a process whereby the individual slowly rationalizes or justifies their actions over time. Interestingly, there is a reliance upon others — the social group — to propel this process forward. The process sometimes involves consuming material that normalizes the behavior, or communicating with like-minded individuals who support the deviant views.

Social media has made it discreet, convenient, and safe to find like-minded individuals by allowing easy access to entire online communities that endorse specific behaviors that are deemed unacceptable or illegal by society. Suddenly, the unaccepted behavior is argued to be the norm. And when there is a cultural kinship of some sort, this effect is even stronger.

Let's consider non-conformity that is pro-social in nature, such as protest activity. In the U.S., we are currently experiencing a time of robust debate around a variety of issues that are emotionally charged, and it is fair to say that we have seen unprecedented polarization around some of those issues. These debates always have the potential to develop from isolated protests to mass movements. There are functional drivers that make this more likely now than in the past.

But what about the behavioral drivers? When polarization moves from healthy debate to demonizing the other side, we see fertile ground for mass movements. Often, these movements energize people around a common, emotional narrative, and when that narrative involves a theme of injustice and attribution of blame, it can be quite enduring.

What is interesting about these group dynamics is that there is evidence to suggest individual attitudes and beliefs become more extreme in an emotional group setting. These attitudes can then pull the entire group to a more polarized position, having the overall effect of normalizing positions that are considered quite extreme to the populous. Does any of this sound familiar?

Q: What does this imply for any ability to anticipate behavior that may imply risk? Kevin Lala suggests here that an appreciation of our evolutionary foundations can help us to be predictive of behavior — “science can now do justice to human social complexity,” he writes — and he’s critical of the fact that many social scientists fail to draw on learnings from evolutionary biology. Your thoughts?

A: Kevin Lala’s appreciation of the social complexity of the human experience is particularly relevant to any discussion around human behavior, prediction, and risk.

What he rightly suggests here is that we can put systems in place that will allow for better decision-making in a variety of circumstances, and those systems can and should be grounded in established empirical findings from a variety of sources.

Generally, these systems, or rules, ensure an overall improvement in the accuracy of decisions or predictions about future trends. As laid out by Lala, the social processes at play are dynamic in nature and in a constant state of flux, adapting to change in order to ensure effectiveness.

At the individual level, we are still learning how numerous factors and their varying weights influence behavior in an ever-evolving, dynamic manner, and we still have much yet to explore.

For example, the human brain, in its complexity and sophistication, relies heavily on past experiences when observing stimuli in the environment, processing those data, and determining the best course or courses of action. This process repeats itself indefinitely as we operate in our day to day lives.

We are able to function because of our ability to rely upon heuristics, or “cognitive shortcuts.” Our interpretation of multiple aspects of a given set of data depends largely on our ability to compare that data with past experiences that involved the same or similar data, to recall how similar circumstances were previously handled, and to make necessary adjustments based on desired future outcomes. Moreover, an individual’s interpretation of events is not only highly dependent upon their perception and interpretation of events, it’s also a collective experience, incorporating the views of the broader community around them.

We have much yet to explore regarding the collective role of evolutionary biology, neurology, social, cognitive and clinical psychology — and so many other disciplines — in an effort to further our understanding of human behavior. It's something I continue to learn about in the applied contexts that I work in, and it's something that makes a report like this so valuable.

Q: Thanks, Terri. Now let's take this a step further. Michael Muthukrishna argues here that things like culture, social norms, and other kinds of social information can now be described mathematically, "and then used to predict overall future patterns of expected behavior." Is this something you've worked with?

A: There are a lot of different ways to approach this idea of predicting human behavior.

The research across a variety of disciplines explains how we approach problems and control for known challenges driven by social norms and culture. Those who are entrusted with these important decisions can use such empirical data to establish better policies and procedures to improve outcomes.

For example, the social psychology literature has long established that if a person is perceived to be an authority on a given topic, others will unintentionally defer to that person regardless of their competence. So, when someone is conducting an interview, whether it is investigative or regulatory, the interviewee will often limit the amount of detail provided when they assume the investigator already has the information they would report. This is not a problem with memory but, rather, with socialization. Subsequent research has consistently shown that, when the investigator directs the interviewee to assume the investigator knows *nothing* about the incident, more details are provided.

The needs of regulatory agencies can and should help to drive future behavioral research efforts.

This type of inoculation can serve a powerful function when training investigators, regulatory officials, attorneys, and others who find themselves in a position of fact-finding.

We can also turn to empirical data to better understand how individual characteristics can impact the assessment of everything, ranging from witness credibility to accuracy of recall. For instance, why do we ask witnesses how confident they are in their reporting when research has shown that such confidence is not highly correlated with accuracy?

These are just a few examples of how behavioral science can help us improve our processes and anticipate certain behavior patterns.

Q: Let's turn to the banking sector. The Federal Reserve Bank's Vice Chair for Supervision, Michael Barr, co-authored a paper on "Behaviorally Informed Regulation." It opens with the observation that "Policy makers typically approach human behavior from the perspective of the rational agent model," and goes on to argue that an alternative behavioral perspective "can yield deeper understanding and improved regulatory insight." Yet we don't see a lot of that in policy practice. Why do you suppose that is?

A: It seems that, while we are always gaining a better understanding of human behavior, the more we learn, the more questions we uncover.

Michael Barr's observation that the rational agent model is insufficient as a foundational approach for policymakers to rely upon is well-taken. We do know from research — some of which is laid out by Barr — that decision-making is highly contextual and rarely dichotomously yes-no in nature. In fact, we have long recognized — and research supports — that we often have little insight into our own behavior and psychological processes. Given that knowledge,

it is reasonable to consider both contextual and foundational characteristics to best understand behavior at the individual level.

At the group level, it has been well established that one's interaction with their environment, including other people, can have a profound effect on the behavior of both the individual and the group. One need look no further than the literature around jury decision-making to see convincing evidence of the dynamic role of context in making decisions that often carry life-altering consequences.

Empirical data gives us a glimpse of the amazing efficiency of the human brain. But we also know that this efficiency comes at a cost — we sometimes make relative judgements and choose the best available options even when those options do not include the correct choice. We also understand, through the work of psychologists, that everyone has a limited capacity of working-memory and that, when those resources are depleted, one's cognitive effectiveness is compromised. Evidence of this increase in cognitive overload manifests in a variety of ways, and can be readily observed in behavior.

There are so many fascinating ways this research can inform policy and regulation — even beyond the assessment of risk. This knowledge base should be utilized not only to inform regulatory practices, but the needs of regulatory agencies can and should help to drive future behavioral research efforts.

“The substantial influence of context on behavior implies, among other things, that institutions will come to play a central role in shaping how people think and what they do.”

MICHAEL BARR
VICE CHAIR FOR SUPERVISION,
US FEDERAL RESERVE BOARD

It might be interesting to educate policymakers on the results of behavioral research pertaining to decision-making and behavioural norms.

Q: Vice Chair Barr also observed that “The substantial influence of context on behavior implies, among other things, that institutions will come to play a central role in shaping how people think and what they do.” These ideas are explored in the context of shaping the conduct of market participants, but what are your thoughts on applying these ideas to the policymaking bodies and official institutions themselves?

A: There is much to explore in the interplay between formal and informal influences on behavior

of individuals, groups, and whole organizations and institutions. This includes state actors who may actively work to manipulate informal, social influences on the behaviors of those same individuals, groups, organizations, and institutions.

We've already seen how influence campaigns of all sorts have successfully shifted behavior. Some states actors, for instance, work through so-called “nudge units” to try and drive public behavior changes for the better. In other instances, nefarious state actors have successfully ‘weaponized’ social media to drive public behavior in rival states in directions counter to those states’ interests.

At play here is that need to belong. People identify with groups — even online groups made up of anonymous others,

some of whom may well be bots rather than other humans at all. Here, formal groups — like state-sponsored organizations — are working to foment the spontaneous creation of informal groups — like distributed collections of like-minded individuals looking to belong among others like themselves.

Once established, those informal groups can be manipulated to behave in very specific ways, with at times a frightening degree of efficacy.

This can happen within specific institutions as well. In Barr's writing, institutions themselves almost serve as a default heuristic. In response to an earlier question, I stated that heuristics are fantastic when they help us to function more efficiently; however, they can also lead to poor decision-making when the facts are contrary to the heuristic. The default institutional norms, that is, may run counter to the default informal norms operating among groups within the institution. This dynamic of "norm conflict" is one that needs further study.

It might be interesting to educate policymakers on the results of behavioral research pertaining to decision-making and behavioural norms. It is reasonable to assume that when decision-makers are educated about social and psychological behaviors — for example, our tendency to rely at times on faulty information, or to over-index on data of personal significance, or to engage in cognitive "shortcuts" as a means of functioning in an environment with increasing amounts of data, etc. — then they would be far better positioned to make better decisions, of policy and of management alike.

If decision makers are educated on social and psychological pitfalls, it is reasonable to assume they will be better equipped to guard against their influences. Total inoculation may be an unrealistic expectation, but moderating the effect of these factors will result in better decision-making.

We are currently seeing an unprecedented fraying of the trust in governing bodies and institutions. In today's polarized, "us against them" environment,

it becomes even more important for policymakers to guard against human cognitive susceptibilities when formulating policy recommendations and regulatory requirements.

Q: Can I ask you to address a tension that falls out of this discussion? That between an emphasis on "character," a psychological perspective, and an emphasis on "context," a sociological perspective. Some bank regulators today are attempting to incorporate assessments of character in to their "fit and proper" regimes. Is this sensible, if context trumps character, as some here seem to suggest?

Context affects the human experience holistically — in the way we interpret information and formulate a response.

An individual's foundational world-view drives how they respond to their environment.

A: My first reaction is that these are not dichotomous discussions — one focusing on character and context. We know the importance of context as a driver of human behavior. Context affects the human experience holistically — in the way we interpret information and formulate a response. Because we are able to assess consequences before acting, our ability to learn from past experiences becomes critical to our future decisions and subsequent behavior.

The psychological perspective, with a focus on "character," is not without merit. Individuals respond to circumstances affecting them in a variety of ways based on largely individual differences. Many of these differences are less consequential than this topic contemplates, but we know that an individual's foundational world-view drives how they respond to their environment.

As a psychologist, I am interested in how a person typically responds in certain situations and what causes a deviation in that response. Repeating what I laid out in an earlier response, we are concerned about a complex combination of factors that lead to

malicious acting-out. When those factors are present, it increases the likelihood that certain individuals will act maliciously.

What we do not discuss often enough are the factors that inoculate an individual from acting-out. I imagine that this holds true also for questions of compliance — whether in banking or other domains. We should be exploring what contextual or other factors might work to help *prevent* an individual from engaging in unsanctioned behavior. I don't think we're giving this avenue of potentially preventative measures sufficient attention.

Generally speaking, these factors might include things like the influence of family, friends, faith, a sense of responsibility (such as caring for an elderly parent), fear of disappointing a child, etc. The way these factors impact the individual has everything to do with their character.

So, I am perhaps taking what will be perceived as the safe way out of this question, but I am of the belief that you cannot fully divest one from the other. If character is the person, their values, identity, collection of behaviors, etc., and context is their environment over the course of a professional career, then it is prudent to consider both.

But it is fair to say that we tend to consider character in isolation, perhaps because we have tools in common use for such — things like “personality style inventories,” etc. We use these tools to try and assess character, but we lack a similar set of tools by which to assess context, or the interplay between character and context. This is another area of potential deserving of greater research and experimentation in the policymaking domain.

Trust is fragile, and fraying trust in leadership often leads to a sense of apathy and discontent among the workforce.

The culture of the organization is important in building and maintaining trust.

Q: To close out, let me ask you to offer your views on how business leaders should think about the challenges they face in this time of deep distrust. They need to satisfy regulators, who may not be working with the best ideas about what makes us tick. They need to keep employees happy and engaged when many are looking to their employers as players in today's “culture wars.” They need to appeal to a broad base of customers, many of whom have taken sides in irresolvable “tribal” conflicts. Your advice?

A: In recent years, we have experienced a rapid shift in how we interact with one another socially and professionally. More dialogue takes place virtually, and the remote workforce remains the norm rather than the exception

for a great many organizations. This certainly has an impact on our ability to build and maintain trust among our teams and in our leadership.

Trust is fragile, and fraying trust in leadership often leads to a sense of apathy and discontent among the workforce. We have also seen how the public can quickly attach to a given issue and publicly shame a corporation or organization for its response — or lack thereof. Business leaders must be circumspect in managing issues that invite volatility and debate. Leaders are finding themselves in a no-win situation when they choose to engage on social or political issues that are ripe for debate.

My advice has generally revolved around corporate leadership setting the tone from the top and trying to establish a culture that reflects the company's values — presumably respect for one another and an expectation of professionalism in the workplace. The culture of the organization is important in building and maintaining trust. When employees buy into

the culture and identify as an integral part of the company, they are more likely to see themselves as an extension of the brand.

Alternately, we have seen time and again how a multitude of issues can lead an insider down a destructive pathway and to feeling justified in harming their employer through theft or sabotage. We have also seen the damaging results of employees joining protests, intentionally wearing their company's brand or insignia in a purposeful effort to attach the brand to controversy.

These behaviors can lead to conflict in the workplace, damage to the brand should the images be publicly displayed, or they may result in a targeting of the company by criminal cyber attackers. For leadership during these times of heightened volatility, striking a balance between protecting the organization's brand and mitigating such risks, all while respecting employee trust and privacy, is the ultimate goal.

Dr. Terri Patterson is a psychologist who previously served as Chief of the US Federal Bureau of Investigation's (FBI) elite Behavioral Analysis Unit, among a number of other roles during her 20-year career as an Executive and Special Agent at the agency. She now serves as a Principal in Control Risks' Crisis and Security Consulting practice.

ENDNOTES

1 https://repository.law.umich.edu/cgi/viewcontent.cgi?article=1083&context=book_chapters



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Peer Perspectives

Why We Follow: The Power and Perils of Belonging

By: LANGLEY SHARP MBE



Langley Sharp MBE

In 2013 I had the privilege of commanding a joint British/Afghan counterinsurgency task force. Our mission was to disrupt Taliban safe havens and, in so doing, supporting the protection of both Afghan civilians and coalition forces in Central Helmand. On 22nd August one of my

junior commanders, Lance Corporal (LCpl) Josh Leakey, undertook an act of bravery that was to cement his name in British military history. A few hours into a routine search operation with our Afghan partners and United States Marine Corps (USMC) allies, an element of the 300-strong force found themselves surrounded by Taliban fighters. Pinned down by extremely accurate enemy fire and with communications failing, a USMC officer was shot and wounded.

Reading the situation and knowing that their comrades were in grave danger, Leakey and his sniper team decided to seize the initiative. Having crossed open ground under fire and with the casualty secured, Leakey proceeded to fight back. Twice more he exposed himself to mortal danger, running up and down a steep hillside to get the silenced machine guns into action. Carrying a mounted gun on his back,

with an all-up weight of over 100lbs, he faced an intensity of fire that saw bullets ricocheting off the frame of the weapon.

Demonstrating extraordinary acts of bravery, Leakey consciously took the decision to risk his life on five separate occasions throughout the firefight. His decisiveness turned the tide of the battle, saving countless lives in the process. For his actions that day Leakey was awarded the Victoria Cross, the UK's highest award for valor. He is one of only 10 living recipients of this honor.

At face value, this remarkable story is one of undoubted bravery, the highest living example of commitment to what the military terms 'unlimited liability.'¹ It is a tale of loyalty, selflessness, courage, and leadership. Yet beyond this surface analysis lies an example of much more. It is simultaneously an act of exemplary *followership*.

As defined in the British Army's recently published Doctrine Note, followership is, "the act of an individual or individuals willingly accepting the influence of others to achieve a shared outcome."² Key to this conceptual understanding is that followership, "requires the consent of those being led, whether consciously or unconsciously."³ Followership, therefore, is a choice.

On 22nd August 2013, as the battle enraged nearby, Leakey had a choice to make; stay safe in the lee of the fire and continue to provide overwatch as directed, or step into the breach and risk his life to save others. It is argued that his decision to step forward that day was born of a career as both a very effective junior commander and leader, but also an exemplary follower. The compounded interest of influence that he had accrued throughout his military career (and indeed prior) had shaped the character, values, identity, and mindset that compelled him into action when it mattered most.

Having served in the British Army for 23 years, including a further 8 operational tours and almost a decade with special forces, I have reflected at length on what drives individuals and teams to high performance. Stripped to its essentials, the answer so often lies in the intricate social dynamics between leaders and followers in pursuit of a shared objective, for success is a collective endeavor. But if followership is a choice, one that requires the “willing acceptance” of a leader’s influence, what compels one to follow?

Undoubtedly the answer is multifaceted and contextually dependent, though perceptions of trust, authority, power and purpose are, from experience, highly influential. Whilst such factors were almost certainly at play in Leakey’s VC-winning actions, his stated rationale was more revealing. “I did it for my mates and I did it for the Regiment,” he said. In this simple yet telling statement, his deep sense of obligation and loyalty to his teammates is evident. But perhaps more insightfully, he added, “I did not feel I had a choice. That was what was expected of me as a paratrooper.”

This heartfelt justification for arguably the most selfless of acts, reveals much about Leakey’s decision-making that day, for it speaks to one of the most basic of human instincts; the need to belong. Not only did he follow the demands of the mission, the values of the organization and the cultural expectations of the team, but at his core, Leakey was driven by his self-identity, indivisible in this instance from the shared identity of the tribe to which he belonged.

To Belong

This apparent juxtaposition between self and others was perhaps best articulated by the father of sociobiology, Edward O. Wilson. In his Pulitzer Prize-

winning book *On Human Nature*, Wilson argued that selflessness is at once also self-serving. In so doing he distinguished between ‘hard-core’ altruism, whereby the “impulse can be irrational and unilaterally directed at others,” and ‘soft-core,’ in which “good behavior is calculating, often in a wholly conscious way, and [...] orchestrated by the excruciatingly intricate sanctions and demands of society.”⁴

Wilson suggested that this balanced, albeit often unconscious, calculation between self-serving and true altruism enables humans to be, “capable of indefinitely greater harmony and social homeostasis.”⁵ Our motivations are therefore driven both by our own needs and those of the social groups with which we identify. Moreover, as Robert Dunbar, Professor of Evolutionary Psychology at Oxford University argues, the closer the social affiliation (family, team, tribe or regiment), the greater the alignment. Beyond the optimum group size of 150 (otherwise known as the ‘Dunbar Number’), “we are a great deal more circumspect in our willingness to act altruistically.”⁶

► READ MORE FROM ROBIN DUNBAR ON STARLING INSIGHTS

As a species, our very survival has predicated on our ability to align such motivational needs. As herd animals, we seek safety, love and meaning in others.⁷ The stronger the bonds we create, the more assured our perceived safety, the greater our affection for and from others, and the higher our sense of self-esteem and respect. As such we have an in-built desire to belong. Our sense of self is inextricably linked to our sense of what it means to belong to a particular social group (or, in reality, the myriad of social groups with which we affiliate, and which define our complex identities). Belonging is both innately individual and intrinsically collective.

.....
“Our ancestors deeply understood
our primal need to belong, before
psychology or neuroscience gathered
the proof. It was visceral to them, part of
every day and every decision.”⁸

OWEN EASTWOOD
.....

Belonging is a fundamental tenet of being human. As David Samson argues in his book *Our Tribal Future*, we have, since Palaeolithic times, sought to answer one of the most important questions of any species’ survival: in whom should we trust? Beyond kin and kith, declares Samson, the answer lies in the tribe: “the evolution of nested groups, each with their own particular symbols — and enshrined shared myths and values — that bound participants together in trusting relationships.”⁹

We seek belonging in these trusted relationships in order to survive and, whilst they are human manifestations, such social connections are born of our in-built biological drivers. When appropriately stimulated, the release of an optimized group of hormones balances a sense of empathy, connection, well-being, trust and social-bonding.¹⁰ In short, we are hard-wired to belong. ►PAGE 393

It is not surprising therefore, that the collective psychology fostered within close-knit groups can prove a powerful force, both for good and ill. Channelled appropriately it can engender strong loyalty, high moral purpose, and superior performance. Misguided, however, and it can sow dissent, distrust, and division.

The Power of Belonging

On 6 June 2019 I found myself nervously waiting to exit out of yet another perfectly serviceable aircraft at 800 feet. This parachute descent, however, was unique and one that will live long in my memory. I was joining my fellow Commanding Officers

of the Parachute Regiment as we conducted a commemorative jump over the village of Ranville, Northern France. The aircraft we sat in was an original WWII Dakota which, 75 years to the day, had flown over the English Channel to drop paratroopers behind enemy lines, just hours ahead of the D-Day beach landings to their north.

Awaiting my turn to ‘stand up and fit chute,’ I scanned around me. Perfectly preserved on the walls of the light alloy aircraft were hastily scrawled messages that our brave forefathers inscribed moments before take-off. Opposite me, one such message read:

Jock Hutton
Operation Overload
Ranville
5/6 June 1944
Nightdrop

Moments later I was out the door and under silk canopy. Having hit the ground and been met by a chorus of cheering crowds (rather than the vengeful German Army of yesteryear), we moved off to await the follow-on troops. More than a dozen Dakotas flew overhead. The door of the first aircraft opened and The Parachute Regiment Freefall team led the way. Having descended under trails of coloured smoke and an oversized Regimental flag, they hit the deck. Jumping tandem was a very special guest, an elderly gentleman dressed in the team’s trademark red jumpsuit. As the pair came to rest, he gingerly got to his feet, donned his Parachute Regiment beret and walked smartly off the ‘drop zone,’ to be met by the then Prince of Wales, now King Charles III. The gentleman’s name was Jock Hutton, aged 95.

For my fellow paratroopers and I, the moment was visceral. We were living our history, sharing an experience that closed a generational divide, uniting us in what it meant to belong to our tribe. We believed we were part of something special,

something that had, and continues to offer, value to our society. For that brief moment, our entity felt meaningful, larger than ourselves. We were part of a legacy, whose story was still in the writing. It was an experience that was both symbolic and real, defining what it meant to be a paratrooper. In that moment, we had a heightened sense that we belonged.

As identified above, a sense of belonging meets both individual and collective needs. It both fosters and enables. At an individual level, belonging fosters the basic need to feel safe. In its purest sense it offers safety from danger, giving us the confidence that we are not alone and as such, we have a more assured chance of survival. More broadly it provides the safety to be oneself, confident in our own abilities, familiar in our surroundings, knowing we will not be judged; 'to dance like no one is watching.'¹¹ As world-renowned performance coach Owen Eastwood articulates, "When our need to belong in a team is met, [...] we can be ourselves. We feel that we are respected and that we matter. We feel included. We can be a good teammate here. Our identity and that of the team happily coexist."¹²

Belonging also fosters meaningfulness. In the unfathomable complexity of our existence, it gives us perspective and control, an appreciation of 'our place.' It also offers "a fundamental sense of life being worth living."¹³ In a world that is arguably more (technologically) connected than ever before, whilst perhaps never more (socially) disconnected, the quest for meaningfulness is acute. In increasingly individualist (largely Western) societies, with post-Covid working patterns exacerbating our sense of isolation and dislocation, we strive to generate our understanding of place, purpose and belonging.¹⁴ "In existential terms, human beings derive meaning from the idea of being part of something larger than the self."¹⁵

The force-multiplying effect of having a purpose beyond self was understood intuitively by Phil Jackson, keen practitioner of Zen, student of the Lakota Sioux and, reputedly, one of the greatest sports coaches of all time. With a record 11 NBA championship titles to his name,¹⁶ Jackson understood that success at the highest level required a collective mindset. Through outstanding leadership he crafted a team, moulding some of the greatest players ever to grace the court — some with egos to match — into a tribe. A tribe which, as Jackson so eloquently put it, "surrendered the 'me' for the 'we'."¹⁷

.....
"But working with the Bulls I've learned that the most effective way to forge a winning team is to call on the players' need to connect with something larger than themselves... It requires the individuals involved to surrender their self-interest for the greater good so that the whole adds up to more than the sum of its parts."¹⁸

PHIL JACKSON AND HUGH DELEHANTY
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In so doing, Jackson fostered belonging, and with it a group consciousness that generated shared commitment to the mission, loyalty to one another, mutual trust and respect, and accountability. He also fostered love — a concept less talked about in the context of high performance teamship, but all-powerful when harnessed.

As Jackson advocates, "Love is the force that ignites the spirit and binds teams together."¹⁹ Such a force would be familiar in militaries the world over, with the intensity of bonds created through shared purpose, experiences and belonging fostering familial love. Hence the well-versed concept of 'band of brothers,' made famous by the WWII exploits of Easy Company, 2nd Battalion, 506th Parachute Infantry Regiment.²⁰

.....
“Belonging is a wildly undervalued condition required for human performance.”²¹

OWEN EASTWOOD
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Once fostered, belonging enables. All-too-often overlooked, it is a key enabler of effective and sustained team performance. Assured psychological safety allows people to take risk, push boundaries, try, make mistakes and, as Professor Amy Edmondson advocates, to intelligently fail.²² It allows for “radical candor,”²³ with teammates confident they can speak their mind, safe in the knowledge that their views will be understood in the context of the task in hand, rather than taken as a personal affront. It encourages a climate of what Dr Timothy Clarke, author of *The Four Stages of Psychological Safety* terms, “high intellectual friction and low social friction.”²⁴ In turn, it unleashes the diversity of thought and experience, a “group intelligence,”²⁵ that resides in any social collective, protecting against the dangers of narrow-minded thinking that homophily can nurture. In turn, this drives much heralded innovation and creativity, enabling personal growth and joint learning.

The collective psychology and mutual trust forged by belonging also enables cultures of ‘freedom and responsibility.’

Freedom is granted to allow devolved decision-making and empowered action where it is needed most, whether that be on the field of play, the forward edge of the battle or in a customer-facing role. In the military, this philosophy is immediately recognizable as Mission Command. It supports one of our basic intrinsic motivations; autonomy.²⁶ Put simply, people perform at their best when they feel respected, are encouraged to contribute, and see themselves as active participants in the team. If people feel valued, they will add value.

But with such freedoms, as the great Viktor Frankl so wisely counselled, comes great responsibility.²⁷ When people feel they belong, when they believe they are part of something larger than themselves, they take responsibility, both for their own actions and for the collective outputs of the group.

Furthermore, belonging builds resilience and enhances well-being, both individual and collective. A deep sense of connection — whether to family, friendship group or work colleagues — offers the security and support necessary to face everyday challenges and hardships. It is not surprising, therefore, that those professions which by their very definition face some of the toughest challenges — specialist police units, firefighters and trauma medics to name but a few — often thrive on the strongest sense of identity and belonging.

From personal experience, the power of belonging is most acute amongst our special forces communities, both in the UK and US. Widely regarded as exemplars of sustained high performance, the Mission Command culture is intuitive. Whilst operating in the same chains of command as their wider military peers, hierarchies are flattened and power distributed, granting ownership as far forward as possible. Reinforced by alignment of intent, clear lines of communication, and a ‘relentless pursuit of excellence,’ individuals step up and take responsibility. All is underpinned by a steadfast belief in why they exist and the greater good they are enabling. This mindset, matched by an intense pride in their tribe and trust in one another, enables tenacity and endurance in the face of the most complex of challenges. The result is a force-multiplying effect, far in excess of the sum of its parts.

The Perils of Belonging

Yet, as respected statesman Edmund Burke once remarked, “The greater the power, the more dangerous the abuse.”²⁸ Intentionally or otherwise, the psychological potency of belonging can be nurtured to achieve great good or manipulated to realize unspeakable evil, as evidenced throughout our checkered human history. ►PAGE 401

“In Sovu, Rwanda, on May 6, 1994, the symbol was a bit of cloth. That day, Tutsi refugees sought escape from bands of Hutus in Sovu’s convent. The mother superior, Sister Gertrude, called in the Hutu militia. Hundreds of the Tutsi were shot, hacked or burned to death. But Sister Gertrude did not turn over the convent’s Tutsi nuns. Their veils protected them. Seeing this, a nineteen-year-old woman named Aline, the niece of a nun, begged for a veil. Sister Gertrude refused.

Seven years later, she was convicted in Belgium of war crimes. Among the witnesses was the murdered niece’s mother. “My daughter was killed because of a little piece of cloth,” she said. [...] A symbolic strip of cloth — its presence saving you from a pack of rampaging killers, its absence marking you as the kind to kill — is something only Homo sapiens create.”²⁹

This horrifying snippet from our recent past, brought to life in David Berreby’s compelling book, *Us and Them*, illustrates the dark side of what it means to belong. We create the meaning of our social identities and stipulate what it means to be a member in our tribe. The symbols, language, traditions, rites, and rituals, and the meaning they offer us, are created by us, for us, as a means of making sense of our world. Yet the lived realities of such creations are real indeed. Our shared identities can be forged to achieve collective greatness — uniting global communities to fight climate change — or manipulated to unleash the very worst of

humanity. The 1994 Rwandan genocide, one of many that sickens human history, demonstrated this yet again. ►PAGE 409

.....
“From massive, breathtaking barbarity to countless pinpricks of microaggression, Us versus Them has produced oceans of pain.”³⁰

ROBERT SAPOLSKY
.....

Our conceptual understanding of ‘Us’ and ‘Them’ was theorized in 1979 in the seminal work of social psychologists Henri Tajfel and John Turner. Their posited “social identity theory”³¹ argued that our own concept of self is inextricably shaped by the shared identities of the social groups with which we affiliate. As such, we see ourselves through the lens of the groups to which we feel we belong and, in so doing, we seek to protect what it means to be part of the ‘in-group.’ Unavoidably, reinforcing concepts of ‘Us’ creates an understanding of what it means not to be ‘Us’ — or one of ‘Them’ in the ‘out-group.’

From gender identities and political affiliations, to sporting passions and regimental loyalties, we are bound up in rich and unique identities through which we understand our reality. As military psychologist Sarah Chapman Trim stated, “Now common sense in hindsight, this simple re-conceptualisation of human behaviour was a paradigm shift that advanced our understanding [of both] the ‘bright side’ of human interaction in groups (trust, cooperation, loyalty and leadership) [and] the ‘dark side’ of social identity (prejudice, discrimination and stereotyping and their outcomes, ranging from workplace bullying and harassment to violence, human atrocities, and genocide).”³²

The perils of belonging, therefore, exist in how we both conform to ‘Us,’ as well as defend against ‘Them.’

‘Us’

Our conceptualization of self is reinforced through the notion of homophily. Defined as, “the tendency for people to seek out or be attracted to those who are similar to themselves,”³³ it is an instinctively human characteristic and a key contributor drawing us to belong.

We crave to affiliate with people like us, those we can relate to, and with whom we share similar views, values and perspectives. There is a familiarity and predictability of one another that underpins interpersonal trust and in turn strengthens social bonds. Having been drawn together through perceived likeness, we reinforce what it means to be ‘Us’ through created narratives, in turn evolving our social identities. Rituals, codes and distinct practices all seek to define group membership.

Military organizations exploit this to great effect. From uniforms, berets and badges, to ceremonies, traditions, and manicured histories, we define what it means to be a ‘British Paratrooper,’ ‘United States Marine,’ or ‘French Legionnaire.’ In so doing we create bonds of association that people will literally put their lives on the line for.

The function of homophily, for connection and relationship-building, is self-evident. But, left unchecked, it reveals a dark side. As Camilleri, Rockey and Dunbar argue in their insightful book, *The Social Brain*, homophily, “can also present challenges for organisations: groupthink, complacency, in-groups versus out-groups, narrow-mindedness and poor decision-making can all easily result from it.”³⁴ The impact to performance can be extensive, influencing siloed working, unchallenged directives, organizational rigidity, and resistance to change in light of shifting market forces.

Furthermore, driven by a desire to belong, we adapt our behavior to align with what is deemed acceptable by the group. What follows is either compliance (changing behavior to conform to others) or acceptance (changing behavior and internalizing and adopting shared beliefs).³⁵

Where group norms are not kept in check by strong leadership, responsible followership and agreed moral codes, we see what Diane Vaughan has termed a “normalization of deviance.” Developed in her organizational analysis of NASA following the 1996 Space Shuttle *Challenger* disaster,³⁶ the “normalization of deviance” refers to ‘a phenomenon in which individuals and teams deviate from what is known to be an acceptable performance standard until the adopted way of practice becomes the new norm.’³⁷

Regrettably our society appears plagued with such dysfunctional organizational cultures in which behavioral transgressions are deep-rooted. From elite sport and global banks, to health trusts and military Services, not a week goes by without another headline unveiling entrenched misogyny, reckless decision-making, harassment and discrimination, or abuse of authority. From individual misery to institutional collapse, high prices are paid as a consequence of morally distorted cultures exploiting the urge to belong.

‘Them’

One of the greatest perils of belonging to the preferential ‘Us,’ however, is the often unconscious bias we exercise against ‘Them.’

As Stanford Professor, Robert Sapolsky explains, “Our brains form Us/Them dichotomies with stunning speed.” Within just a fifty-millisecond exposure to a face, we instinctively categorize those of a different race, gender or social-status.³⁸ We are genetically wired, at great speed, to classify

ourselves and others into a vast array of what Berreby refers to as ‘human-kinds’;³⁹ Republicans, United fans, Chinese men, firefighters or Gen Zs. We simplify complexity through such human-defined categories, to each of which we add meaning, assumptions, and bias. As the science tells us, to our own we demonstrate in-group bias, favoritism, and prosociality, while ‘others’ typically invoke our distrust, anger and, at its worst, vilification.⁴⁰

At the professional level, I have experienced the perils of these dichotomies throughout my career. In an institution whose operational effectiveness is underpinned by the loyalty, pride and confidence inspired by our regimental (tribal) system, too often this is unmatched by the humility necessary to optimize performance. Such institutional arrogance, of which my own regiment has been guilty of in the past, has at best led to parochial and insular mindsets preventing evolution, collaboration, and integration, and at worst yielded toxic protectionism or sown dissent and distrust.

Such dangers appear to be worsening. Our daily interpretation of the world around us is increasingly fuelled by bite-size news briefings and 140-character social media posts,⁴¹ simplify complexity in language fraught with subjective meaning. We read about our politics through the prism of Republican v Democrat, discuss the impact of Brexit from a standpoint of Leave or Remain, or analyse our economic policies by reference to the wealthy elite, welfare claimants, or illegal immigrants. Our conceptualization and rationalization of our own realities are fraught with bias, misunderstanding and misrepresentation and, as the vitriolic rhetoric fills our phones and news channels, we seem to be further entrenching into our own tribes. This polarization of Us and Them is arguable one of the greatest dangers we face today. ►PAGE 421

However, as Berreby reminds, the ability to control the perils of belonging remains in our hands, or rather, our heads. “Your human-kind code makes nothing happen, for good or ill, unless you choose to act,” he writes. “Ethnic tensions, religious strife, political conflict, clan rivalries, and the like have never harmed anyone and never will. People do the harm. In other words, the Us-Them code does not own you; you own it.”⁴²

Leadership and Followership: A Collective Responsibility

And own it we must, for the dangers of leaving ‘belonging’ to chance are too fearful, and the rewards are demonstrably force-multiplying. But how are the somewhat ethereal concepts of values, beliefs, and ideals turned into a lived reality? How are they embedded across a team —or the team of teams as exists in most organizations⁴³ — to foster the positive identity and sense of belonging that supports a united purpose?

For the British Army, with a history dating back to 1660, the answers are deep-rooted. It is an institution which has nurtured the power of belonging — and, regrettably, the perils perhaps more than it would care to admit — for over three and a half centuries. From regimental tattoos, berets, and cap badges, to parades, pageantry, and customs, a rich tapestry of tangible and intangible markers has evolved, defining its social identity. The policies codified, standards reinforced, past glories regaled, and colloquial language refined, collectively seek to ascribe, consciously and unconsciously, what it means to belong.

.....
“I see values as shorthand for our Us story.”⁴⁴

OWEN EASTWOOD
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Yet, as I have sought to argue, the meaning attributed to any of these mechanisms can be skewed, deliberately or otherwise, for both good and ill. What defines the chosen path is our moral code, our shared principles of right and wrong. For the British Army, such foundations are grounded in its Values (courage, discipline, respect for others, integrity, loyalty and selfless commitment) and Standards (lawful, acceptable behaviour and total professionalism.)⁴⁵

Whilst only inscribed for the first time just over two decades ago, these Values and Standards would be just as familiar to Wellington's soldiers, two centuries ago, as they are to the young men and women deployed on British Army operations today. Embedded in reward systems, disciplinary procedures, training and histories, our Values and Standards provide the moral anchor points that shape individual and collective senses of self, shape the character of our soldiers and, in turn, influence their behaviors.

Yet, as is all too often the case in many organizations today, values remain nothing more than words on a page unless they are lived. It is people who turn concepts into reality. It is the habitual, everyday decisions and actions of both leaders *and* followers that give meaning to principles, defining what it means to be 'Us.' Regardless of role, we all have a part to play.

Leaders are duty bound to ensure that the shared identity of the team is fit for purpose but also evolving in line with societal expectations. Strong moral leadership is fundamental: setting the example to others, modelling expected standards, and leading with integrity — not just as regards one's own behavior but also with the moral courage to hold others to account where expectations have not been met.

Leaders set the cultural climate within their immediate sphere of influence: clear direction, alignment of responsibilities, effective

communication, support, and challenge are all staples of the role. To guard against an Us-Them dichotomy, leaders must work conscientiously to drive what a former commander of mine, Brigadier Charlie Stickland,⁴⁶ termed "infectious inclusivity." Pride in team performance must be matched with the humility to learn from and collaborate with others.

Concurrently and symbiotically, those in follower roles have an equal responsibility to define what it means to belong. Followers too must demonstrate moral courage and a strength of character, ensuring that behaviors are in line with what is known to be right, rather than reflecting blind subservience to the norms of the social group even where transgressions of Values and Standards are evident. Followers must be loyal, professional, and accountable and, above all, they must be driven by the needs of the team over self.

Shaping, nurturing and evolving the power of belonging, is a collective responsibility: a reciprocal partnership between effective leaders and courageous followers, operating at every level of the organization, jointly doing the right thing in pursuit of the shared mission.

On 22 August 2013, LCpl Leakey VC did just that. His actions were the epitome of courageous followership. He exemplified the Army's Values and Standards; courage, discipline, loyalty, selfless commitment and total professionalism. He lived the philosophy of Mission Command, understanding the commander's intent and, with agency to act, doing everything in his power to deliver. He took responsibility, for his teammates and the task in hand.

Paradoxically, Leakey showed leadership in his followership. Not only did he inspire others into action that day, but in so doing he set the standard for future generations, modelling what it means to belong to his tribe. Despite his trademark humility, declaring, "I

didn't feel I had a choice," consciously or otherwise, he did. His rationale? "That was what was expected of me as a paratrooper."

Leakey surrendered the "me" for the "we," putting his life on the line because he belonged.

Langley Sharp MBE is the former head of the Centre for Army Leadership, responsible for championing leadership excellence across the British Army. Having himself graduated from Sandhurst two decades ago, his career in the Parachute Regiment, which included operational command at every rank, saw him deployed to Northern Ireland, Macedonia, Afghanistan and Iraq. Among his many varied roles, he led a counter-insurgency Task

Force operation, commanded a Parachute Regiment Battalion and delivered the Ministry of Defence's training programme for the London 2012 Olympics venue security, for which he was awarded an MBE. He is the author of the British Army's official account of leadership, [The Habit of Excellence](#), distilling over three centuries of the Army's experience in the art, science and practice of leadership.

The breadth of Langley's life experiences has fostered in him a steadfast belief in the potential of people. As an executive coach and leadership consultant, working with executives and senior leadership teams across the private and public sectors, his passion is to help unleash this potential. Langley is the Founder and Director of the consultancy firm [Frontier Leadership](#).

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Peer Perspectives

Culture & Consequence: The Case for Change

By: ELIZABETH BRODERICK



Elizabeth Broderick

Introduction

In today's business world, workplace culture lays the foundation for success, linking the lived experiences of employees with the performance metrics of the organisation. The greatest organisational

successes occur when human dignity meets corporate prosperity. This is where the values of inclusivity and respect become not just moral imperatives but also strategic advantages.

Leading this work demands a new style of leadership — one characterized by courage, empathy, and a relentless commitment to fostering healthy workplace cultures. While the CEO bears ultimate responsibility, it is the work of everyone across the organisation, from the boardroom to those on the frontline, to create workplaces where all employees can thrive.

In this paper we delve into the interplay between workplace culture, human rights, community expectations, courageous leadership and organizational performance.

The case for change

HUMAN RIGHTS

At the heart of the case for change lies the recognition that culture is a matter of human rights. Every worker, irrespective of their role or background, has a fundamental right to be safe at work. This includes both physical and psychological safety.

In Australia, recent legislative amendments to the Sex Discrimination Act have created a positive duty — that is, an employer's responsibility to take 'proactive and meaningful action' to prevent sexual harassment and sex-based harassment from occurring in the workplace or in connection to work. This reflects a proactive shift, mandating that businesses take active and robust measures. This legislation now recognises that responding to alleged incidents of sexual and sex-based harassment is critical but insufficient, and that preventative action is also necessary to create safe, respectful and inclusive workplaces.

Culture is a matter of human rights.

In 2019, the International Labour Organisation (ILO) adopted the first-ever international treaty on violence and harassment in the workplace. ILO Convention 190, and its accompanying Recommendation 206, recognise the right of all people to work free from violence and harassment, amplifying the imperative for businesses to champion human dignity. Protections in this Convention also cover gender-based violence and sexual harassment.

COMMUNITY EXPECTATIONS

The call for businesses to improve workplace culture reverberates well beyond the legal mandates. The evolving expectations of our communities and society demand that contemporary workplaces be safe and respectful.

Social movements like #MeToo, which elevated the voices of women who experienced sexual harm in the workplace, and the Black Lives Matter movement, which confronted the racial injustice persistent in many institutions and social practices, have galvanized a collective community push for justice and equity. This has led to a reframing of workplace dynamics and sharpening the focus on organizational conduct.

As community scrutiny intensifies, businesses find themselves under the spotlight, with reputational risks now being clearly associated with cultural deficiencies. This scrutiny has been enabled by a media environment which has shown increased appetite for reporting on internal and cultural dynamics within businesses.

Whereas historically these matters may have been dealt with 'in-house' and without media coverage, today there is a greater likelihood that media will seek out opportunities to examine the extent to which a business is meeting societal norms and expectations. There are now many examples of businesses whose culture was poor and who consequently suffered a range of adverse outcomes, including stakeholder backlash, loss of reputation and potentially a threat to their social licence to operate.

Organisational performance

The link between workplace culture and organisational performance in many instances is clear. A positive, inclusive and respectful workplace culture is a key enabler of innovation, productivity, resilience and retention of high-value employees.

A positive, inclusive and respectful workplace culture is a key enabler of innovation, productivity, resilience and retention.

Workplace culture that does not align with a firm's stated values can generate a range of costs, both direct and indirect.

Cultures that foster inclusivity and respect for individuals tend to align more seamlessly with financial stability and growth. Conversely, cultures that tolerate human harm also harbour financial risks for prospective investors.¹

Studies by McKinsey and Co. and Boston Consulting Group illuminate the tangible dividends of diversity and inclusion, showing that businesses embracing these principles outperform their peers significantly. For example, McKinsey and Co. found that companies with top quartile gender and ethnic diversity outperform peers by 21% and 33%, respectively.² Boston Consulting Group found that companies with higher-than-average diversity within their management teams reported innovation revenue that was 19% higher than companies with lower-than-average leadership diversity.³ Conversely, companies in the bottom quartile for diversity were 29% less likely to achieve above-average profitability and were therefore "lagging."⁴

Workplace culture that does not align with a firm's stated values can generate a range of costs, both direct and indirect. In addition to reduced capacity for innovation, workplaces with poor culture can experience reduced productivity, in the first instance due to lower positive engagement in the workplace, and over time through negative impacts on retention and recruitment. In one recent review undertaken by our team, over a third of the firm's mid-tier managers were seeking new opportunities outside the firm, primarily due to a culture of long working hours. Losing even a proportion of those managers would create critical gaps in capability and corporate knowledge and ultimately undermine performance and profitability.

There are also potentially significant direct financial costs associated with poor organisational culture, including increased insurance costs, litigation costs and, in some instances, criminal penalties. One study examined high-profile firms that had reported and made public incidents of sexual harassment and found that: “the average effect of a sexual harassment scandal on company value is around a 1.5% abnormal share price decrease over the event day and the following trading day.”⁵

Looking at the impacts of culture-based risks over a five-year time frame, they further found that companies with unusually high sexual harassment scores experienced declines in operating profitability, future stock performance, and shareholder returns; and recorded increases in labour costs.⁶ This is consistent with the findings of an Australian study by Deloitte Access Economics which estimated that, in one year alone, workplace sexual harassment cost the Australian economy \$3.8 billion.⁷

These factors, combined with a growing awareness of environmental, social and governance (ESG) as business imperatives, have in turn shifted investor expectations. Although the environmental component has previously dominated ESG considerations, investors are now placing increased importance on the social element in their assessment of an organisation. This encompasses company-workforce relations, including diversity, equity and inclusion, health and safety, employee engagement and satisfaction; as well as the relationships that companies build with the communities in which they operate.

EXERCISING LEADERSHIP

Navigating these complex dynamics demands a new style of leadership — one characterized by courage, empathy, and a relentless commitment to fostering healthy cultures. While CEOs bear ultimate

responsibility, the onus to create a healthy culture extends across the entire organisation. Central to this is shifting the mindset of the business.

CEOs must be exemplary in modelling the workplace behaviours they seek and deliver transparency and accountability regarding harmful workplace incidents when they do occur. Boards must pivot towards proactive governance, actively addressing culture-based risks and fostering an environment conducive to transparency and accountability. Similarly, People, Culture, and Talent teams must reframe their roles, moving beyond reactive grievance management to champion systemic change and trauma-informed practices. Harmful behaviours are not isolated workplace grievances but, rather, leadership issues that are symptomatic of an unhealthy culture.

Boards must pivot towards proactive governance, actively addressing culture-based risks.

The approach to managing culture-based risks needs to shift beyond human resources departments to the enterprise risk level, with greater visibility and accountability from CEOs and boards.⁸ Crucially, leadership entails not just listening to but truly hearing the voices of those within the organization. Low reporting rates underscore the need for leaders to proactively seek insights into the lived experiences of their workforce, fostering psychological safety and trust. Transparency emerges as a cornerstone, not just in addressing immediate concerns, but also in laying the groundwork for sustainable cultural transformation.

By itself leadership is not enough; it must be complemented by robust systems and processes. From reporting mechanisms to remuneration policies, every facet of organizational infrastructure must align with the ethos of inclusivity and respect, and actively design for inclusivity.⁹ Harnessing data is essential, providing the empirical foundation for identifying strengths, mitigating risks, and charting progress over time.

Likewise, Legal teams have a central role in advising CEOs and Boards on how to navigate a response to complaints. There is an urgent need for a reframing of risk that includes both the harm to the individual but also the broader harm to an organisation's culture associated with harmful behaviours. There is a need for new principles around transparency, and there must be an end to NDAs and settlements that block individuals from speaking out. They are not in the best interests of individuals or organisations. In fact, the only person that really benefits from these arrangements is the perpetrator.

Inquiry and the inner work of leadership

Leaders are responsible for deeply understanding the culture and conduct within the business they lead. The patterns and behaviours are not always visible, particularly to those at the top. It can be tempting for leaders to think "if I am not hearing about it, then it is not happening." In reality, if leaders are not hearing about issues, that itself can be an indication that it is not safe to speak about these issues within the business.

In my experience, formal reporting rates in organisations can be extremely low, with as few as 3% of those experiencing harm choosing to speak out and access formal reporting and support mechanisms. There are many reasons for this, including a fear of victimisation (either from the alleged perpetrator or from others within the business) and fear of a negative impact on their career. This can be an issue for the individuals who have experienced harm — as they miss out on support and protection from retribution — but it

Leaders are responsible for deeply understanding the culture and conduct within the business they lead.

Leaders must go out and actively look for insights into the lived experience of working in the business.

also means that the business lacks data and insight. Relying on a good complaints process is not enough — leaders must go out and actively look for insights into the lived experience of working in the business.

Doing this requires leaders to step into conversations in a different way, to reconceptualise what it is to be a leader. This must include creating enough psychological safety and trust for people to feel

willing to speak, and to feel that there is a purpose and a benefit to speaking up. It also requires that leaders be vulnerable enough to listen without immediately judging or leaping to action. The practice of deep listening, and adopting a mindset of inquiry (rather than solution), are central to learning about lived experience and thus obtaining enough data to understand which aspects of a business's culture are strong, healthy and values-aligned, and which may pose a risk to individuals and the enterprise.

Transparency

Transparency is also integral to creating healthy, productive and inclusive cultures. Transparency is important to the immediate task of creating enough

psychological safety for people to share their lived experience, *and* to the longer-term task of building safe and productive cultures.

Our experience of conducting organisational reviews has shown us that people will generously share their experience if they are assured that

the findings and recommendations of a review will be shared back with them. For many, this transparency is symbolic of a business's genuine desire to learn from people's stories and to partner with their people in sense making and shaping future directions.

Research shows that, in at least some instances, organisations which seek to avoid public scrutiny, or to cover up wrongdoing, experience greater financial harm than those which are upfront about misconduct, with one study showing that self-disclosure of misconduct or culture-based risk experience a smaller decrease in share price than those which do not self-disclose.¹⁰

In recognition of the importance of transparency to organisational culture, the World 50 Group (which brings together the leaders of the world's most respected companies) established the Transparency Award. In announcing Rio Tinto as this year's winner, the judges highlighted Rio's willingness to share hard truths:

Rio Tinto stood out for its unwavering commitment to transparency. They didn't shy away from publicly declaring their stance, even when it involved acknowledging shortcomings. Their open sharing of intention and improvement targets showcases honesty, realism and ambition, setting a stellar example for others.

There are far greater opportunities for learning from peers.

cared for. Reporting systems which disempower those who have experienced harm, which are slow and lack empathy, undermine individual well-being and can contribute to a divided workforce. Likewise, confidentiality and disclosure policies which seek to cover up troubling issues ultimately benefit the alleged perpetrator and further harm alleged victims. They must be replaced with new principles of transparency and confidentiality that are human-centred and work to protect those who have experienced harm.

Remuneration policies and systems, too, can unintentionally undermine good leadership, with key performance indicators unduly weighted toward financial metrics at the expense of people leadership. There is a clear need for these systems to reward the creation of an environment that enables all people within the business to make their best contribution, as a hallmark and requirement of leadership.

Our work has shown that there are often untapped opportunities to be found within existing organisational systems and processes. For example, many industries (including the resources sector and the health sector) have existing mechanisms for tracking safety and human harm, and there is potential to expand the framing of risk to allow monitoring (and, thus, learning and action) of psychosocial risk within the workplace. This expansion of existing systems can often be more effective than trying to build systems which only deliver on one purpose and are at risk of being abandoned after a short time because they are not embedded within dominant organisational systems.

All of this must be underpinned by data systems that enable the collection of data on both the lived experience of the workplace and the quality and effectiveness of reporting systems. This data provides

Systems and processes

In her work on corporate accountability, Elise Bant **►PAGE 107** positions an organisation's systems, policies and behaviours as a manifestation of the corporate mindset.¹¹ Shifting organisational culture, then, requires shifting mindsets, but also shifting the systems and policies borne of those mindsets.

Central to this are some of the systems and processes traditionally used for responding to allegations of harmful behaviour or toxic culture.

Reporting and response systems must align with a business's commitment to having a healthy and productive culture. This includes ensuring that those who are impacted are empowered, listened to and

the foundations for identifying bright spots, for exploring potential hot spots, and for monitoring change over time.

Learning from and with peers

Whilst the work of leadership is more complex today, there are far greater opportunities for learning from peers as well. In recent years, leaders with a shared commitment to building healthy, inclusive and productive cultures have welcomed the opportunities for peer support and learning offered by initiatives such as the [Champions of Change Coalition](#), and the [UN Global Compact](#).

Conclusion

The imperative for healthy, inclusive, and productive cultures transcends rhetoric, embodying the essence of sustainable business practices. Courageous leadership, purposeful action, and unwavering commitment to the values that underpin human rights are critical. The intersection of a healthy workplace culture with excellent corporate performance brings greater benefits than just prosperity. It also brings the promise of a more equitable and just future for all.

Elizabeth Broderick is an internationally recognised human rights expert, and Principal of EB&Co, a specialist consultancy focusing on high-level strategic consulting and transformation, particularly in the areas of gender equality, diversity, inclusion and cultural renewal. As Principal of EB&Co, Elizabeth has conducted more than 25 independent cultural reviews of organisations as diverse as the Australian Defence Force, Rio Tinto and EY Oceania.

She is the Founder and Convenor of the Champions of Change Coalition, a globally recognized strategy engaging over 260 CEOs and their organisations to lead on diversity, equity and inclusion.

From 2017-2023, Elizabeth was a Special Rapporteur and Independent Expert on the United Nations Working Group on discrimination against women and girls. In that role, she carried out UN country missions and had a global mandate to issue official UN communications to nation states drawing their attention to human rights violations, particularly against women and girls.

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Peer Perspectives

An Interview with Robert Stout



Robert Stout



Q: You helped to manage regulatory affairs at bp (formerly, British Petroleum) in the wake of the Deepwater Horizon oil spill in 2010. That spill has been described as one of the worst environmental disasters of all time. What was your role in bp's recovery from that crisis?

A: In April 2010, I served as the Associate General Counsel responsible for advice and support on health, safety and environmental legal issues for bp globally.

As such, from the time I received an urgent call in the middle of the night as the crisis was just unfolding until I took on a new role leading regulatory affairs and policy in 2014, I was intimately involved in counseling bp's global and US boards and executives and leading bp's internal and external lawyers on the many environmental and safety legal matters arising from the spill.

My primary responsibilities included engaging with the Department of Justice and multiple federal and state trustees on bp's response to and restoration of natural resources affected by the spill and

counseling bp's internal safety and operational risk organization on its efforts to investigate the causes of the spill.

Q: The Deepwater Horizon oil spill was ruinously costly, and nearly existentially so, with bp's total outlay to rectify the spill tallied at \$65 billion. This does not include reputational damage both to the firm itself and to senior leaders responsible for its operations. Could you take us back to that moment in time? What was the internal thinking regarding the stakes involved?

A: The loss of 11 men on the drilling rig, along with the injuries and trauma suffered by many others and their families, weighed heavily on us. For many, it brought back to mind the tragic explosion at bp's Texas City refinery in 2005. I distinctly recall watching the television monitors in bp's crisis center in Houston with a number of close colleagues as the burning rig sank into the Gulf.

Sad and sobering are insufficient words to describe what we felt. We knew the stakes for the company were existential, in this case literally rather than figuratively. The markets confirmed it, as the credit default swap markets at one point were betting that bp would go belly up.

We knew the stakes for the company were existential.

But most of all, at the top of our minds and in the pit of our stomachs was the realization that the only way the company could survive was to devote every human and material resource we had to responding to the crisis and stopping the spill, compensating all who were injured fully and fairly, cleaning up and restoring the environment and natural resources that were affected, and investigating the root causes of the accident diligently and openly. We had to do everything within our power to understand what went wrong and then take steps to prevent such a tragedy from ever happening again.

Q: After a crisis of this sort, a firm's relationship with its regulators and trust with the public are often crippling impaired. What was it like for you to manage these relationships as you dealt with the consequences of the spill? How did you go about rebuilding credibility?

A: The incident placed extraordinary pressure on our colleagues in the federal and state government — right up to President Obama himself — to show that they were doing everything possible to respond. Secretary of the Interior [Ken Salazar](#) stated publicly that the US government had its boot on bp's neck. But, in reality, the government urgently needed bp's full support and expertise to mount an effective response, and bp chose to give it freely and proactively rather than begrudgingly.

From the outset, we began working in close cooperation with the Unified Command and the full range of federal and state government agencies and officials on a comprehensive response. We knew that we could only rebuild the company's credibility over time with our actions and not merely with our words. As such, we acted swiftly to demonstrate our commitment to the immediate response to the spill, to providing full compensation to the government and private parties for legitimate claims and to restoring the affected natural resources, without exception and without delay.

The scope and scale of the spill response, which involved the US Coast Guard and a wide array of government agencies along with bp and other private parties, was unprecedented and extraordinary.

To provide some sense of this, according to a report by the on-site commander from the Coast Guard, on the most demanding day of the response over 6000 vessels, 82 helicopters, 20 fixed-wing aircraft and over 47,849 personnel/responders were involved.

We had to do everything within our power to prevent such a tragedy from ever happening again.

We knew that we could only rebuild the company's credibility over time with our actions and not merely with our words.

bp played a critical role throughout the response. As noted in a January 2011 Incident Specific Preparedness Review report developed under the direction of the Coast Guard to review best practices and lessons learned during the Response: "bp was very proactive and placed no limits on what was needed to make this response successful."

Q: Can you provide some examples of the proactive measures bp took to compensate for economic and environmental damages caused by the spill?

A: bp took a number of proactive steps to demonstrate its commitment to compensating individuals and businesses for all legitimate claims for environmental and financial damages resulting from the incident. For starters, bp quickly and publicly reassured stakeholders that it would not seek shelter under the \$75 million dollar cap that the federal Oil Pollution Act put on oil spill liabilities, a waiver later made formal in court. And in June 2010, following a meeting with President Obama, bp committed to establish a \$20 billion claims fund over the following 3 ½ years to compensate claimants.

Along with its lead environmental counsel, the law firm of Arnold & Porter, bp also developed a strategy to fund early restoration of natural resources damaged by the spill. bp tapped Arnold & Porter for this role because of both their deep environmental expertise and advocacy skills, and their collegiality and ability to work constructively with government agencies and their counsel. Along with [Brian Israel](#) from that firm, a former trial attorney at the Department of Justice who literally wrote the book on the complex law governing so-called "natural resource damages," I was personally involved in helping to negotiate an unprecedented early restoration agreement with

the federal government for bp to provide \$1 billion for projects to help restore the flora and fauna impacted by the spill.

Normally, funds for natural resource damages are not provided under federal law until long after the fact. This typically follows a detailed assessment by federal and state trustees and lengthy discovery and litigation between the government and the responsible parties. But in this case, bp quickly signaled its interest in funding projects and began working with government lawyers to develop a legal framework for selecting and funding specific projects that would be credited against the natural resource damages ultimately assessed years later.

The teams at the US Departments of Justice, Interior and Commerce — notably including [John Cruden](#), [Lois Schiffer](#), and [Rachel Jacobson](#) — were not only worthy legal adversaries but also highly professional and creative colleagues in this process. Once the agreement was inked, we began meeting regularly and working closely with the many federal and state government trustees to select and fund projects.

As to be expected, that process was not easy and was sometimes contentious. However the government officials involved, and their counsel, saw bp's commitment to begin making things right, and this was an early and critical step in rebuilding bp's credibility with government stakeholders.

Q: I imagine a key aspect of this, internally, was answering the “How did this happen?” question, so that you could communicate externally how it would be avoided in the future. Could you walk us through that?

We decided that the investigation would not be conducted by lawyers operating under legal privilege.

We wanted to help prevent such an incident from ever happening again — not only at bp, but throughout the industry.

A: Within twenty-four hours of the explosion of the rig, bp commissioned a detailed investigation of the root causes of the incident.

And despite the tens of billions of dollars in potential costs and liabilities that bp would face coming out of the largest environmental case in history, we decided that the investigation would not be conducted by lawyers operating under legal privilege, but instead by operational and safety professionals under the supervision of bp's global head of Safety & Operational Risk (Mark Bly). He assembled a team of over 50 top experts with expertise ranging from engineering and operations to safety practices and culture who worked almost around the clock to produce and release a detailed and comprehensive report four months later.

President Obama also created a Presidential Commission to investigate the causes of the incident. bp not only fully cooperated with their investigation team, but also provided them with substantial data, analysis and witness statements. When the Presidential Commission held public hearings on their investigation several months later, their lead counsel [Fred Bartlit](#) thanked bp for its efforts, noting that he agreed with ninety percent of the findings in bp's investigation.

There was some public criticism of both reports for not being sufficiently critical of bp and the other companies involved. This was inevitable given the political and media dynamics and the understandable anger over the incident and its impacts. But our primary goal was to conduct a detailed, thorough and non-privileged inquiry into what went wrong and then report it publicly for all to see. We wanted to help prevent such an incident from ever happening again — not only at bp, but throughout the industry. In that context, the Presidential

Commission's recognition that we had done a good job was deeply gratifying and meaningful to all of us who were involved.

Q: This series of reports is concerned with the management of risks that are often considered to be intangible or unquantifiable, particularly those that flow from organizational culture, the behavior it promotes, and the performance outcomes that follow. Within that context, what role do you think culture might have played in allowing for this crisis to unfold at bp?

A: Starting with the investigation reports, bp's own investigation found that: "A complex and interlinked series of mechanical failures, human judgments, engineering design, operational implementation and team interfaces came together to allow the initiation and escalation of the accident." The Presidential Commission likewise found a series of causes, including organizational issues within bp and the other companies involved, such as an engineering reorganization within bp that led to distraction and delay for the team drilling the well.

Treatises have been written on the technical and cultural factors that led to the incident. Rather than trying to summarize those analyses here, I will offer my personal reflections drawn from my years of experience before and after the incident. Like most process safety incidents, I believe it happened not because of any single cultural factor, but instead from a failure of the various operational and organizational barriers designed to prevent or mitigate against such safety risk and incidents.

These failures created an overlapping series of holes that lined up, as in the classic process safety diagram of slices of Swiss cheese, to allow the tragedy to

occur. I am uncertain about what role this played in causing the incident, or whether earlier recognition of this factor would have changed what happened on that rig, but I do believe that the process safety learnings of bp's refining organization after the 2005 Texas City refinery explosion were not translated or implemented as well as they should have been within bp's exploration and production organization.

So, a key organizational and cultural lesson for large organizations is to ensure that, when a safety or compliance failure occurs in one part of the organization, the lessons from that incident — and the safeguards put in place to prevent it from happening again — are widely shared and incorporated across the organization.

A key organizational and cultural lesson is to ensure that, when a safety or compliance failure occurs in one part of the organization, the lessons from that incident are widely shared and incorporated across the organization.

One final point about cultural factors that may have contributed to the incident. Despite the caricatures of the individuals involved in the incident, notably in the Deepwater Horizon film, this tragedy did not occur because they consciously chose to put cost over people or place themselves or their co-workers

at risk. As Fred Bartlit emphasized: "To date we have not seen a single instance where a human being made a conscious decision to favor dollars over safety... They want to be efficient, they don't want to waste money, but they also don't want to get their buddies killed."

Q: What did bp do after the incident to address the cultural factors that may have contributed to this tragedy?

A: In the months and years following the incident, bp developed and deployed a rigorous and comprehensive set of measures that fundamentally affected the culture, governance, and organization

of the company — in the US and globally — from the board and executives on down to workers in the field or on a rig.

As any compliance expert would say, the tone from the top is critical in successfully implementing cultural and operational changes. In this case, bp's global CEO [Bob Dudley](#), US CEOs [Lamar McKay](#) and [John Minge](#), Global General Counsel [Rupert Bondy](#), US General Counsel [Jack Lynch](#), and leaders across the businesses sent a clear message that the company would not only meet its legal and compliance obligations but would go well beyond them in embracing and rapidly making the changes required to embed environmental, health and safety best practices and culture across the company.

It is not too much to say that Bob Dudley and his extended leadership team literally saved the company then, and built the platform for its success now, 14 years hence. And it is also important to note that our subsequent success was built upon a deeply embedded cultural foundation of dedication, commitment and teamwork that represented the best of bp. This was made manifest in the company's response to the tragedy from the top ranks to the grassroots. In fact, as the spill and response were ongoing, a number of prominent bp retirees came back to help with the effort. This included former senior executive Laura Folse, who rejoined bp soon after the incident and led bp's response to the spill for years thereafter.

Q: What do you think was most particularly effective in this regard?

A: Without trying to catalog all of the multitude of voluntary actions bp took to enhance our safety culture following the incident, I would point to a couple which, in my personal view, were critical

to our success and may be instructive for other companies responding to a major safety and/or environmental incident.

First, bp designed a robust and clearly written operating management system and implemented a strong Safety & Operational Risk (S&OR) organization to embed and enforce that management system across its global operations. Key operational or engineering decisions that could implicate safety, such as deviations from procedures, could not be made without S&OR approval.

Our subsequent success was built upon a deeply embedded cultural foundation of dedication, commitment and teamwork.

Line employees were explicitly authorized to stop work, and S&OR staff were empowered to “throw a red card,” if and when they thought safety was at risk. Because this power existed and was enforced, it rarely had to be exercised. A yellow card, followed by a candid

assessment and discussion of the issue between the line operator and their S&OR counterpart, was usually sufficient to address issues as they arose.

Second, and equally important, bp carefully selected and appointed leaders and staff from S&OR who were esteemed peers of the leaders of the line businesses they supported, such as oil & gas drilling or production, refining or petrochemicals. Indeed, one of those senior S&OR leaders, Gordon Birrell, now serves as the head of bp's global upstream and downstream operations. Because these S&OR leaders were selected for their operational background and acumen, their peers in the business line took it seriously when they raised a safety concern, rather than writing it off to naïveté or overreaction to minor risks — as can often happen in companies when functional safety or compliance staff confront business leaders with a concern.

S&OR leaders sat on line leadership teams and were sincerely valued and relied upon for proactively identifying and recommending practical ways to

mitigate safety and operational risks as they arose in operations, not just brought in as or after a major problem had arisen. Regardless of the business sector — whether it is in finance or banking, manufacturing or energy — I believe that in any organization employees will assess the seriousness of a company in implementing change by the expertise and character of the leaders appointed to the task, and the extent to which they are actually empowered to identify problems and effect change. Companies would be well advised to consider this as they create and staff compliance and safety functions within their organization.

It is also important to note that bp developed and implemented its drilling safety program and measures with the independent oversight and supervision of federal regulatory agencies, such as the Bureau of Safety and Environmental Enforcement (BSEE), which regulated drilling, and the EPA.

Moreover, bp entered into a plea agreement with the Department of Justice and a compliance agreement with EPA that included an array of requirements relating to governance and culture. Under those agreements, an independent monitor was appointed to oversee and report on bp's compliance.

Q: Given all of those internal efforts — and the sincerity with which they were executed, as you describe here — how was it received when an external monitor was appointed?

A: Companies often consider external oversight to be burdensome and intrusive, and thus respond by keeping regulatory personnel and compliance monitors at arm's length and doing the minimum required for technical compliance. To their credit, and to the

Employees will assess the seriousness of a company in implementing change by the expertise and character of the leaders appointed to the task.

bp's executives actually invited and embraced the oversight and instructed their teams to do the same.

benefit of bp and the industry, bp's executives actually invited and embraced the oversight and instructed their teams to do the same.

Thus, for example, we not only provided the required written compliance reports, but the head of bp's Gulf of Mexico business (Richard Morrison) also met regularly with BSEE leadership to outline and solicit their input on steps bp was taking to enhance safety on offshore drilling rigs in the Gulf of Mexico. This included industry-leading measures like establishing a monitoring center in Houston to provide oversight of offshore operations, staffed by experienced technical experts working on shifts to provide 24-hour coverage.

To their own credit, and to the benefit of the public, the leaders and staff from the regulatory agencies and the compliance monitor responded in kind to bp's collaborative approach by sharing their candid advice and insights as we were designing and implementing corrective actions to be most effective in our organization, while also holding us accountable for strict compliance with the agreements.

Q: I imagine leaders at Boeing and other companies who are confronted by similar culture challenges and disastrous performance outcomes will find the experience you recount here very instructive. Any closing thoughts?

A: It is worth adding that bp's compliance monitor, [Patrick Gnazzo](#), was not only one of the deans of corporate compliance programs, but also had decades of hands-on experience with designing and implementing programs in large, complex global companies.

This experience made him particularly effective in monitoring whether bp was in compliance with the letter and spirit of its government agreements. Gnazzo also advised the government and bp on how to ensure that the necessary changes were being embedded throughout the organization and its culture. bp was fortunate to have him as a trusted collaborator as well as a compliance monitor.

In recruiting and selecting compliance monitors, I would urge government agencies, as well as company personnel, to focus on their understanding of and experience in dealing with corporate cultures rather than solely or primarily their law enforcement background and expertise.

Robert Stout spent nearly three decades as a lawyer and executive with bp, most recently as the VP and Head of US policy and regulatory affairs in bp's Washington office from 2014-20. Before that, he served as bp's global Associate General Counsel for environmental, health, and safety and led bp's environmental legal response to the Deepwater Horizon oil spill. He now serves as the Executive Director of the Energy Emissions Modeling and Data Lab and as a Senior Fellow at the Nicholas Institute for Energy, Environment & Sustainability.



Peer Perspectives

Building a High-Performance Board Culture

By PETER GLEASON



Peter Gleason



of the board — and its ultimate success as a trusted steward of long-term value.

Each boardroom harbors a distinct ecosystem, nurtured by shared values, beliefs, assumptions, experiences, and expectations that may differ from or even undermine the corporate culture. If left unattended, a dysfunctional board culture may foster misunderstandings and conflict and contribute to poor board decision-making that could increase the risk of company failure. ▶[READ MORE ON STARLING INSIGHTS](#)

Companies are well aware of the importance of corporate culture in driving corporate performance, but what about the impact of *board* culture in driving *board* performance and effective governance of the enterprise? While often overlooked, the board's shared norms, protocols, and practices influence each interaction, discussion, and decision

Each boardroom harbors a distinct ecosystem that may differ from or even undermine the corporate culture.

Today, boards and companies are grappling with a permacrisis — an extended period marked by change and uncertainty. Events and their effects such as the COVID-19 pandemic, supply chain disruptions, technological advances, cyber threats, geopolitical instability, and new regulatory requirements have fundamentally reshaped business and redefined how companies need to be governed.

In response, board responsibilities have intensified, gained greater visibility, and now carry higher stakes. The expectations for both overall board and individual director performance have reached unprecedented levels, encompassing demands for increased transparency, diversity, and accountability.

When a crisis hits, stakeholders are turning their attention to the role of the board. Major investors are closely scrutinizing the range of experiences and expertise of directors, and activists are targeting those who are not keeping pace.

Boards are adopting new governance practices in an effort to become more agile in this environment. For example, boards are refreshing their boardroom composition, bringing in directors with new and diverse perspectives, backgrounds, and skill sets to meet new governance expectations and evolving needs. The pursuit for greater board agility has driven boards to forge more dynamic and fluid relationships with management.

Each year, NACD convenes a Blue Ribbon Commission, a collective of experienced directors and leading governance professionals (the "Commission"). The

Commission examines a challenging issue facing boards and sets a new standard for effective board practices. Recognizing the rising demands on the board, in 2023, NACD looked at the role that board culture plays in board performance.

The [*Blue Ribbon Commission Report on Culture as the Foundation: Building a High-Performance Board*](#) offers recommendations and tools to help boards intentionally shape their culture and use it as an instrument to drive board performance. The report emphasizes that both activities within the boardroom and interactions between the board and management are integral elements of a high-performing board, necessitating an initial evaluation of cultural red flags.

Identifying Red Flags: Key Indicators of Dysfunctional Board Culture

Most boards evaluate their own performance, considering factors such as effective agenda setting, meeting preparation and engagement, adherence to committee charters, and other functional elements. But directors may fail to see the telltale signs of cultural dysfunction on the board that can impact performance.

They can include these:

- Agendas that feel stale, repetitive, and uninspiring, leading to disengaged directors and rubber-stamped decisions
- Packed agendas that leave little room for thoughtful discussion and healthy debate, hindering collaborative problem-solving
- A poor board relationship with the CEO and C-suite members, resulting in strained interactions
- Some directors hesitate to contribute, resulting in skewed discussions dominated by a few loud voices
- A single director who frequently steers the agenda and conversation, silencing diverse perspectives and deterring effective collaboration

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Faced with cultural dysfunction, boards may feel that they have only two choices: either tolerate the status quo or institute a complete overhaul. Instead of resorting to the extremes of inaction or explosion, boards can intentionally build a strong board culture deeply rooted in continuous improvement. The path forward to elevate board culture and, consequently, board performance, demands a collective and unwavering commitment from each director. This united effort empowers the board to face emerging challenges with greater agility.

Board Culture by Design: Three Fundamental Steps

The Blue Ribbon Commission identified 10 recommendations in three key areas of focus for boards to intentionally (re)shape their culture to build a high-performance board.

Define the optimal board culture. Boards must first deconstruct their current cultural reality — the unspoken rules, communication patterns, and decision-making dynamics that currently shape their interactions. Then, the directors must embark on a shared journey to define their ideal cultural state. This involves envisioning the values, norms, and behaviors that will best enable them to navigate today's dynamic and demanding environment. Do they aspire to be agile and decisive, swiftly adapting to market shifts? Or perhaps their strength lies in deeply held consensus and thorough analysis? Understanding their aspirational culture allows directors to bridge the gap between their current reality and their desired future.

Reinforce the board's culture and behavioral norms. Once the cultural aspirations are defined, the focus shifts to integrating them into everything the board does. Board leadership (board chairs, lead independent directors, and committee chairs) serve as culture carriers and are supported by the nominating and

governance committee. Together, they can monitor the board's effectiveness, hold directors accountable for upholding the desired cultural norms, and lead by example. The board's culture can be embedded in processes such as recruitment and onboarding, with a focus on integrating new directors into the boardroom, culture, and evaluation process, advancing accountability and continuous improvement.

Address major cultural fault lines. No culture is perfect, and boardrooms are no exception. Boards must address these "fault lines" — areas that can divide the board — to build and maintain an effective culture. For example, perhaps silos have developed between groups of directors or there may be "problematic directors" — those exhibiting disengagement, unpreparedness, staleness, or even unethical behavior. Boards must have the courage to take action and address these issues that undermine board culture and performance. Directors need to get more comfortable making fellow directors uncomfortable. An "off-boarding" strategy for both individual directors and the full board, aside from age or term limits, should be established. Board service is not a lifetime appointment, and rigorous individual director evaluations and self-reflections should be prioritized.

Some boards will benefit from a comprehensive road map approach, while others may benefit from specific recommendations, such as equipping board leadership to affect the culture. This journey toward an engaged and high-performing board requires a shared commitment to continuous refinement and culture reinforcements woven through the workings of the board — by both directors and members of management.

No culture is perfect, and boardrooms are no exception.

Effective Board-Management Relationship Is Vital to Board Culture

NACD research found that a healthy board-management relationship is one of the most significant factors contributing to strengthening board culture.¹ Internal dynamics and established norms are deeply intertwined with how effectively the board interacts with management.

While a more fluid board-management relationship fosters collaboration, it also poses a risk of micromanagement or unproductive tension, which can impact overall board performance. This dynamic shift in board-management relationships requires ongoing dialogue, especially between the board leader and CEO, to promote a constructive relationship.

The Commission identified the following actions to clarify (or reset) the board-management relationship:

- **Specify management and board communication protocols.** These include:
 - outlining the board's expectations for information provided by management, establishing a clear process for individual directors to request additional information (and preventing the board from inundating management with requests)
 - defining crisis readiness
 - defining response plans
- **Assess and improve the quality of reporting and meeting materials.** Management should strive for concise but thorough board materials that highlight key information relevant to agenda items and discussions. Distributing materials in advance to allow for adequate review time and limiting presentations during meetings allows a focus on discussions and forward-looking issues.

- **Outline board engagement expectations.** The independent board chair (or lead independent director) and CEO, with board input, should define each agenda item's purpose in meeting materials. The "ask" of the board may include "informational only," "for approval," or "soliciting feedback."
- **Invest in ongoing relationships.** Relationship building between the board and CEO and the board and management can no longer be viewed as a "nice to have." Boards may host management at board dinners or participate in a mentorship program with high-potential employees.
- **Create psychological safety.** Directors should reflect on the level of psychological safety that exists in the boardroom. How often does management raise problems and concerns with the board? How are missteps addressed with management? Boards should ensure a safe environment where ideas and concerns can be shared, and mistakes can be discussed.

For decades, the adage "nose in, fingers out" has stood as a guiding principle for boardroom engagement. It paints a picture of vigilant oversight ("nose in") by directors without interfering in the day-to-day operations of management ("fingers out"). Coined by NACD's founding president John Nash, it captures the crucial distinction between observation and advice versus direct action. Given the complexities of today's environment, a nuanced approach and a more proactive and deeply engaged board is necessary.

Directors should reflect on the level of psychological safety that exists in the boardroom.

Visionary directors ask pointed questions to guide management's focus on emerging issues. They actively listen to responses, seek out short- and long-term consequences, and analyze complex issues from various angles, offering diverse perspectives. Active questioning strengthens board oversight without overstepping operational boundaries, uncovering the "whys" and "hows" behind management's decisions without dictating or micromanaging. During the Commission's discussion, some commissioners added "eyes open" and "fingers on the pulse" to the original adage to capture this approach. Directors must maintain a clear line between oversight and management to avoid unnecessary friction with the management team and safeguard board independence.

Conclusion

In the dynamic landscape of today's business environment, the pursuit of board agility is shedding light on the pivotal role that the board's culture plays. Boards must create performance cultures on the board akin to the performance culture they expect management to create and sustain. Often underestimated, the shared norms, protocols, and practices within the boardroom exert a profound influence on every interaction, discussion, and decision. Neglecting to cultivate a purposeful board culture isn't simply a missed opportunity, it's a breeding ground for misunderstandings, conflicts, and, ultimately, the erosion of good governance.

To seasoned directors operating within performance-enhancing cultures, a detailed focus on culture and specific activities to enhance and maintain board culture may seem like common sense. But looking at the rearview mirror to boards associated with company failures, it becomes clear that board culture deserves keener attention than it has been receiving.

Peter Gleason is president and CEO of the National Association of Corporate Directors (NACD), the most trusted association for corporate directors who want to expand their knowledge, grow their network, and maximize their potential. For nearly 50 years, NACD has been the leading voice of the director, setting the standard for governance education, best practices, and thought leadership. Our leadership continues to raise standards of excellence and advance board effectiveness at thousands of member companies.

NACD's value insights, professional development events, and resources, such as the [NACD Directors Summit™](#) and the [NACD Directorship Certification®](#) program, support boards in navigating complex challenges. With a growing network of more than 24,000 members across more than [20 chapters](#), boards are better equipped to make well-informed decisions on the critical, strategic issues facing their businesses today. Learn more at www.nacdonline.org.

ENDNOTES

- 1 See p. 26 of the [2023 NACD Public Company Board Practices and Oversight Survey](#) and p. 27 of the [2023 NACD Private Company Board Practices and Oversight Survey](#).



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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, as we call it. It is organized 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 within each nation. No other body of work

that we know of offers this degree of granularity and comprehensiveness regarding the matters we address in this series of reports.

Here we describe the activities and priorities that were in evidence over the last year, both with regard to the supervision of culture and conduct risk concerns in the industry, and in terms of expectations for the governance thereof within firms. This year’s report also considers deeply questions of culture and conduct risks as they have plagued supervisory bodies themselves.

Some markets have experienced more significant public activity, often driven by crisis or scandal. 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 view. We’ve done our best to capture whatever was publicly available.

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 figures from many of the major financial markets worldwide. You will see that input incorporated throughout this section, significantly enriching it.

Please note that the summary contained within the *Compendium*-proper seeks not to offer qualitative judgments of our own, but rather to provide our readers with some organized information concerning the global culture and conduct risk supervisory agenda, identifying trends and open questions, and invariably reflecting the various and at times conflicting qualitative judgements on offer from those whose views we seek to curate.

Every year, in the course of writing this report, we pull out a list of ten Key Takeaways which represent the topics that appear to have received the greatest attention in the past year, or which serve to highlight new trends and developments of particular note.

The first Key Takeaway from this report reflects the discussion around **governance failures** exposed by the 2023 “banking turmoil.” In October 2023, the Basel Committee on Banking Supervision (BCBS) published its report on the regulatory and supervisory implications of the 2023 bank failures. The BCBS argued that they exposed widespread shortcomings in risk management and culture, highlighting the need for more effective supervision to assess such concerns.¹³¹ ▶ **PAGE 384**

A second Key Takeaway is the focus on **supervisory failures**, which some argue permitted for the governance and cultural failures that produced the turmoil. In its own post-mortem, the International Monetary Fund (IMF) argued that supervisory agencies must attend to their own cultures to better ensure that supervisors take more timely action to compel firms to resolve these governance deficiencies.¹³² ▶ **PAGE 388**

A third Key Takeaway from this conversation has centered around whether the supervisory and governance deficiencies at the root of last spring’s bank failures were **systemic** or **idiosyncratic** in nature. Viewed closely, the consensus view that emerges here suggests that we should view these deficiencies as “uniquely similar.” Daniela Jaramillo, Head of Sustainable Investing in Australia for Fidelity International, explains here why she believes culture-based risks have real financial implications, and are systemic in nature. ▶ **PAGE 81**

Whether you agree that shortcomings in culture and conduct risk governance and supervision are systemic, they are clearly **prudential** in nature, as evidenced by their role in the downfall of Credit Suisse, a G-SIB. Herein, Sharon Donnery, Deputy Governor for Financial Regulation at the Central Bank of Ireland and newly appointed member of the ECB’s supervisory board, explains why culture and conduct risks warrant prudential attention. ▶ **PAGE 283**

Another Key Takeaway from the occurrences of the past year is that supervisors are susceptible to the same culture challenges as the firms they oversee — **“As Above, So Below.”** The clearest example of this is the culture crisis at the US Federal Deposit Insurance Corporation, which has captured headlines and Congressional attention in the US. ▶ **PAGE 201**

In an attempt to drive governance and culture improvements in the financial industry, regulators globally have established tests to determine whether applicants are “fit and proper” for their prospective leadership roles. Some of these regimes include a focus on **character**, among them most recently the NY Department of Financial Services. ▶ **PAGE 183** But while character is certainly important, contributors here argue that it is perhaps more important to attend to cultural **context**, as this has greater influence on employee conduct.

Culture & Conduct Risk Regulatory Landscape

Summary

For the fifth year, Starling offers its Culture and Conduct Risk Regulatory Landscape. This chart aims to provide a simple means of comparison, among global regulatory bodies, as different agencies place different degrees of emphasis on approaches to the supervision of Culture and Conduct Risk.

The X-axis reflects whether the strategies regulators have taken toward overseeing culture and conduct risks tend more towards a Rules-based vs a Principles-based approach.

The Y-axis describes the relative prioritization of activities targeting culture and conduct risk versus other supervisory priorities. This does not necessarily reflect total resource commitments, but each

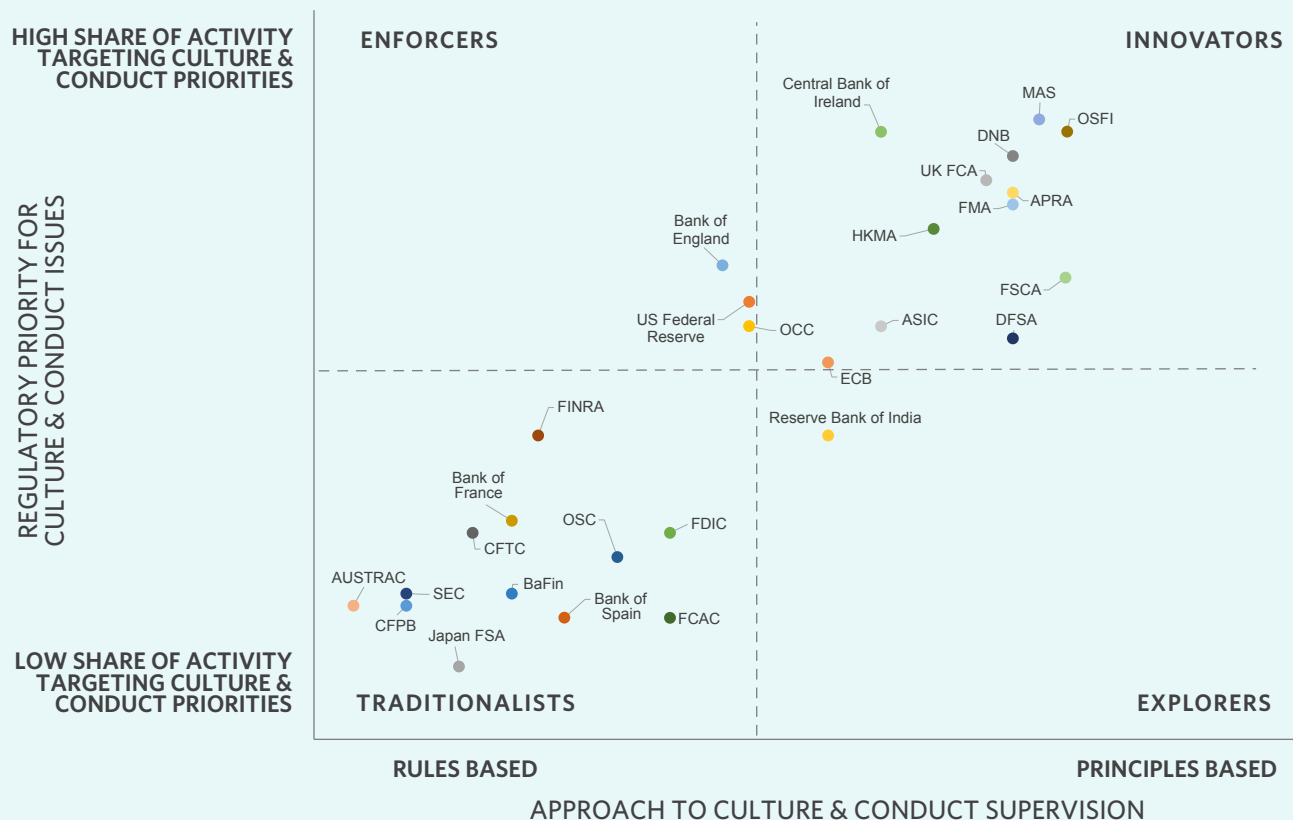
regulator's relative mix and range of activities and programs that are designed to support a culture and conduct agenda.

In producing this chart, we relied on responses to our annual Survey, complemented by a study of public information from regulatory bodies. As such, this analysis does not reflect any private guidance regulators may have issued.

As the industry evolves, as regulators roll out new initiatives, and as new information becomes available to us, we will of course incorporate those developments into future updates to this chart. Readers may have suggestions as to how we might improve on this current work and, if so, we encourage you to be in touch. Please write us at compendium@starlingtrust.com.

A summary of our Methodology is available in the Appendix. **PAGE 456**

Culture & Conduct Risk Regulatory Landscape



These fitness and probity regimes are just one example of judgment-based supervisory aims that have faced industry push-back over the past year. Without reliable objective metrics, the assertion of subjective supervisory judgments that imply real economic consequences raises questions of **due process**. This argument is taken up herein by Greg Baer, CEO of the Bank Policy Institute — a US-based banking sector advocacy group. ▶PAGE 187

We have also noted here an apparent conflict between regulators' calls for enhanced **accountability** and their emphasis on the cultivation of **"speak-up"** cultures. This is a key concern surrounding the efforts to establish accountability regimes, as in Ireland, ▶PAGE 304 or to upgrade existing regimes, as in Australia. ▶PAGE 333

In their attempts to confront all of the foregoing challenges, many firms and supervisors turn to a long relied-upon set of tools: whistleblower hotlines, surveillance and monitoring, etc. While perhaps representing good hygiene, at best, these tools afford **advanced hindsight** rather than the leading indicators of risk that would permit for proactive corrective interventions.

If we want to develop lasting solutions to these problems, we will need to look to **predictive behavioral analytics**. For more on the potential of these tools to transform our management capabilities, please reference the views offered here by numerous contributors from **The Academy**, each a prominent figure in their specific fields of study.

The main body of our annual *Compendium* begins with the United States, where we have seen all the foregoing key themes at work, making that market a good starting point for this global tour of happenings relevant to culture and conduct risk in the financial sector. We hope you will find this to be a valuable desk-reference and of course we welcome any constructive feedback. Please don't hesitate to reach out to us at info@starlingtrust.com.

Cameron Lawrence

Director of Research

11 June 2024

In Focus

Accountability for Banks, Accountability for Regulators

By: MICHELLE W. BOWMAN



Michelle W. Bowman
Photo: Chris A. Williams



The U.S. Federal banking agencies provide critical oversight of and play a vital role in maintaining a safe and sound banking system. These roles are carefully defined and expressly limited by statute. The banking agencies' focus on the safety and soundness of individual financial institutions and the stability of the broader financial system lays a solid foundation for a robust financial services industry in the U.S. and abroad.

To accomplish these goals of safety and soundness and financial stability, the banking agencies must ensure that banks are held to high standards through financial regulation and supervision. This takes many forms:

bank regulators enforce robust regulatory standards to promote safety and soundness, they engage in periodic examinations of banks and their holding companies, and banks must comply with periodic regulatory reporting requirements. When necessary, regulators

Accountability is no less important for bank regulators than it is for banks.

hold banks accountable for lapses in adherence to these standards by requiring prompt remediation of supervisory findings, or by taking enforcement actions.

Bank regulators have a great deal of independence and autonomy in the execution of these duties, and this independence serves as a strength. Independence in the Federal Reserve's bank regulatory function is designed to ensure that supervisory and regulatory decisions are driven by the goals of promoting a safe and sound financial system and safeguarding the stability of the U.S. financial system. In this context, independence also means that the Federal Reserve should not be influenced by political considerations in making policy decisions or in the drafting of regulations. Historically, the Federal Reserve's independence in bank regulation and supervision has also provided stability and consistency to regulated institutions. This is not to suggest that bank regulation should remain static in the face of change. To the contrary, the Federal Reserve's regulatory approach must be capable of addressing and adapting to new banking activities and new risks but also must be aligned with furthering our statutory objectives.

Accountability Does Not Undermine Independence

Of course, this independence in bank regulation must be accompanied by accountability, to both Congress and the American public. Accountability is no less important for bank regulators than it is for banks. Bank regulators serve an important public function, and as we have seen in the past year, the stakes are high. Bank failures and stress in the banking system pose significant risks, not only to the bank customers, depositors, and creditors of a failed bank, but also to the broader financial system, the U.S. economy, and U.S. taxpayers.

Existing law provides a number of mechanisms to ensure accountability to Congress. First, members of the Board of Governors are appointed by the President, subject to the advice and consent of the Senate. Second, the Board also regularly communicates with Congress, both through in-person testimony to relevant banking and financial services committees and by providing regular reports on key areas within the Federal Reserve's areas of responsibility, including semiannual reports on monetary policy, bank applications activity, supervision and regulation, cybersecurity and financial system resilience, and financial stability.

While this regular cadence of testimony and public reporting provides visibility into the inner workings of the Federal Reserve — not just for Congress, but also for the public — this is only one aspect of regulatory accountability.

Accountability Requires Transparency

Accountability also requires transparent policies and procedures and conducting supervision in a way that is predictable and fair. These actions demonstrate to the public and regulated institutions that the agencies hold not only those institutions but also themselves to high standards.

Transparency builds legitimacy by demonstrating that the Federal Reserve executes its responsibilities fairly across all regulated institutions. For example, the supervisory standards and expectations applied during the examination process should not vary by geography or by supervisor but should only vary by the risks presented during the examination process. Another area deserving continuous attention and improvement is in the publication of clear, appropriate, and tailored guidance. One example in

which we accomplished this goal was by providing tools to help community banks estimate losses under the Current Expected Credit Loss, or CECL, accounting standard. But we owe this duty of transparency to all of our regulated institutions, and increased transparency will help to ensure that banks are being held to the same standards as their peers over time.

Transparency assists in ensuring accountability, in addition to building legitimacy and public trust.

Transparency assists in ensuring accountability, in addition to building legitimacy and public trust. To be clear, in this context, transparency does not equate to leniency. We hold banks of all sizes to high standards, commensurate with their size and risk. Being transparent does not dilute the rigor of our regulatory standards, in fact it helps to ensure that banks are aware of these standards and expectations so that they can more effectively and efficiently work to meet them. That same transparency helps show that we regulators are holding ourselves to high standards — that we are appropriately exercising the power granted to us by Congress and have done so in a way that supports due process and fairness.

We should not be afraid to show our work in the execution of our regulatory or supervisory responsibilities.

The Fed's Responsibility for Appropriate Implementation of Supervision and Regulation

Perhaps most importantly, though, we must implement the laws that Congress has passed as they are written and not stretch that authority to venture into other areas of policymaking. As an example, consider the distinction between (1) making sure institutions are managing all of their material risks and (2) instructing banks to make certain credit allocation decisions by influencing banks to make or not make loans to certain industries. The first objective — the

management of material risks — is a central function of a bank supervisor and is fundamental to safety and soundness. But it is equally clear that the second objective — influencing a bank to make certain credit allocation decisions — is not the role of a banking regulator, nor of a central bank. A broad view across the regulated banking sectors reveals a diverse ecosystem of banks, with each bank making different credit decisions in reaction to both market demand and economic conditions, but also furthering the bank's business strategy. I share the widely held view that the appropriate role of the Federal Reserve is not to make credit allocation decisions for banks.

The Fed's role as a banking supervisor is not to replace a bank's management and board of directors in adopting a banking strategy and risk appetite. Instead, it is to apply appropriate, targeted regulation and supervision, to assess whether a bank is operating in compliance with applicable laws and in a safe and sound manner. This can be a difficult balance to strike but it is something we must always keep in mind whenever the Federal Reserve uses or proposes using its regulatory or supervisory tools. Banking regulation and supervision is not the appropriate method to implement new policies that are not mandated by Congress.

We live in a time when confidence in public institutions is waning. As such, the banking agencies should strive to demonstrate beyond doubt that they execute their duties in an independent manner, focusing on statutory obligations. We should embrace holding ourselves to high standards — just as we hold banks to high standards — and do so in a way that promotes public accountability. When we identify shortcomings in our own performance, we must humbly acknowledge these shortcomings and make appropriate adjustments. Accountability promotes healthy bank regulation and supervision, just as accountability promotes a healthy banking system.

The views expressed in this article are my own and do not necessarily reflect those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee.

This article originally appeared in Starling Insights' ["Physician, Heal Thyself"](#) Deeper Dive.

Michelle W. Bowman has been a member of the Board of Governors of the US Federal Reserve System since she was appointed in November 2018, and her term ends in January 2034. Prior to this, she served as the state bank commissioner of Kansas.

In Focus

An Interview with Adrienne A. Harris



Adrienne A. Harris



Q: For our international readers who may be unfamiliar with the New York State Department of Financial Services (DFS), could you provide some background on the organization and its mandate?

A: The New York State Department of Financial Services was established in the wake of the 2008 financial crisis with the goal of creating a more efficient, comprehensive financial regulator to oversee the

financial services industry, better protect consumers, and encourage economic growth in the financial capital of the world. Today, DFS is considered one of the premier financial regulators in the world.

The Department regulates the activities of over 3,000 financial institutions with nearly \$10 trillion in assets. This includes over 1,300 banks and nonbank entities, including 20 foreign banks and 15 Global Systemically Important Banks, credit unions, money services businesses, credit reporting agencies, and student loan servicers, and over 1,900 insurance companies, including life, health, and property and casualty insurers, and pharmacy benefit managers.

DFS was the first U.S. regulator to start licensing virtual currency companies and has since developed a world-leading virtual currency regulatory framework.

We are the only prudential regulator in the U.S. — state or federal — with authority specific to virtual currency. To support this work, I have built the largest virtual currency regulatory team in the world. DFS was also the first to institute comprehensive cybersecurity regulations, and has led the nation in establishing a standalone climate division.

When I joined DFS, my mission was to make DFS a regulator fitting of the financial capital of the world. I have spent my time aligning our policies and processes to the values we hold as an agency and the outcomes we hope to achieve.

Q: Earlier this year, DFS published an industry letter containing guidance on how firms should assess the character and fitness of their directors, senior officers, and managers. DFS's expectations are reminiscent of the "fit and proper" tests that have been adopted in many countries but have not been seen in the U.S. What led DFS to develop this guidance? What sort of character should we look for in those we trust to lead a bank, and how can we test for that?

A: One of my primary goals has been to ensure the Department is caring for the safety and soundness of our regulated entities by considering all potential risks, including the fundamental role that senior leadership plays in the overall integrity and security of financial institutions.

As such, earlier this year, DFS issued final guidance to New York State banking organizations and non-depository financial institutions with updated expectations regarding the review and assessment of the character and fitness of their directors, senior officers, and managers. The guidance reflects an ongoing effort to raise corporate governance and oversight standards following the banking crisis in March 2023, and to ensure confidence in the management of New York's financial institutions. In light of the 2023 bank failures and the major transactions that followed on their heels, the

Department wanted to emphasize to institutions that it is critical they do their own diligence, rather than relying on an individual's service with another regulated institution as a proxy for a full vetting.

As regulators, we recognize that different institutions will have different business models, different risk profiles, and different areas of expertise they want to highlight, so we do not presume to dictate exactly what they should be controlling for. Instead, the Department encourages institutions to take a risk-based and tailored approach so that frameworks are well-suited to organizations. Our guidance provided resources to assist institutions in supplementing or revising their vetting frameworks.

DFS's character and fitness guidance is one of several steps the Department has taken to ensure the health of the entities we regulate and to preserve the stability of the global financial system. Since March 2023, the Department has streamlined and simplified examination policies and procedures, while also incorporating specific protocols for the escalation of persistent regulatory concerns at institutions. The Department is implementing new examination training modules to ensure staff are kept current on new and emerging issues. We have also piloted an operational stress testing exercise with representative institutions. This exercise is intended to help both the Department and our institutions assess operational readiness to produce accurate financial data, timely secure contingent liquidity, and successfully navigate a crisis situation.

DFS remains laser-focused on innovation

The Department now has an AI Steering Committee that is exploring new ways to regulate and utilize AI.

Q: DFS was one of the first U.S. state agencies to join the [Global Financial Innovation Network \(GFIN\)](#). A key pillar of the GFIN's work is driving innovation in regulatory technology (RegTech) and supervisory technology (SupTech). These are topics discussed extensively by other contributors to this report. Has DFS sought to adopt these new technologies to improve its own capabilities?

A: Absolutely. DFS remains laser-focused on innovation — it is a key area shaping my vision for the Department, its transformation, and its future. In revising the Department's mission statement, it was important to me that we specifically articulated DFS's commitment to driving economic growth through *responsible* innovation.

We have committed to becoming a more efficient and effective organization and are engaging in a department-wide technology transformation. Key to our RegTech and SupTech strategy is our implementation of a new customer relationship management platform, which will modernize the Department's operations. This system will create a single portal to manage relationships and communications with financial institutions. It will improve the licensing and renewal process for our regulated entities, create a centralized and streamlined information system for teams throughout our organization, and maximize efficiency in our oversight.

The Department now has an AI Steering Committee that is exploring new ways to regulate and utilize AI, including through the development of an AI chatbot that will allow stakeholders to engage with DFS resources and guidance more efficiently. We also are enhancing our data warehouse, data visualization tools, and productivity tools across the enterprise.

As a prudential regulator that oversees thousands of financial institutions — including globally systemic institutions — these technology and system upgrades give DFS the modern tools needed to identify and respond to risk and better protect financial markets in New York and globally.

Q: In January, DFS also issued a circular letter with [guidance on how insurers can adopt AI to improve efficiency while mitigating potential customer harm. More generally, how do you think AI will impact the financial sector? And how can we extract maximum value from this technology while managing the associated risks?](#)

A: The Department plays a critical role in ensuring that New York is a leader in cutting-edge technology development and use. And the same principles I mentioned earlier about responsible innovation apply to AI, where significant benefits and risks coexist. I firmly believe that AI brings enormous potential for the financial services sector with opportunities ranging from greater efficiencies for both businesses and consumers, to new and improved product offerings that leverage AI and GenAI.

At the same time, it is imperative that technological advances never come at the expense of consumer protection. I think good public policy can be both pro-innovation and pro-consumer. At DFS, when it comes to innovation, we are not interested in participating in a “race to the bottom,” a term many regulators like to use when jurisdictions sacrifice consumer protections for the purpose of attracting business. We can protect consumers and markets, while also helping to grow a robust and thriving marketplace where companies want to do business.

I firmly believe that AI brings enormous potential for the financial services sector.

Regulators have proven to be effective at implementing policies and requirements that address yesterday’s problems.

As regulators, we must develop clear expectations for our regulated entities. I think this is especially important for our businesses when it comes to complicated issues around AI and other emerging technologies. And while DFS has taken a leading role in regulating the use of AI, we also are actively exploring how we can leverage this technology to enhance our ability to predict and respond to market events and risks.

Q: This year, you are co-chair of the Salzburg Global Seminar’s Finance Forum on “Financial Technology

Innovation, Social Impact & Regulation.” The Forum seeks to bring together global leaders in finance, regulation, technology, academia, and other sectors to discuss how we can adapt our financial system to navigate the challenges and make the most of the opportunities we face today. What do you hope to achieve with the Forum? And why is such collaboration so important?

A: I am honored to have been invited to co-chair this year’s Salzburg Global Seminar’s Finance Forum, and I am looking forward to tackling issues critical to global economic growth and stability. Collaboration and transparency are central to that goal.

Broadly speaking, financial regulators have proven to be effective at implementing policies and requirements that address *yesterday’s* problems. Bringing together leaders from across disciplines and from around the world allows us to set an agenda and develop comprehensive solutions for the future. Collaboration facilitated through the Forum will help us to advance a seamless global environment where regulatory principles extend beyond geographic jurisdictions to eliminate regulatory arbitrage.

Additionally, all good regulators prioritize self-reflection and accountability — looking internally, and then determining how we can improve practices, enhance policy decisions, and tackle regulatory challenges and risks. The exchange of information through the Forum will ensure regulators can better make those determinations.

Finally, regulation is most effective when there is clarity and transparency established through ongoing consultation with all stakeholders, including industry. Continued dialog among regulators, industry, and academics is not just important, but necessary, for recognizing early warning signs and safeguarding financial markets. At DFS, we are committed to constant growth to keep pace with the markets we regulate, and I welcome such a unique opportunity to do so in lockstep with leaders from across the financial services industry at this year's Salzburg Global Seminar's Finance Forum.

Regulation is most effective when there is clarity and transparency established through ongoing consultation with all stakeholders.

Adrienne A. Harris joined the New York State Department of Financial Services (DFS) in September 2021 and was confirmed as Superintendent on January 25, 2022. Prior to joining DFS, Superintendent Harris served as Senior Advisor to Deputy Treasury Secretary, Sarah Bloom Raskin. She then moved to the White House where she managed the financial services portfolio at the National Economic Council for President Obama. After leaving the White House, Superintendent Harris served as General Counsel and Chief Business Officer at Doma and served as a Professor and Faculty Co-Director at the University of Michigan's Gerald R. Ford School of Public Policy's Center on Finance, Law and Policy. At DFS, Superintendent Harris has taken decisive actions on defining issues such as digital currency, financial inclusion, and climate change.

In Focus

Rethinking Bank Examination

By: GREG BAER



Greg Baer



When most think of the regulatory requirements imposed on banks, the financial cost of capital and liquidity requirements come to mind, because they are significant and overt. In contrast, details of the examination regime are difficult to ascertain, because it operates in secret. In recent years, bank examination has expanded significantly in scope and increasingly

is used as a substitute for regulation, imposing significant restrictions on banks outside of public view.

It is a major driver of the relative unattractiveness of bank equity, the migration of assets from the banking industry, and the drive for economies of scale through merger or acquisition, as that scale includes the ability to absorb massive examination and associated compliance costs.

The C-suite of the average bank spends 42 percent of its time on compliance tasks or examiner mandates.

(OCC) reports that it employs more than 3,000 full-time bank examiners, and the Federal Reserve employs over 2,300. The Federal Deposit Insurance Corporation (FDIC) does not disclose the size of its examination force.¹ There are also examiners at state banking departments and the Consumer Financial Protection Bureau (CFPB). Anecdotally, regional banks have dozens of full-time examiners and are subject to constant examination; for the largest banks, that number is in the hundreds, with a dozen or more examinations ongoing at all times, and examiners are resident at all large banks.

DEMANDS

The Bank Policy Institute (BPI) recently conducted a survey of its members, which generally have assets above \$100 billion, to determine the extent of the burden the examination process is imposing on those banks.² The results are striking:

- The average bank employs 1,585 full-time equivalent employees in compliance functions, representing 5 percent of the bank's workforce.³
- Despite the competitive challenges and geopolitical risks present today, the C-suite of the average bank spends 42 percent of its time on compliance tasks or examiner mandates, while the board of directors spends 44 percent of its time on those tasks.
 - For the average bank, 13 percent of its IT-budget is devoted to demonstrating compliance with law or meeting other examiner mandates rather than investment in innovation or improved customer service.

The US Examination Regime

SUPPLY

The examination regime for banking in the United States is unique in our federal administrative state. The Office of the Comptroller of the Currency

In the survey we asked the same questions we had posed to members in 2016. We chose that earlier date because it was both long after the Global Financial Crisis — and a resulting, significant increase in risk and compliance staff. It is also the year just preceding what some contend to have witnessed four years of banking sector deregulation.

The results showed otherwise: since 2016, the average percentage of C-suite time focused on compliance tasks or examiner mandates has increased 75 percent; percentage of board time 64 percent; FTEs in compliance functions 62 percent; percentage of IT budgets 40 percent.

An unusually frank description of the process was offered by the late Bob Wilmers in his final shareholder letter as CEO of M&T Bank in 2016 (that is, prior to the upsurge our survey reveals):

At M&T, our own estimated cost of complying with regulation has increased from \$90 million in 2010 to \$440 million in 2016, representing nearly 15% of our total operating expenses. These monetary costs are exacerbated by the toll they take on our human capital. Hundreds of M&T colleagues have logged tens of thousands of hours navigating an ever more entangled web of ... examinations.... During 2016 alone, M&T faced 27 different examinations from six regulatory agencies.

Examinations were ongoing during 50 of the 52 weeks of the year, with as many as six exams occurring simultaneously. In advance of these reviews, M&T received more than 1,200 distinct requests for information, and provided more than 225,000 pages of documentation in response. The onsite visits themselves were accompanied by an additional, often duplicative, 2,500 requests that required more than 100,000 pages to fulfill—a level of industry that, beyond being exhausting, inhibits our ability to invest in our franchise and meet the needs of our customers.

Another feature of the current examination regime deserves note. Increasingly, examiners have decided that banks cannot be allowed to fix their problems

and must instead retain outside consultants to either perform or validate their remediation work, adding significant expense and considerable delay.

That is the big picture, but some close-ups can provide further insights. Last year, we conducted a survey of the Chief Information Security Officers at banks — the people responsible for guarding against cyberattacks. They reported that they spent 30-50% of their time on compliance and examiner management; their teams spent 70 percent of their time on those functions. They reported on average over 100 requests for information leading up to an average examination, with anywhere from 75 to 100 supplemental requests during the exam. And 25 percent of examination requests duplicate requests from other agencies. By innumerable anecdotal accounts, this system has severely affected morale

and retention among a class of experts who can freely move to other industries.

Examination with respect to anti-money laundering and sanctions is a similar story. Large banks employ tens of thousands of people and spend billions on systems to

generate alerts, which then must be investigated. The examination process emphasizes reliance on computer models to generate large volumes of alerts, requiring human investigation of each alert. Examiners expect these alerts and investigations to result in suspicious activity reports, even for the most insignificant of offenses which no federal law enforcement agency would ever prosecute.

With respect to the current sanctions regime, examiners require that firms screen wires as well as customer and related-party accounts for potential OFAC matches, including domestic, small-dollar transactions. In that connection, institutions reported true matches with an overall median of 0.00004%.⁴ For both AML and sanctions risk governance, more advanced techniques are far more effective in

Since 2016, the average percentage of C-suite time focused on compliance tasks or examiner mandates has increased 75 percent.

actually detecting and preventing financial crime, but examiners prefer the existing procedures and manual review, which come with written policies and procedures and provide a clear audit trail.

The Purpose of Bank Examination

The banking industry is the only industry in America subject to such a regime; that includes financial firms that compete directly with banks and offer the same products to the same customers. Why?

There was and is one good reason: banks have access to a federal safety net in the form of insured deposits and the Federal Reserve's discount window.⁵ The ability to impose some of the costs of risk-taking on others while still earning the full reward creates moral hazard — an incentive to take more financial risk than a company without that power would take. That is a valid reason to require a bank to take less risk than its shareholders and management might otherwise decide is appropriate.

Furthermore, and certainly since 2009, we know that some banks can pose systemic risk. Leverage, correlation of exposures, and inter-connectivity can produce runs, fire-sales, and financial contagion.

The statutory authority granted by Congress to the federal banking agencies maps these priorities. First, while the agencies have authority to examine all the affairs of a bank, their ability to enforce changes at the bank is limited and circumscribed by law, not open-ended. Most prominent among their enforcement tools is the authority to issue orders to a bank to cease and desist from unsafe or unsound practices or conditions or violations of law.⁶

Courts have defined what constitutes an unsafe and unsound practice for this purpose, which generally must be quite serious; as explained by the D.C. Circuit Court of Appeals, an unsafe or unsound practice “refers only to practices that threaten the financial integrity of the institution.”⁷ As another court has explained, “The imprudent act must pose an abnormal risk to the financial stability of the banking institution... Contingent, remote harms that could ultimately result in ‘minor financial loss’ to the institution are insufficient to pose the danger that warrants cease and desist proceedings.”⁸

This system has severely affected morale and retention among a class of experts who can freely move to other industries.

For banks that pose systemic risk, the Federal Reserve is authorized under Section 165 of the *Dodd-Frank Act* to impose heightened prudential standards on large, interconnected financial institutions.⁹ That authority, however, does not extend to the OCC or the FDIC and,

crucially, it reflects additional regulatory authority, not examination authority. To be sure, examiners must validate compliance with the heightened capital standards that the Federal Reserve has imposed pursuant to Section 165, but nothing in that statute changes the character or the scope of the examination function, and it has no effect on the authority of the OCC or FDIC at all.

The Current Focus of Bank Examination

As the number of examiners and compliance officers would suggest, examiners are not focused primarily on material financial risks. Examiners now seek to supervise every aspect of banks' businesses — from IT systems to vendor selection to the newest focus, “operational resilience.”

As a practical matter, this means requiring that the bank enshrine its processes in written policies and

procedures and employ hundreds or thousands of people to check for compliance with those policies and procedures, subject to a multi-layered governance regime that the examiners define as “three lines of defense” — that is, (i) the line of business, (ii) a compliance function, and (iii) an audit function, all subject to review by agency examiners. (Notably, there is no statutory authority or analytical basis for this approach, but it is now dogma at the agencies, and no other structure is permitted.)

In areas that have minimal relationship to material financial risk, examiners routinely request volumes of information from bank management and then require meetings to have the information explained to them. Deadlines for remediating issues are shortening — whether those issues are serious or nonconsequential, self- or examiner-identified — effectively, setting banks up for failure.

Consider this situation in light of the purpose and legal authority for bank examination. Neither moral hazard nor systemic risk provides grounds to examine, through constant on-site supervision, the IT systems of a bank, or co-manage its relationship with third party vendors, or evaluate the background of its directors and their performance in meetings. Banks fully understand and bear the costs of problems in these areas: cost of IT breakdowns (angry and departing customers), bad vendors (lost money, more angry customers), cyberattacks, and bad directors.

More broadly, as a society, we may care that a regional bank has good cybersecurity, but presumably we also care that Microsoft and Boeing have good cybersecurity. We would hope that a large bank monitors its vendors well, but we would also hope that General Motors and Chipotle manage their vendors well.

Other examination priorities are not so focused on written policies and procedures. Examiners also

focus on “reputational risk,” which is conduct that is safe, sound, and legal, but of which the banking agencies disapprove for other reasons. Governance is a major focus, which includes mandates about the composition of management and board committees to compensation decisions. Many of these mandates come under the broader topic of supervising bank “culture.”

While no one would doubt the importance of culture in any organization, government examiners do not attempt to supervise culture at any other type of institution. Given recent revelations about culture at the FDIC, and the Acting Comptroller of the Currency’s endorsement of the FDIC’s longtime chairman as the person to lead a reversal of that

culture, one might question the qualification of agencies to make that judgment.¹⁰

The greatest current debate concerning bank culture is whether in-office work is required to maintain a good culture but,

here again, the agencies would appear uniquely ill-equipped to judge, given that at least their Washington office workers are rarely in the office.¹¹

More broadly, there is no established research or metrics by which an examiner could cogently and consistently assess culture. Instead, examiners pore through meeting minutes — which they insist be voluminous — to determine whether risk officers or board members are providing “credible challenge.” Of course, that requires those keeping the minutes to adjust them accordingly, and that they assure discussion participants perform for the minutes.

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Note that the focus of the above has been banks, but supervisors also now examine non-bank affiliates that are not deposit-funded, have no discount window access, and are subject to strict limits on their dealings with bank affiliates to ensure that the

There is no established research or metrics by which an examiner could cogently and consistently assess culture.

benefits of deposit insurance and discount window access cannot be passed to non-bank affiliates. Thus, the broker-dealer affiliate of a mid-sized regional bank is subject to Federal Reserve examination; Citadel Securities — which accounts for 23 percent of U.S. equity market volume — is not.

The examination framework's focus on non-financial issues is also apparent in the examination ratings system. Under the Federal Reserve's Large Financial Institution Rating System, the aggregate supervisory rating for a large bank holding company is the lowest of three components: (1) capital planning and positions; (2) liquidity risk management and positions; and (3) governance and controls.

As a result, banks that are well capitalized and liquid can be — and frequently are — rated in unsatisfactory condition because of amorphous and inherently subjective “governance and controls” concerns alone. The story is similar at the bank level, where the CAMELS rating system in theory evaluates six factors, but the management rating — the “M” — dominates for purposes of determining the composite rating. And the “M” can be determined by non-financial factors and the bank's willingness to cede to examiner mandates.

A last departure from the statutory authority of examination is worth particular note. Section 1025 of the Dodd-Frank Act in 2010 transferred to the CFPB “exclusive authority to require reports and conduct examinations on a periodic basis” of an insured depository institution with total assets of more than \$10 billion. Section 1061 of Dodd-Frank also transferred all “consumer financial protection functions” from the federal banking agencies to the

CFPB, including “all authority to prescribe rules or issue orders or guidelines” pursuant to any Federal consumer financial law.¹²

The statute explicitly states: “All consumer financial protection functions of the Board of Governors are transferred to the Bureau”; “All consumer financial protection functions of the Comptroller of the Currency are transferred to the Bureau.” The law could not be more clear; the CFPB is the exclusive regulator of bank consumer compliance, and the exclusive examiner of bank consumer compliance at larger banks.

Banks that are well capitalized and liquid can be — and frequently are — rated in unsatisfactory condition because of amorphous and inherently subjective “governance and controls” concerns alone.

After passage, there was an expectation that most of the consumer compliance examiners at the banking agencies would transfer to the CFPB. But they did not; by all accounts, the banking agencies increased their consumer compliance examination activity at larger banks in the years after Congress clearly divested them of the authority to engage in it.

Unchecked Power

The existence of this compliance/examination/consulting complex depends on one crucial reality: banks generally must do as the agencies tell them through the examination process, even if they disagree with the substance or importance of what they are being told to do. It is important to understand why.

Under the banking laws as written, the agencies' examination authority is not self-executing, and disputes between examiners and banks are resolved only by the banking agency bringing an enforcement action on the grounds that the bank is engaged in an unsafe or unsound practice or acting in violation of law. That enforcement action includes the right of the bank to contest the charges.

Sensibly, the structure reflected in the law used to also apply in practice. At least a generation ago, when I was an attorney at the Federal Reserve, if the case was a close one or the stakes were low, a bank would accede to the examiner's demands; conversely, if the bank felt it was clearly in the right and the stakes were high, it might challenge the agency to bring the action, knowing it would have the ability to contest it. Of course, for reputational reasons, a bank would be very reluctant to risk such an action. But on the other hand, the agencies knew that the standard for what constitutes an unsafe or unsound practice is high and, therefore, were willing to act on that threat only in important cases. That balance of power generally resulted in a reasonable outcome.

Nonpublic ratings downgrades — or the threat thereof — are now just as effective as formal enforcement actions.

Today, however, nonpublic ratings downgrades — or the threat thereof — are now just as effective as formal enforcement actions. Why?

- A change to banking law made in 1999 provides that if any bank subsidiary of a financial holding company receives a “3” (or lower) rating for Management, the company becomes subject to significant limits on its non-bank activities; its only recourse is to seek a temporary waiver from the Federal Reserve, which is conditioned on promptly complying with examiner mandates.
- A “3” rating triggers significantly higher insurance premiums and limits on access to Federal Home Loan Bank funding.¹³
- Finally, under guidance from both the Federal Reserve and the OCC, a “3” rating now also disqualifies the bank from mergers and acquisitions. ►PAGE 101

Importantly, these grave consequences are typically imposed for years, as ratings are not upgraded until after multiple examination cycles — and, of course, double and triple checking by compliance and

audit and, in many cases, the hiring of an outside consultant to verify that all identified issues have been completely resolved.

Thus, in practical effect, a Management downgrade (the “M” in CAMELS) is no longer an examination criticism but rather effectively a large financial penalty, a multi-year cap on organic and inorganic growth, and potentially an order to divest whole

businesses. And no violation of law or finding of unsafe or unsound practices is required for these penalties to be imposed; un-remediated Matters Requiring Attention notices (MRAs) for governance and controls can form the principal grounds for a Management downgrade.

So, the next logical question would be: why don't banks object to an unjustified “3” rating for Management?

First and foremost, there can be no public objection whatsoever; the agencies take the position that any disclosure of examination-related information is criminal theft of government property, so there can be no public complaint or discussion of the rating at all.

Second, the agencies have adopted an internal appeals process, but that process almost invariably upholds the examination finding, which is not surprising given that the appeal is to the same division of the agency that imposed the finding.¹⁴ Furthermore, while these consequences of a ratings downgrade are significant and concrete, the assignment of these ratings is effectively left entirely to the subjective judgment of the examiner: the relative ratings frameworks themselves provide no meaningful standard at all to govern their use (or misuse). Thus, it is quite easy to uphold any examination finding on internal appeal, as there is no standard against which to judge it.

Third, even if there were a chance of a favorable appeal, any such victory would likely come at significant cost, as retaliation in future examinations is a real concern. The agencies do not disguise this fact: a favorite expression is that “examiners have long memories.” Such concerns were heightened by a speech by the Acting Comptroller of the Currency, who stated that disagreement with examination findings constitutes evidence of “hubris, contempt and indifference” by bank management and thus could constitute grounds for finding the bank “too big to manage.”¹⁵

One simple fact demonstrates how significant this fear of retaliation really is: banks almost never take the final step of seeking judicial review of ratings determinations, and the few cases in which they have almost exclusively involve banks that are no longer operating.¹⁶ Thus, over time, the banking agencies have increasingly avoided using regulation and public orders to enforce change at banks, preferring instead to “supervise” through the secret, effectively unappealable powers of the examination process.

How the Regime Is Failing at Its Core Mission

While that secrecy gives us little ability to evaluate what has gone wrong, there is some evidence.

In its Supervision Report released in November 2022, the Federal Reserve disclosed that fewer than half of the large financial institutions it examined were rated as in satisfactory or better condition. This finding was remarkable, as large banks held extraordinarily high and rising levels of capital and liquidity, well above

regulatory requirements. They had performed well in 2020, providing massive funding to the economy before governmental assistance commenced, and were prepared to do so again during the ensuing banking turmoil of March 2023.

Clearly, for a majority of those banks to be considered in unsatisfactory condition, examiners must have been focused on something else. We know what it was. The report states:

The assignment of these ratings is effectively left entirely to the subjective judgment of the examiner: the relative ratings frameworks themselves provide no meaningful standard at all to govern the use (or misuse).

While many firms have broadly met expectations in capital planning and liquidity risk management, they still have work to do to meet supervisory expectations for governance and controls... Governance and controls findings represent over 75 percent of the outstanding issues at large financial institutions. Governance and controls findings include deficiencies related to operational resilience, information technology, third-party risk management, and compliance.¹⁷

We also know with certainty that low ratings as of November 2022 were *not* attributable to prescient concerns about interest rate risk or liquidity risk of the type that emerged at certain banks five months later. The record at those banks is quite clear:

- With respect to Silicon Valley Bank, the GAO reports that its final composite CAMELS rating was “2,” or satisfactory.¹⁸
- The story was similar at First Republic. “From 2018 through March 2023, the FDIC assigned a Composite “2” CAMELS rating to First Republic, indicating that the overall condition of the bank was satisfactory. Its rating for Liquidity was 1, indicating that it was strong.¹⁹

- At Signature Bank, the FDIC found that the bank's overall condition was satisfactory from December 2018 until its final rating in December 2021.

Thus, examiners at these institutions were giving them a clean bill of financial health while focusing heavily on "governance and control" issues that did not really matter at all. As two former senior Federal Reserve officials, now our Senior Fellows, have written of SVB:²⁰

Fed examiners appear to have been largely focused on nonfinancial risks, governance structures and compliance processes and procedures that were only weakly and indirectly related to its actual financial condition and safety and soundness.

This misguided focus is quite evident in the composition of the 31 MRAs and MRIAs that remained open at the end of 2022... Of these 31, only six directly concern management of liquidity risk, and only one concerns management of interest rate risk; the remainder concern informational technology and security (13), lending and credit risk management (3), broad programmatic concerns about governance, audit, and risk management (3), vendor management (2), BSA/AML (2) and trust and fiduciary risk management (1). Looking only at the 12 MRIAs open at that time, the story is similar — only two dealt with liquidity risk, and none addressed interest rate risk.

It is hard to escape the conclusion that SVB had too many examiners, not too few. If two experienced examiners had been sent to SVB with the specific task of identifying its largest financial risks, it seems highly likely that the eventual outcome would have been different. Instead, examiners dedicated an enormous amount of time trying to identify every risk — 25,000

hours spent on actual scheduled supervisory activities at SVB in 2022, according to the Federal Reserve — and co-manage the bank's operations.²¹

While secrecy prevents much research on examination effectiveness, a recent paper confirms the impression gleaned from SVB.²² The study looked at the Liquidity (L) and Sensitivity to Market Risk Including Interest Rate Risk (S) ratings assigned as the Federal Reserve was raising interest rates. They find that L and S downgrades accelerated at banks with high interest rate risk exposure, though only 15% of the quintile of banks with the highest levels of IRR saw a downgrade.

More significant for present purposes is their finding that there was no correlation to downgrades in the Management rating, and no correlation to downgrades in the composite rating, which is generally driven by the Management rating.²³ Presumably these banks were managing their vendors well and acting quickly to meet examiner mandates.

While recent experience has taught a clear lesson, the banking agencies have not learned it. To the contrary, by all accounts, agency examiners have redoubled their pursuit of immaterial concerns, increased the number of MRAs and MRIAs, and begun downgrading banks for non-financial risks. The results can be seen in the most recent Federal Reserve Supervision Report, from May 2024.²⁴

Only one third of large U.S. banks are now rated as well managed.²⁵ Under Federal Reserve, guidance, "A 'well managed' firm has sufficient financial and operational strength and resilience to maintain safe-and-sound operations through a range of conditions, including stressful ones."²⁶ One would expect that a finding that two thirds of large U.S. banks cannot maintain safe and sound operations would be a major policy concern, but of course it is not — because that conclusion is flatly inconsistent with the extremely strong capital and liquidity position of large U.S. banks; the external credit ratings of those banks; universal analyst opinions of those

banks; and innumerable statements from Federal Reserve officials that large U.S. banks are in excellent condition. Indeed, it is even inconsistent with the Supervision Report itself, which begins by stating, “The banking system remains sound and resilient” and later reports:

In the first quarter of 2024, large banks reported healthy financial performance. Aggregate large bank profitability, as measured by return on equity, was 12 percent, compared to 5 percent in the fourth quarter of 2023 and 13 percent in the first quarter of 2023... [L]arge banks reported higher quarter-over-quarter earnings due to higher capital market and investment management fee revenues, lower nonrecurring costs, and smaller credit loss provisions, which were partially offset by lower net interest income.²⁷

How could the Federal Reserve’s Report reach a conclusion that is so patently absurd? The answer is simple: according to the Report, governance and controls findings represented two-thirds of outstanding issues.²⁸ Process won out over substance yet again; the immaterial trumped the material.

Consequences

The focus of both the CAMELS and the Federal Reserve’s rating system on governance and controls has significant adverse effects.

Given the Federal Reserve’s Report, under existing agency guidance, one can assume that at least two thirds of large U.S. banks are now effectively prohibited from M&A activity and likely subject to other, secret sanctions.

Other problems are endemic. Massive resources are dedicated to reports that are of no practical use, and resolution plans at a level of specificity that is wholly unnecessary. Management teams spend a

disproportionate amount of time answering requests for documentation and process improvements regarding non-financial risk, distracting them from more critical work.

More subtly, the focus on governance and controls is degrading the quality of risk management and banks (and the banking agencies). As one CEO put it to me, his risk executives are becoming “process engineers” who advance through good documentation, good meeting skills, and good examiner relations. The ability to accurately assess financial risk — credit risk, liquidity risk, capital adequacy — is not valued by examiners.

Unfortunately, the costs of misguided examination attention do not just take the form of dead weight compliance burdens and diversion of resources to immaterial matters. Increasingly, examiners impose business choices on the banks they examine. As an example, consider the exponential growth in private credit markets at the expense of bank lending, particularly for so-called leveraged loans, or loans to growing companies. Frequently cited causes are higher bank capital requirements, but there is a simpler explanation that many seem to have been overlooked or forgotten: banking agency examiners publicly and privately bullied banks out of making these loans in a now clearly failed attempt at market timing and “macroprudential” supervision. This effort included FAQs that set explicit, arbitrary limits on what loans banks could make. As we wrote in 2019:

[I]n one form or another, the U.S. banking agencies have been warning banks of impending losses in leveraged lending for twenty years, and over the last five years they heightened their rhetoric and took increasingly aggressive efforts to force banks to restrict lending to growing businesses that meet the agencies’ definition of leveraged. As such, this effort has been the most continuing and serious U.S. foray into what global regulators have begun calling

“macroprudential” regulation. It also has been a demonstrated failure and a cautionary tale for future such efforts.²⁹

Failure took two forms: (1) no evidence of the losses that they so long predicted, and (2) a direct migration of leveraged lending to non-banks, thereby defeating the “macroprudential” purpose of the exercise.³⁰

Furthermore, the Government Accounting Office (GAO) subsequently determined that the guidance and subsequent FAQs (issued without public comment) which set arbitrary limits on bank leveraged lending constitute a rule that was never properly submitted to Congress under the Congressional Review Act; they were almost certainly also an illegal rule for purposes of the Administrative Procedure Act.

In all likelihood, similar dysfunction is playing out currently. First, while the banking agencies are currently drafting a proposed rule on liquidity as a response to the events at Silicon Valley Bank, there is every reason to believe that agency examiners are already imposing changes behind closed doors. The binding constraint on liquidity for large banks generally is not the regulatory liquidity coverage ratio or net stable funding ratio but rather non-public internal liquidity stress tests and resolution planning requirements, imposed under the cloak of examination secrecy. And while agency heads are emphasizing the importance of banks being prepared to use the standing repo facility and the discount window, at least some agency examiners are telling banks that they will ignore such access when assessing the bank’s liquidity strength. Perhaps not surprisingly, a large number of large banks have publicly reported decreasing loans and increasing their holdings of Treasury and agency securities.

The focus of both the CAMELS and the Federal Reserve’s rating system on governance and controls has significant adverse effects.

The Motive

It is not difficult to understand why this was inevitable, given the incentive structure and culture of the banking agencies and the unchecked power granted to them.

First, the best way for an examiner to advance is to issue MRAs and insist that they be resolved expeditiously. The way for an examiner to seem weak is to report that all is well. The way for an examiner to lose a career is to have something go wrong at a bank to which he or she has assigned a high rating and issued few MRAs. The same is true at the senior level, where those in charge of supervision worry for themselves and their agency about the consequences of a major problem at a bank that was rated satisfactory or better.

Second, as described above, examiner focus is necessarily on process and documentation rather than substance. They require written procedures and rigid, documented adherence to them, with multiple “lines of defense” double or triple checking for compliance. For the same reason, more vague concepts like “reputational risk” and “credible challenge” have become major areas of focus for examiners, because they involve judgments that are effectively in the eye of the examiner, with no objective standard against which they can be disproved.

In sum, examiners have every incentive and human impulse to issue many MRAs and insist on their prompt remediation at any cost, and they have every incentive to impose (or threaten to impose) a low rating on the bank, and to disregard or even punish dissent. They are under no pressure to limit their oversight to material matters. And because banks have no effective way to appeal or object, and no objective standard by which to hold examiners accountable, even if they could, there is now no

countervailing force. ►PAGE 179 In the absence of any external accountability mechanism, we should not be surprised by the inevitable result.

These incentives play out not only at the individual examination level but also in the policy arena. Consider the state of the CAMELS rating system, adopted in 1979.³¹ Except for the addition of the “S” component in 1996, the CAMELS standards have not been materially updated in the almost 40 years since their adoption — not after adoption of the original Basel Accord on capital in 1988, the Basel III regime in 2010, the Comprehensive Liquidity Analysis and Review in 2012, or the Liquidity Coverage Ratio in 2014. More than four years ago, BPI filed a petition for rulemaking asking the agencies to seek comment on how the CAMELS framework could be improved — that’s all, no specifics, just after 40 years, we thought to ask, “How’s it going?”³²

That petition was recently denied. The regime, it seems, is working so perfectly that there is no reason even to solicit input on it.

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ENDNOTES

- 1 See “Department of the Treasury: Office of the Comptroller of the Currency, Congressional Budget Justification and Annual Performance Plan and Report” at table 1.1 listing FTEs for “supervise” category at <https://home.treasury.gov/system/files/266/23.-OCC-FY-2021-CJ.pdf>; see also “Federal Reserve Board - Approaches to Bank Supervision” at <https://www.federalreserve.gov/supervisionreg/approaches-to-bank-supervision.htm>.
- 2 Results reported, and summarized in an appendix, are for a subset of 20 BPI member banks, with the sample size for individual questions ranging from 16 to 19.
- 3 Numbers reported in this paragraph are the mean; the median is also reported in the appendix. The survey defined a compliance FTE as one dedicated to supporting the organization’s compliance with law, regulation, guidance or other governmental mandate, which includes responding to mandates, recommendations and requests from federal and state banking agencies, the CFPB, SEC or other U.S. market or prudential regulatory agencies. It excluded employees monitoring risk for financial purposes.
- 4 Testimony of Greg Baer, CEO Bank Policy Institute, Subcommittee on National Security, International Development and Monetary Policy House Committee on Financial Services, “Promoting Corporate Transparency: Examining Legislative Proposals to Detect and Deter Financial Crime” (March 13, 2019)
- 5 Of course, bank examination in the United States predates the introduction of deposit insurance and the Federal Reserve, and also has older historical roots in banks’ once-unique ability to create private money in the form of bank deposits. However, today’s financial markets feature a proliferation of private money creation, including money market funds, securitization markets, digital payment wallets and stablecoins; none of these are subject to anything like bank examination, making it hard to believe that this historical argument for bank examination has any credibility today.
- 6 12 U.S.C. 1818. Similarly, the agencies have authority to establish by regulation specific safety and soundness standards and order banks to remediate violations of those standards. 12 U.S.C. 1831p-1.
- 7 Johnson v. OTS, 81 F.3d 195, 204 (D.C. Cir. 1996).
- 8 *Seidman v. Office of Thrift Supervision*, 37 F.3d 911 (3d Cir. 1994); see also *Hoffman v. FDIC*, 912 F.2d 1172, 1174 (9th Cir. 1990) (requiring “abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds”). A minority of circuits employ a different standard that describe an unsafe and unsound practice as “contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk of loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.” See, e.g., *First National Bank of Eden v. Department of the Treasury*, 568 F.2d 610 (8th Cir. 1978). That said, the law of the D.C. Circuit is effectively dispositive, given that the defendant in any action under 12 U.S.C. 1818 has the option of appealing to the D.C. Circuit, in addition to the relevant circuit for traditional venue purposes. Thus, a bank seeking to challenge an action can do no worse than the law of the D.C. Circuit.
- 9 12 U.S.C. 5365.
- 10 See Luke 4:23.
- 11 See Bloomberg News, Wall Street is Back in Office While Its Regulators Stay Home (February 16, 2022) <https://www.bloomberg.com/news/articles/2022-02-16/wall-street-is-back-in-office-while-its-regulators-stay-home?embedded-checkout=true>
- 12 12 U.S.C. 5581
- 13 See FDIC Deposit Insurance Assessments, Risk-Based Assessments at <https://www.fdic.gov/deposit/insurance/assessments/risk.html>; see also FHLB Lending and Collateral Q&A at https://www.fhlb-of.com/ofweb_userWeb/resources/lendingqanda.pdf.
- 14 See “Supervisory Ratings and Other Nonpublic OCC Information: Statement on Confidentiality” at <https://www.occ.gov/news-issuances/bulletins/2019/bulletin-2019-15.html>
- 15 Acting Comptroller of the Currency Michael J. Hsu, “Remarks at Brookings ‘Detecting, Preventing and Addressing Too Big to Manage,’” (January 17, 2023).
- 16 *Builders Bank, LLC v. Federal Deposit Insurance Corp.*, No. 18-2804 (7th Cir. 2019)
- 17 <https://www.federalreserve.gov/publications/files/202211-supervision-and-regulation-report.pdf> at 26-27.

- 18 <https://www.gao.gov/assets/gao-23-106736.pdf>
- 19 <https://www.fdic.gov/news/press-releases/2023/pr23073a.pdf>
- 20 <https://bpi.com/a-failure-of-self-examination-a-thorough-review-of-svbs-exam-reports-yields-conclusions-very-different-from-those-in-the-feds-self-assessment/>
- 21 See Michael Barr’s “Review of the Federal Reserve’s Supervision and Regulation of Silicon Valley Bank” at 38 / <https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf>
- 22 Gopalan, Y. and Granja, J., “How (In)Effective was Bank Supervision During the 2022 Monetary Tightening,” Becker Friedman Institute, University of Chicago (September 2023). [_efaidnbmnnibpcajpcglclefindmkaj/https://bfi.uchicago.edu/wp-content/uploads/2023/09/BFI_WP_2023-130.pdf](https://bfi.uchicago.edu/wp-content/uploads/2023/09/BFI_WP_2023-130.pdf)
- 23 *Id.* at 18-19.
- 24 <https://www.federalreserve.gov/publications/files/202405-supervision-and-regulation-report.pdf>
- 25 *Id.* at 17.
- 26 Federal Reserve SR 19-3/CA letter 19-2, Large Financial Institution Rating System (February 2019), www.federalreserve.gov/supervisionreg/srletters/SR1903a1.pdf
- 27 *Id.* at 1, 8-9.
- 28 *Id.* at 18 and Figure 13.
- 29 <https://bpi.com/the-banking-agencies-and-leveraged-lending-a-case-study-in-the-hazards-of-macroprudential-regulation/>
- 30 Kim, Sooji and Plosser, Matthew C. and Santos, João A. C., Macroprudential Policy and the Revolving Door of Risk: Lessons from Leveraged Lending Guidance (2017-05-01). FRB of NY Staff Report No. 815 at 23-24. (“Our evidence on the migration of leveraged lending from large banks to foreign banks and nonbanks together with our evidence on nonbanks’ increased use of bank funding to finance the growth of their leveraged lending business indicates that this migration was not accompanied by a similar reduction in risk in the banking sector. This finding is important because it shows that to evaluate the effectiveness of macroprudential policies it is not enough to consider targeted institutions’ responses to policies.”)
- 31 <https://www.fdic.gov/resources/regulations/federal-register-publications/2019/2019-application-of-the-uniform-financial-institutions-rating-system-3064-za08-c-004.pdf>
- 32 <https://bpi.com/wp-content/uploads/2020/01/BPI-Comment-Letter-re-CAMELS-Docket-no-OP-1681-RIN-3064-ZA08-002.pdf>



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INDUSTRY AND REGULATORY BACKGROUND

Over the past six editions of this *Compendium*, we have reported on a long series of conduct scandals and consequent regulatory enforcement actions and punitive sanctions in the US financial sector. Propagating seemingly unabated, these crises have been deleterious to public trust in banks, of course. But they have also eroded faith in banking sector regulators and in our institutions more generally. The bank failures of spring 2023 have likely accelerated this decline.

A September 2023 *American Banker* article reported the results of the publication's annual reputation survey. It found that — as a consequence of the bank failures — US banks saw the highest decline in positive sentiment reported in the last five years, among customers and non-customers alike.¹³³ Regional banks saw the largest drop. Customers expressed concern about financial stability and service quality, and were five times more likely than customers of larger banks to report a readiness to switch to another bank.

Notably, Wells Fargo had the second-lowest reputation among its customers, only besting First Republic Bank, which collapsed during the survey period. Among non-customers, Wells Fargo was ranked dead last. Seven years on from its false accounts scandals, the bank has struggled to convince regulators and the public that it has cleaned up its act.

We have long argued that banks' continuing efforts to demonstrate better ability to manage misconduct risk follows from an insufficient focus on the true drivers of human behavior — discussed by several of those contributing views from [The Academy](#) in this year's report. ► **PAGE 391**

Below, we will discuss how a lack of understanding in this regard proved to be a key factor in the banking sector turmoil of 2023. We will review the reforms sought by legislators and regulators, and consider whether those reforms are fit for purpose. We will provide numerous examples of how these matters have driven misconduct of other forms over the past year. And, finally, we will highlight what regulators have done, or are planning to do, in an attempt to drive lasting change.

Bank Failures & Accountability

In our 2023 *Compendium*, we discussed in significant detail the circumstances which led to the failures of Silicon Valley Bank and Signature Bank, in March 2023, and First Republic Bank, less than three months later. Herein, we will reflect upon the resulting policy, regulatory, and supervisory discussions that have occurred over the past year.

The Basel "Endgame" Debate

A key means by which regulators seek to prevent bank failures is by establishing some amount of reserve capital banks are required to keep on hand. Determining this amount with sufficient prudential rigor has been a policy priority since the "too big to fail" experience of the 2007-8 financial crisis. Reasonable people will disagree on how much is too much or too little. And in a global financial system, where a crisis in one jurisdiction can swiftly impact others, there is need to achieve some global agreement in this regard, if only to maintain an even playing field.

Federal Reserve Board Vice Chair for Supervision, Michael Barr, has argued that the bank failures of 2023 exposed shortcomings in banks' resilience. Heightened capital requirements are necessary to plug these holes, he believes.¹³⁴

In late July 2023, US regulators proposed sweeping changes to capital requirements for the country's largest banks, seeking to increase capital reserves by about 16% or \$200 billion.¹³⁵ The proposal is called the "Basel III Endgame," after the final set of rules developed by the Basel Committee on Banking Supervision following the Global Financial Crisis.¹³⁶

Others contend that Barr's proposed reforms miss the mark on the true causes of last spring's banking sector turmoil. "While there is more to learn about the recent bank failures, it seems apparent that these failures were caused primarily by poor risk management and deficient supervision, not by a lack of capital," Federal Reserve Board Governor Michelle W. Bowman has argued.¹³⁷ ► **PAGE 179**

Unsurprisingly, major US banks and their advocates fiercely opposed the capital requirement increase. A consultation period for the proposed capital reforms was originally intended to run through November 30, 2023, but to accommodate overwhelming industry reaction, the deadline was eventually extended to January 16, 2024.¹³⁸

The industry's response included a 314-page letter from the American Bankers Association (ABA) and the Bank Policy Institute (BPI), arguing that the proposal, as originally written, would profoundly affect credit availability and cost. Further, the industry advocates asserted that the proposed rule change lacked sufficient analysis to justify such significant capital increases.¹³⁹ ► **PAGE 187**

Banks contended that the industry was already flush with capital and that the proposal's stringent requirements could detrimentally impact various services. Citigroup CEO Jane Fraser, for instance, warned that the rules could weaken US banks' competitiveness and push lending towards less-regulated "shadow banks."

While indicating he would consider all feedback and potential adjustments to the rule, Barr has nevertheless sought to maintain that the rule's impact on borrowing would be limited. As evidence, he argued that US banks have long remained more competitive than European counterparts despite having stricter capital requirements.

It is perhaps expected that regulators would face pushback from the industry on such a proposal. However, a more daunting obstacle for the proposal was the unusual resistance within the Federal Reserve's own governing board. Typically emphasizing consensus, the Fed's Board of Governors showed a rare division with a 4-2 vote on the plan. The opposition from two Republican-appointed governors, alongside Chair Jerome Powell's exceedingly cautious support, underscored the need for broad support to finalize the proposal.¹⁴⁰

The proposal also faced unexpected opposition from Congressional Democrats and civil rights groups, who expressed concerns that the requirements would hurt American competitiveness and exacerbate the racial homeownership gap. Key Democrats, including members of the Congressional Black Caucus and housing advocates, contended that the new rules could make mortgages more costly for lower-income and minority borrowers. Others worried about US banks facing stricter rules than their international counterparts, potentially harming consumers, banks, and businesses.¹⁴¹

In March 2024, 29 Republicans in the House of Representatives urged regulators to withdraw the Basel Endgame proposal. "As issued, the proposal lacks justification, lacks rigorous quantitative analysis, and is procedurally flawed," the congressman wrote in a letter to Federal Reserve Chair Jerome Powell, Acting Comptroller of the Currency Michael Hsu, and Federal Deposit Insurance Corporation (FDIC) Chair Martin Gruenberg. Among the authors of the letter

was Patrick McHenry, Chair of the House Financial Services Committee (HFSC), who has been one of the most vocal opponents of the proposal.¹⁴²

That same day, Powell appeared before the Committee and indicated that there were likely to be “broad, material changes” to the capital proposal. According to *Banking Dive*, these were likely to include reducing the capital large banks would be required to hold. This signaled a win for Wall Street lobbyists who fought hard against the proposal.¹⁴³

Throughout this contentious capital debate, some have questioned whether capital requirements were fit for purpose in resolving the underlying causes of the banking turmoil. Instead, they have argued for supervisory reforms to improve supervisors’ capabilities in assessing the governance and risk management deficiencies that ultimately led to the bank failures.

Driving Supervisory Reforms

In his review into the Fed’s supervision of SVB, published in April 2023, Vice Chair Barr argued that the bank’s collapse demonstrated “weaknesses in regulation and supervision that must be addressed.” While supervisors had been able to identify many of the relevant issues at SVB that eventually led to its collapse, Barr complained, they were nonetheless far too hesitant, or potentially complacent, to take swift action to compel the bank to resolve those deficiencies.¹⁴⁴

“We need to develop a culture that empowers supervisors to act in the face of uncertainty,” Barr wrote. “In the case of SVB, supervisors delayed action to gather more evidence even as weaknesses were clear and growing. This meant that supervisors did not force SVB to fix its problems, even as those problems worsened.”

We need to develop a culture that empowers supervisors to act in the face of uncertainty.

MICHAEL BARR



FROM OUR 2023 Compendium

An Interview with Randal Quarles, past-Vice Chair for Supervision at the US Federal Reserve Board

“If we can find a way to identify key markers of culture that are both reliably measurable and replicable across institutions, then culture would be a factor that we could supervise effectively. And, given the importance of culture to the conduct and performance of a financial institution, it would be an appropriate area of focus for supervisors.”



[CLICK HERE to READ MORE](#)

At the NY Federal Reserve’s annual Governance and Culture Reform Conference, in June 2023, Barr discussed what the Fed is doing to review and bolster its supervisory capabilities.¹⁴⁵ He stated that, while the Fed does not explicitly call out culture as a matter of supervisory concern, many of its efforts focus on governance-related aspects of culture.

For example, Fed supervisors look to ensure that firms have a strong challenge process, that boards set an appropriate risk appetite and oversee the adherence to such, and that firms behave in a way that is consistent with their strategy and objectives.

Barr argued that the collapse of SVB was, at root, caused by cultural failings. A compensation scheme which rewarded only short-term profitability, and efforts to downplay the risk it faced, served as “examples of a firm that is not taking on board the importance of risk management as essential to its culture,” Barr contended.

With such matters in view, Barr announced that the Fed was undertaking a wholesale review of its supervisory culture, capabilities, and proclivities. This might include recruiting behavioral scientists and experts from other fields, he said.

“The most important work I did as an academic was when I collaborated with a behavioral economist and a psychologist, looking at ways that regulation, economics, and psychology come together to form a full picture of the way in which financial institutions ought to be regulated,” Barr recounted. “I would love to see us move to a system where we bring in much more of that interdisciplinary expertise to look at risk in the system.”¹⁴⁶

In a speech delivered at the Salzburg Global Seminar that same month, Fed Governor Michelle Bowman described how she felt bank regulation and supervision could be made more responsive and responsible following the failures of SVB and Credit Suisse.¹⁴⁷ “These bank failures and recent stress in the banking system have highlighted key deficiencies in risk management practices, and key deficiencies in supervisory priorities,” she argued.

Bowman called for an independent review to analyze the events surrounding the bank failures, expressing concern that the review produced by Vice Chair Barr had been too limited in scope and external input to be considered definitive. She also stressed the need for transparency and public debate amid reform efforts. “We must be circumspect about what went wrong, deliberate about what to fix, and cognizant of unintended consequences,” Bowman asserted.

“It is abundantly clear that regulatory and supervisory reform is on the way,” Bowman concluded. “But we should ensure that changes ultimately promote a safe and sound banking system. That system should serve the needs of customers and support the broader economy.”

In written testimony provided to the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs in May 2024, Michael Barr explained how the Fed had progressed on reforming its supervision in the wake of the 2023 banking turmoil.¹⁴⁸

“It has been a little over a year since the sudden failure of SVB and ensuing stress in the banking system—events which prompted questions about how banks manage risks and how we at the Federal Reserve and other agencies supervise that risk-taking,” Barr wrote. “As noted in my testimonies last year, these events highlighted the need to improve the speed, force, and agility of supervision to align better with the risks, size, and complexity of supervised banks, as appropriate.”

As shown by the 2023 bank failures, developments in the financial sector mean that risks can materialize, and become existential, more

quickly than ever before, Barr cautioned. “Therefore, supervisors must take timely action as risks build up; deploy supervisory tools and escalation effectively; account for changes in market, economic, and financial conditions in their examination priorities and supervisory conclusions; and identify new and different patterns of risks,” he explained. The Fed has sought to achieve this through several key areas of work.

“First, we are working to ensure supervision intensifies at the right pace as a bank grows in size and complexity,” he wrote. “This involves more frequently assessing the condition, strategy, and risk management of large and complex banking organizations and engaging more frequently with these firms through the supervisory process.” In this direction, supervisors are working to ensure that regional banks enhance their risk management capabilities commensurate with the growth of their risk profiles.

It is abundantly clear that regulatory and supervisory reform is on the way.

MICHELLE BOWMAN

“Second, we are modifying supervisory processes so that once issues are identified, they are addressed more quickly by both banks and supervisors,” he wrote. Over the past year, examiners have conducted additional supervisory activities for firms facing material vulnerabilities, requiring that any identified weaknesses in risk management are addressed promptly.

“Third, we are finding ways to better incorporate forward-looking analysis into supervision,” Barr explained. “A forward-looking view supports the goal of identifying and addressing material risks before they become serious issues. Forward-looking risk analysis also may help to challenge supervisory assessments and foster meaningful action where risks are underappreciated.”

Too little, too late

In September 2023, the FDIC released a post-mortem regarding its oversight of collapsed bank First Republic, admitting that it had missed opportunities to bring a more holistic approach to its supervision of the bank.¹⁴⁹

“We cannot say whether taking earlier supervisory action such as criticizing interest rate risk or liquidity risk management would have prevented First Republic from failing given the significance and speed of deposit withdrawals,” the FDIC wrote. “However, meaningful action to mitigate interest rate risk and address funding concentrations would have made the bank more resilient and less vulnerable to the March 2023 contagion event.”

The report noted that First Republic had experienced rapid growth in the years leading up to its failure. Yet that growth coincided with a concurrent decline in the hours of FDIC examination the bank faced.

The postmortem report also challenged the FDIC’s decision to give the bank top ratings on its liquidity risk management in 2021, calling the assessment both “too generous” and “inconsistent with First Republic’s high level of uninsured deposits.”

In a September 2023 blog post, attorneys Max Bonici, Ellen Traupman Berge, and Andrew E. Bigart of US law firm Venable analyzed how bank supervision and enforcement had changed after last spring’s banking turmoil and pursuant suggestion that regulators had taken insufficient preventative action. “In the wake of the recent bank failures,” the Venable lawyers wrote, “not only must the regulators now take effective action, they must be seen to be doing so.”¹⁵⁰

A then-recent leak of confidential supervisory information (CSI), revealing specific financial institutions and the supervisory issues examiners had called out, showed that bank supervision was intensifying, with heightened scrutiny extending well beyond large banks alone.

Later last September, the Fed’s Office of the Inspector General (OIG) published its own postmortem of the banking turmoil. Therein, the OIG argued that supervisors had failed to take swift enough action

to correct issues at SVB before its collapse. “With the benefit of hindsight, we noted multiple instances in which the Board and FRB San Francisco should have acted earlier or taken stronger action to address identified weaknesses at SVB,” the report read.¹⁵¹

In response to the OIG’s review, Michael Gibson, Director of Supervision and Regulation at the

Fed, indicated that the regulator was undertaking a “comprehensive review” of its supervisory approach for regional banks. Learnings from that exercise were

We noted multiple instances in which the Board and FRB San Francisco should have acted earlier or taken stronger action.

OFFICE OF THE INSPECTOR GENERAL, US FEDERAL RESERVE

then to be developed into training for supervisors, Gibson said, with the effort set to be completed by December 2024.

In a speech in January 2024, Fed Governor Bowman again emphasized a necessary shift in focus, away from reforming regulation and toward improving supervision. “Last year’s stress, precipitated by the spring bank failures, validated the tenet that supervision, when implemented effectively and appropriately, is the single most effective tool to support a safe and sound banking system,” Bowman said.¹⁵²

In the case of Silicon Valley Bank, supervisors failed to take sufficient action to mitigate the “known significant, idiosyncratic risks” of the bank’s business model. “Understandably, the bank failures led regulators to take a hard look at what may have been missed in our supervision and what had driven regulatory and supervisory priorities leading up to these bank failures,” Bowman explained. However, more effective supervision cannot be created through regulation, she argued. Instead, agencies must analyze their processes and systems to ensure that supervision is applied consistently across all regulated entities and among their various operational units.

In a March 2024 speech, Bowman emphasized the importance of engaging with stakeholders to ensure that regulation and supervision are effective, transparent, and fair.¹⁵³ Highlighting shifts in supervisory practices following the banking turmoil, she argued that the Fed must work toward more effective and consistent supervision tailored to each institution: 2023’s bank failures should not be taken as a “blank check” to remake supervision into a “blunt instrument,” Bowman said.

Supervision, when implemented effectively and appropriately, is the single most effective tool to support a safe and sound banking system.

MICHELLE BOWMAN

Also in March 2024, the Government Accountability Office (GAO) published its own post-mortem inquiry into the 2023 bank failures, identifying shortcomings in supervision and escalation.

“In the 5 years before 2023, regulators identified liquidity and risk-management deficiencies at SVB and Signature Bank,” the GAO wrote. “However, both banks were slow to mitigate problems regulators identified and regulators did not escalate supervisory actions in a timely fashion, which could have helped to prevent the failures.”¹⁵⁴

The GAO provided several recommendations, including that Congress consider reforms requiring “forceful regulatory actions tied to unsafe banking practices,” and that regulators revise their procedures for escalating supervisory efforts. Notably, the GAO report included little to no discussion of the culture, governance, and other non-financial risk concerns that are widely considered to have been among the root cause of last year’s bank failures.

Individual Accountability

Another means by which some have sought to prevent future bank failures is by insisting upon greater executive accountability for such.

In June 2023, the Senate Banking, Housing, and Urban Affairs Committee approved the “Recovering Executive Compensation From Unaccountable Practices Act,” also known as the RECOUP Act, with bipartisan support.¹⁵⁵ Sponsored by Senators Sherrod Brown (Dem.) and Tim Scott (Rep.), the legislation proposes to grant federal bank regulators expanded powers to hold senior executives accountable for non-compliance or bank failures.

The RECOUP Act would enable regulators to claw back compensation and trading profits and to ban executives from the industry. It would raise the maximum civil money penalty for reckless conduct by senior executives to \$3 million, and allow regulators to recover profits obtained by senior executives through the sale of securities of the failed institution or its holding company.

As of this writing, the RECOUP Act has not yet become law, however.

In an opinion piece appearing in the *Washington Post* in February 2024, Sheila Bair, past-Chair of the FDIC, and Charles Goodhart, an Emeritus Professor in the Financial Markets Group at the London School of Economics, highlighted the need for increased executive accountability.¹⁵⁶ “While there were disagreements about the role that supervisory lapses and monetary policy played in the failures, there was consensus that these three [US] banks were grossly mismanaged, failing in the most basic lessons of Banking 101,” they wrote.

Legislation such as the RECOUP Act would give executives a “significant personal stake in their banks’ survival,” Bair and Goodhart argued, incentivizing them to prioritize soundness, safety, and effective risk management. “Even with the Recoup Act, some banks might still fail,” they concluded. “But by forcing culpable bank executives to have more skin in the game, the Recoup Act should significantly reduce the number of failures. And if that happens, the public can take some satisfaction in knowing that the persons responsible will be held to account.”

In May 2024, several US banking regulators — the FDIC, the Office of the Comptroller of the Currency (OCC), the Federal Housing Finance Agency (FHFA) and the National Credit Union Administration (NCUA) — re-proposed a joint rule to regulate incentive-based compensation paid by certain financial services firms. Notably, the proposal only

had the backing of four of the six agencies required to approve a joint rule, missing the Federal Reserve and the Securities and Exchange Commission (SEC).¹⁵⁷

The proposal stems from the Dodd-Frank Act, which required that the six agencies establish guidelines regarding incentive-based compensation practices. There were two previous attempts to pass such regulation, in 2011 and 2016, both of which received fierce pushback from the industry. In particular, the 2016 proposal was seen as especially strict and prescriptive.

While the new version restates the rules that were proposed in 2016 in their entirety, it also includes several alternative provisions for comment. Many of the alternative provisions would make the rules even more strict, such as prohibiting all incentive-based compensation based in any way upon transaction revenue or volume, while the previous proposal only prohibited that which is *solely* based upon transaction revenue or volume.

The future of the proposal is unclear, as it is ineligible to be published in the Federal Register or opened for formal comment until and unless it gains the support of the Fed and the SEC. In the meantime, the four agencies that support it currently are accepting comments on the pre-publication version.

Market Discipline

While little legislative progress has since been in evidence institutional investors have appeared quite willing to take executives to task for what they deem to have been mismanagement.

In December 2023, Norges Bank Investment Management (NBIM), Norway’s sovereign wealth fund, announced that it would be co-leading a US securities class action lawsuit related to the collapse of SVB, alongside Swedish pension fund Sjunde AP-fonden (AP7).¹⁵⁸

This marks the first time NBIM has spearheaded such legal proceedings, as it seeks to recover substantial investment losses incurred by the fund and other similarly situated investors. “We manage money on behalf of all Norwegians,” said Norges CEO Nicolai Tangen. “I see it as our duty to take legal action to both maximise our recoveries after the SVB collapse and to signal that this is not acceptable market behaviour.” ►PAGE 77

NBIM alleges that losses resulted from misrepresentations regarding the risk management efficacy actually achieved by SVB’s former officers and directors. As a co-lead plaintiff, NBIM aims to maximize recoveries while addressing broader concerns about market integrity, the governance of financial institutions, and the protection of investor community interests.

“It is important for us to take legal action where the alleged conduct raises significant concerns about market integrity,” said Chief Governance and Compliance Officer Carine Smith Ihenacho. “We have clear expectations towards the companies we are invested in and see this as a part of being a responsible investor.”

In January this year, the plaintiffs expanded their lawsuit to include the bank’s auditor and the investment banks that helped it raise money, naming accounting firm KPMG and four Wall Street banks — Goldman Sachs, Bank of America, Keefe, Bruyette & Woods, and Morgan Stanley.¹⁵⁹ They allege that these firms “utterly failed in their role as gatekeepers,” leading to \$24 billion in lost market value. The lawsuit argues that SVB “suffered from rampant weaknesses in its controls” and that executives failed to act even after employees had raised concerns.

I see it as our duty to take legal action to signal that this is not acceptable market behaviour.

CARINE SMITH
IHENACHO

Other Efforts

In an August 2023 speech, Federal Deposit Insurance Corporation (FDIC) Chairman Martin Gruenberg previewed a proposal for regulatory reforms aimed at the operating practices of large regional banks, targeting capital requirements, bank oversight, and deposit insurance pricing. The 2023 bank failures made “a compelling case for action by the federal bank regulatory agencies,” Gruenberg claimed, “to address the underlying vulnerabilities that made the failure of these institutions possible.”¹⁶⁰

The proposed reforms would align with the Basel III capital rules for banks exceeding \$100 billion in assets. Gruenberg highlighted the importance of retaining capital against potential losses to maintain market confidence and prevent liquidity crises. “Had Silicon Valley Bank been required to hold capital against the unrealized losses on its available for sale securities, as the proposed Basel III framework would require, the bank might have averted the loss of market confidence and the liquidity run,” Gruenberg said.

In an August 2023 letter sent to the Fed Board of Governors, Democrat Senators Sherrod Brown, Elizabeth Warren, Jack Reed, and John Fetterman raised questions regarding the Fed’s analysis of financial stability considerations in the context of evaluating proposed bank mergers. The senators voiced worries about what they felt to be a lack of adequate guidance specifying which bank mergers might result in financial stability concerns.

“In the past, Federal Reserve orders approving mergers have contained cursory analysis and reasoning to support the determination that such mergers would not result in greater financial stability risks,” they wrote to Fed Chairman Jerome Powell and Vice-Chair Michael Barr.¹⁶¹

The letter cited the example of SVB's 2021 acquisition of Boston Private. When approving the merger, the Fed said the resultant organization would not pose a "significant risk to the financial system in the event of financial distress." However, when SVB failed in 2023, the Fed was forced to invoke the systemic risk exception to "reduce stress across the financial system" and "support financial stability." As such, the letter called for a more thoughtful financial stability risk assessment of the resultant organization when reviewing bank mergers.

"We hope that, following the failures of SVB, Signature Bank and First Republic Bank, and the acquisition of Credit Suisse by UBS, we will see real changes to the bank merger process to protect financial stability and ensure that we have a fair and competitive banking system that serves all communities," the senators concluded. "We cannot perpetuate a banking system that favors the largest, most complex institutions and puts consumers, smaller institutions, and our financial system at risk."

In October 2023, the FDIC requested comment on a set of proposed corporate governance and risk management guidelines for regional banks. Under the proposed guidelines, small banks would face stricter requirements for the structure of their corporate governance and risk management regimes, including a three lines of defense approach, an emphasis on written policies, and expectations for active board oversight.¹⁶²

Notably, the new regime would mandate that boards "establish a corporate culture and work environment that promotes responsible, ethical behavior" and that does not "condone or encourage imprudent risk-taking, unethical behavior, or violations of law, regulation, or policy in pursuit of profit or other business objectives." As a part of this effort, Boards would have to establish a written code of ethics that covers directors, management, and employees. The

proposal would also set new requirements for board composition, requiring that a majority of directors be independent.

Continued Bank Failure Fears

In early 2024, the fears surrounding community bank solvency were reignited, as New York Community Bancorp (NYCB) racked up increasingly large losses on real estate loans. In a February regulatory filing, NYCB reported that it had found "material weaknesses" in its internal controls that govern how loans were reviewed and that it had replaced its CEO.¹⁶³

The deficiencies in its internal controls stemmed from "ineffective oversight, risk assessment and monitoring activities," the bank said. It promised to lay out a remediation plan in its annual report, which would be delayed. "While we've faced recent challenges, we are confident in the direction of our bank and our ability to deliver for our customers, employees and shareholders in the long term," said Alessandro DiNello, the bank's new CEO and former Executive Chair. "The changes we're making to our board and leadership team are reflective of a new chapter that is under way."

That new direction was, evidently, short-lived. The following week, NYCB again replaced its CEO, bringing in former Comptroller of the Currency Joseph Otting to run the bank. NYCB also announced that it was raising more than \$1 billion from investors to shore up the bank's financial position and stem the losses it had faced from its real-estate loan profile. In addition, the bank named new Chief Risk and Audit officers, appointed board directors from its new investors, and purged legacy members of the board.¹⁶⁴

Separately, in May, regulators seized the Philadelphia-based Republic First bank and sold it to a fellow regional bank, Fulton Financial. Republic First reportedly faced some of the same problems as the

regional banks that failed in spring of 2023. However, notably, it was much smaller than any of those banks, having only \$6 billion in assets at the end of 2023.¹⁶⁵

Continued Conduct Challenges

As we have chronicled over the past six editions of this *Compendium*, organizations in the US have long struggled to get a handle on their culture and the conduct such culture engenders. This report focuses primarily on the financial sector. However, it is sometimes helpful to examine case studies from other industries when a company or governmental institution's culture leads to misconduct and both financial and reputational costs.

Below, we will take a look at the audit sector, which has faced mounting pressure to attend to its culture to improve audit quality and professional conduct outcomes. We will then return to the financial sector, discussing several major themes that have emerged over the past year — to include gender, race, and nationality-based discrimination, continued employee messaging misconduct, and national security concerns — before ending by taking a more general look at some of the largest financial firms in the US and how these culture and conduct issues have impacted them.

Accounting Industry Woes

Over the past several *Compendium* editions, our attention has increasingly been called to the audit sector, which has faced scrutiny regarding culture and conduct challenges much as we have seen in the financial industry. This scrutiny was further elevated throughout 2023, and looks set to continue for the foreseeable future. Last spring, we published a *Deeper Dive* — “Renal Failure” — discussing these topics in more detail. ▶SEE “RENAL FAILURE” ON STARLING INSIGHTS

In 2023, the Public Company Accounting Oversight Board (PCAOB) issued a record \$20 million in fines amidst continued conduct shortcomings in the audit industry, alongside continuing concerns for audit quality.¹⁶⁶

Under the leadership of Chair Erica Williams, the PCAOB has intensified enforcement efforts. In a statement to the *Financial Times* in November 2023, Williams said the PCAOB would “continue to use every tool in our enforcement toolbox to make sure people know that there are consequences for putting investors at risk.”¹⁶⁷ In this section, we will review some of the major examples of the PCAOB using these powers to compel change in the audit sector.

In December 2023, PwC was fined \$7 million after an investigation by the PCAOB revealed that over 1,000 audit staff in China and Hong Kong had cheated on internal training exams focused on US standards.¹⁶⁸

According to the PCAOB, PwC staff used two unauthorized software applications to share test answers over at least two years up to 2020. PwC's Hong Kong and China branches agreed to settle, with the former paying \$4 million and the latter \$3 million, without admitting to the allegations. In a joint statement from its Hong Kong and Chinese businesses, PwC said it was “highly regrettable” that staff had shared test answers.

“The days of China-based firms evading accountability are over,” said PCAOB Chair Erica Williams. “The PCAOB will impose tough sanctions against anyone who violates PCAOB rules and standards, no matter where they are located.”

Auditors have not had it any easier in 2024. In January, *Forbes* reported that the SEC had uncovered a startling case of financial misrepresentation involving a Nigerian company, the Tingo Group. Despite Tingo receiving a clean audit from Deloitte that “verified” a cash balance of \$462 million, the SEC found only \$50 (no, not \$50 million) in the company's accounts.¹⁶⁹

Earlier that month, the SEC indicted Tingo CEO Dozy Mmobuosi for securities fraud, making false filings, and conspiracy charges. “Dozy Mmobuosi allegedly orchestrated a massive scheme to inflate Tingo Group’s financial statements and make it appear as though the cellular and agriculture companies he founded were profitable and cash rich companies when, in fact, they were not,” said US Attorney Damian Williams. “With this Indictment, Mmobuosi’s alleged deceitful scheme comes to an end.”

Short-seller Hindenburg Research had previously raised concerns about Tingo, questioning its legitimacy and Deloitte’s due diligence. “The issues in Tingo’s financials are glaring enough that we’d expect they could have been spotted by any semi-conscious finance undergrad with severe vision loss,” Hindenburg wrote in its June 2023 report. “These issues were apparently not glaring enough for the company’s auditor, however.”

In February 2024, Gartner reported the results of a survey of 497 individuals working in the controller function. The survey found that 8% of accountants make financial errors daily, and one-third make at least a few errors every week, identifying increased workload and low capacity as key causes of these errors.¹⁷⁰

“In the past three years, 73% of accountants report that their workload has increased because of new regulations, and 82% say economic volatility has increased demands for their work,” said Mallory Barg Bulman, Senior Director of Research in the Gartner Finance practice. “If these financial and regulatory pressures continue to increase, as history suggests it will, the already-limited capacity accountants will be stretched further and increase error rates.”

Such errors have tangible business outcomes, Bulman cautioned. For example, enterprises may make decisions on incorrect data or, even worse, issue inaccurate financial statements to their investors. Gartner found that accountants who displayed

acceptance of technology made substantially fewer errors. And companies that garner high technology acceptance among their employees saw a 75% reduction in financial errors.

“The accounting functions that are managing to build technology acceptance don’t necessarily have different technology: building acceptance is more to do with putting in place practices that allow staff to perceive technology as easy to use and helpful,” said Bulman. “Given the potential of technology acceptance to reduce error rates in accounting, controllers should make sure they understand the levels of acceptance in their functions and improve it where necessary,”

In April 2024, the PCAOB levied its largest ever fine, \$25 million, on KPMG Netherlands for “egregious” and widespread exam cheating at the firm from 2017-2022. This one fine was larger than the total amount of fines issued by the PCAOB in 2023, which was, as discussed earlier, a record year. The regulator also banned KPMG Netherlands’ former head of assurance, Marc Hogeboom, from the industry.¹⁷¹

Beyond its enforcement, the PCAOB has also sought to take a more preventative approach to these widespread audit quality and fraud concerns.

In June 2023, the regulator sought comment on a proposal which would, among other things, strengthen auditor requirements to identify, evaluate, and report possible or actual noncompliance with laws and regulations. The current standards only require auditors to detect and report direct wrongdoing affecting financial statements. The proposed rules would hold auditors accountable for identifying behaviors that could indirectly impact a company, such as potentially exposing it to large fines. “By catching and communicating noncompliance sooner, auditors can help companies course correct and better protect investors from risk,” PCAOB Chair Erica Williams said.¹⁷²

Unsurprisingly, many in the accounting industry came out against the proposal. The Center for Audit Quality (CAQ), an advocacy group representing the Big Four, asked corporate directors to sign a letter opposing the reforms, claiming that the changes would stretch auditors beyond their core competencies and significantly increase audit costs without sufficient benefit. “Auditors are not lawyers and as a result the proposed amendments would expand the auditor’s role to include knowledge and expertise outside their core competencies,” the letter said.¹⁷³

The CAQ said it would not be opposed to reforming existing requirements, but the current proposal goes too far. “I worry for auditors that they are never going to be able to live up to the standard,” said Sandra Hanna, an attorney at Miller & Chevalier who has represented audit firms. According to her, the proposal was an attempt to turn auditors into “fraud examiners” and impose on them a “forensic” standard where even the smallest concern would have to be investigated.

Despite all of the foregoing scrutiny on auditors and audit quality, some have also questioned whether the opinion of the auditor actually impacts investment decision making. In December 2023, the Second US Circuit Court of Appeals dismissed a lawsuit by an investor seeking retribution after an auditor signed off on the books of an insurer that was inflating its profits. The court found that the audit report was so general that investors would not have relied on it, and as such was “immaterial.”¹⁷⁴

In response to this ruling, the SEC filed a brief with the court urging it to reconsider its decision. “That audit certifications use a standardized form prescribed by the PCAOB does not render them less meaningful,” the SEC wrote. “Instead, the form language imports greater meaning by providing a clear and consistent signal permitting investors to quickly classify the associated investment risk.”¹⁷⁵

In May 2024, the SEC shut down auditor BF Borgers accusing it of “massive fraud.” The SEC Charged BF Borgers and its founder, Ben Borgers, with falsely representing to its clients that its audit work complied with US audit standards. “Ben Borgers and his audit firm, BF Borgers, were responsible for one of the largest wholesale failures by gatekeepers in our financial markets,” said the Gurbir S. Grewal, Director of the SEC’s Division of Enforcement. “As a result of their fraudulent conduct, they not only put investors and markets at risk by causing public companies to incorporate noncompliant audits and reviews into more than 1,500 filings with the Commission, but also undermined trust and confidence in our markets.”¹⁷⁶

Of the 369 clients whose public filings from January 2021 through June 2023 included BF Borgers’ audits and reviews, at least 75 percent did not meet PCAOB standards. The firm, which Grewal called a “sham audit mill,” agreed to pay \$12 million to settle the SEC’s charges, while its founder paid \$2 million.¹⁷⁷ This story is rather significant, as BF Borgers had the eighth-largest client list of any US audit firm. However, perhaps even more significantly, Borgers also happened to serve as the auditor of Donald Trump’s media and technology company.¹⁷⁸

If nothing else, this connection will likely result in still more heightened attention being brought to audit quality and professional conduct in the accounting sector as we move into the 2024 elections and beyond.

Discrimination, Harassment & Bullying

In November 2023, Ardith Lindsey, a managing director at Citi, filed a lawsuit against the bank, accusing it of fostering a work culture where she experienced sexual harassment and abuse by male executives. Lindsey, who had worked at Citi for 15 years, said that her traumatic experiences intensified after ending a relationship with a former supervisor who sent her threatening messages.¹⁷⁹

The lawsuit alleged a workplace culture where female employees face comments about their sexuality and attractiveness, fearing career repercussions if they complain. Mark Costiglio, a Citi spokesman, said the bank had opened an investigation shortly after Ms. Lindsey disclosed the relationship in November 2022. “Our colleagues should feel confident they can raise concerns about themselves or others without fear of retribution, and decisive action must be taken when unacceptable behavior takes place,” he said.

In early November, Citi was fined nearly \$26 million by the Consumer Financial Protection Bureau (CFPB) for allegedly discriminating against Armenian American credit card applicants from 2015 to 2021. The CPB accused Citi of negatively assessing, and often denying, the applicants based on their national origin, and failing to provide the applicants with a reason for the decision.¹⁸⁰

Later in November, Congresswoman Maxine Waters, the top Democrat on the House Financial Services Committee, sent a letter to Acting Comptroller of the Currency Michael Hsu urging him to consider additional actions against Citibank, including downgrading its Community Reinvestment Act (CRA) rating.¹⁸¹

Waters highlighted that Citi employees engaged in discriminatory practices based on stereotypes about Armenian criminality. This seemed to contradict the bank’s rating of “Outstanding” in the OCC’s most recent CRA performance evaluation, issued in 2021.

Waters called on the OCC to promptly examine the case and take appropriate measures to hold the bank accountable. “The Community Reinvestment Act (CRA) is a crucial tool in promoting economic development and fair lending practices in communities across the country,” she

asserted. “It is essential that all banks adhere to the spirit and intent of the CRA, fostering inclusivity and preventing discrimination against any ethnic or cultural group,” Waters wrote. “Ensuring that financial institutions comply with the highest standards of fairness and equality is essential to maintaining the integrity of the banking system and fostering trust among the public. I trust that the OCC will handle this matter with the utmost diligence and impartiality.”

Citi was not the only bank to be accused of discrimination in 2023. In December, a class-action lawsuit was filed against US-based Navy Federal Credit Union alleging discrimination against Black and Latino mortgage applicants. The lawsuit followed a CNN report revealing a significant gap in acceptance rates for Black (48.5%), Latino (55.8%), and White (77.1%) mortgage applicants in 2022.¹⁸²

“The statistics in the article do not appear to have considered several key credit criteria that all financial institutions, including Navy Federal, rely on to assess mortgage applications,” the credit union said, contesting the report.

The class-action suit asserted that the credit union violated the Fair Housing Act and the Equal Credit Opportunity Act, alleging systematic discrimination. The lawsuit aimed to represent nonwhite Navy Federal residential loan applicants from 2018 to the present who experienced denial, higher interest rates,

less favorable terms, or delayed processing compared to similar non-minority applicants.

There have also been concerns around perceived shortages of female executives at major investment banks. Five years ago, David Solomon, CEO of Goldman Sachs, took control and promised to prioritize

promoting women to senior positions within the firm. However, as reported by the *Wall Street Journal* in

Ensuring that financial institutions comply with the highest standards of fairness and equality is essential to maintaining the integrity of the banking system and fostering trust among the public.

CONGRESSWOMAN MAXINE WATERS

March 2024, the bank has experienced a significant exodus of female partners, with around two-thirds leaving their positions since 2018.¹⁸³

Notably, the *WSJ* wrote, no woman led a major division or was considered a credible candidate for future leadership. And Goldman's efforts to elevate women have faced challenges. "Advancing women into our most senior ranks is an area where we have not accomplished our goals," Solomon said in a written statement to the *WSJ*. "Our longer term success depends significantly on developing female partners in senior roles."

A spokesman for Goldman maintained that partner departures were within historical norms. Nevertheless, the situation underscores broader challenges in Wall Street firms' efforts to advance women to top positions.

At Goldman, management decisions and practices have appeared to disproportionately affect women partners. Observers point to instances of organizational restructuring that placed male executives above women and the adoption of new experience requirements for advancement that favored areas where fewer women were working.

Solomon has arranged meetings to address these concerns, but progress remains slow. While Goldman claims to have increased recruitment and promotion of women, disparities persist, with recent partner classes being predominantly male. Last year, Goldman settled a lawsuit alleging discrimination against women in lower-level positions.

In January 2023, Starling Insights published "The Era of Accountability," a *Deeper Dive* report discussing a global trend of employees in every industry holding their employer accountable for conduct that does not align with their own values. In a Preamble therein, Jamie Fiore Higgins, author of *Bully Market: My Story of Money and Misogyny at Goldman Sachs*, offers a harrowing recounting of the pressures and

outright abuses she suffered during a long career at Goldman Sachs. ▶SEE "THE ERA OF ACCOUNTABILITY" ON STARLING INSIGHTS

In April 2024, a former Wells Fargo bond saleswoman filed a lawsuit against the bank for allegedly denying women pay and promotions and tolerating an "unapologetically sexist" workplace. The lawsuit accuses Wells Fargo of steering larger accounts toward men, and of making women wait much longer than men for important promotions. "The financial institutions group is a self-acknowledged 'boys club' where locker room talk on the sales floor is de rigueur," the claimant said.¹⁸⁴

Employee Messaging

Since the start of the Covid pandemic, employee misuse of communication apps to conduct business has emerged as a primary concern for banks and their regulators. These tensions came to a head in 2022, when the SEC and the Commodity Futures Trading Commission (CFTC) levied fines totalling more than \$2 billion against major Wall Street Banks and brokerages.¹⁸⁵

The regulators have continued to pressure firms to improve their communication practices over the past year.

In June 2023, JPMorgan Chase's brokerage arm agreed to pay \$4 million to settle with the SEC over the accidental deletion of 47 million electronic messages it was required to have retained.¹⁸⁶ According to the SEC, the deletion, which took place in 2019 and was self-reported by the bank in 2020, violated rules that mandate retaining messages for three years.

"Because the deleted records are unrecoverable, it is unknown—and unknowable—how the lost records may have affected the regulatory investigations," the SEC said. In 12 investigations, including eight directly

involving the SEC, JPMorgan was unable to produce communications that were sought because they had been deleted.

Later that summer, the brokerage units at several large banks — including Wells Fargo, BNP Paribas, Bank of Montreal, Société Générale and Mizuho Financial Group — were fined a total of \$555 million by the SEC and the CFTC for employee misuse of messaging apps. As a part of the settlements, the firms committed to retaining independent compliance consultants to review their policies and procedures related to electronic communications retention.¹⁸⁷

“So here are three takeaways for those firms who haven’t yet done so: self-report, cooperate and remediate,” said Gurbir S. Grewal, Director of the Division of Enforcement for the SEC. “If you adopt that playbook, you’ll have a better outcome than if you wait for us to come calling,”

In September, Goldman Sachs fired several employees in its transaction banking business due to “serious violations” of communication policies. Hari Moorthy, Goldman’s Global Head of Transaction Banking, was reportedly among those dismissed.¹⁸⁸

“[T]he firm terminated the employment of several leaders in the transaction banking (TxB) business after losing confidence in them following serious violations of firm policies,” Goldman stated in a memo to staff. “As a general matter, we take our communications policy seriously, and we expect all of our personnel to comply with it.”

In February 2024, the SEC announced \$81 million in fines against 16 financial firms for employee use of unauthorized messaging apps. The penalized firms included Northwestern Mutual Investment Services (NMIS), US Bancorp, and Huntington Investment Company.¹⁸⁹

“Today’s actions against these 16 firms result from our continuing efforts to ensure that all regulated entities comply with the recordkeeping requirements, which are essential to our ability to monitor and enforce compliance with the federal securities laws,” Grewal said in the related announcement. “[O]ne of these orders is not like the others: Huntington’s penalty reflects its voluntary self-report and cooperation.”

The fines against the firms whose transgressions had been discovered by regulators ranged from \$8 million (US Bancorp) to \$16.5 million (NMIS). However, the penalty against Huntington was a comparatively small \$1.25 million as a result of its decision to self-report the misconduct. In addition to the fines, each firm was ordered to cease and desist from future violations and agreed to retain independent compliance consultants to review their policies and procedures relating to the retention of electronic records.

This story shows the value of firms ensuring their culture and governance allow them to identify when things go wrong and rectify them quickly. Regulators globally, and especially those in the US, have made clear that they are prepared to penalize firms that fail to do so.

National Security Implications

In July 2023, Deutsche Bank was fined \$186 million by the Federal Reserve for “a material failure” to fix “unsafe and unsound banking practices.” The Fed criticized the bank for its inadequate controls on sanctions compliance, transaction monitoring, and money-laundering checks.¹⁹⁰

This fine marks the continuation of struggles faced by Christian Sewing, the bank’s CEO, to address control shortcomings and fulfill promises made as far back as 2015. The bank had previously been fined \$99 million by the Fed in 2015 and 2017 for similar issues. Despite having committed to addressing the problems, the Fed found that Deutsche Bank had “made insufficient progress in remediation efforts.”

The Fed's latest intervention required Deutsche Bank to complete key milestones by the end of 2023. The bank expressed confidence in meeting regulatory expectations, citing investments made in control functions since 2019 and increased headcount in its global financial crime team. However, the Fed warned of additional penalties if the bank fails to meet the set measures.

In January 2024, the Industrial and Commercial Bank of China (ICBC) agreed to pay \$32.4 million to settle investigations by the Federal Reserve and the New York State Department of Financial Services (NYDFS) over compliance issues at its New York branch.¹⁹¹

The NYDFS found deficiencies in ICBC's Anti-Money Laundering and Bank Secrecy Act compliance programs from 2018 to 2022. The Federal Reserve levied its own penalty for the alleged unauthorized use and disclosure of confidential supervisory information.

"Bank Secrecy Act and Anti-Money Laundering laws and regulations are critical national security protections, safeguarding financial markets and consumers from bad actors," said NY's Superintendent of Financial Services Adrienne A. Harris in a related announcement. "Regulated institutions must be held accountable for failing to adhere to New York's rigorous legal and regulatory standards." ► **PAGE 183**

Other Costs of Misconduct

From here, we will delve into case studies of major US firms that have struggled with managing culture and conduct issues over the past year, as well as some of their efforts to drive meaningful change going forward.

Wells Fargo

In May 2023, Wells Fargo agreed to pay \$1 billion to settle a lawsuit alleging it defrauded shareholders about its progress in recovering from the scandals that have plagued it in recent years. Wells has operated under consent orders from several regulators since 2018, requiring that it improve its governance and risk management. The shareholders claim that the bank overstated its compliance with these orders, losing more than \$54 billion in market value in the two years ending March 2020 due to the continuing deficiencies.¹⁹²

CEO Charlie Scharf, has said that repairing issues at the bank has been more challenging than he expected when taking the role in 2019. "When I arrived, we did not have the culture, effective processes, or appropriate management oversight in place to

remediate weaknesses on a timely basis," he wrote in a March 2023 letter to shareholders. "Today, we approach these issues differently," Scharf said, though it is unclear precisely how any new approaches differ from what went before.

In September 2023, it was reported by the *Wall Street Journal* that Wells Fargo was still grappling with the fallout from its fake accounts scandal that came to light seven years before. At a conference earlier that year, Scharf spoke to what he perceived to be regulators' increased willingness to take drastic action when banks aren't meeting their expectations. "Until our work is done, we're still at risk," he said.¹⁹³

Since the scandal arose in 2016, the bank's stock price has suffered. This is at least in part due to an asset cap imposed by the Federal Reserve in 2018 that has severely hampered growth. The challenge is compounded by the bank's complex digital infrastructure and a culture that has been described as insular and decentralized.

Bank Secrecy Act and Anti-Money Laundering laws and regulations are critical national security protections.

ADRIENNE A. HARRIS

The bank's employees reportedly participate in daily workshops in which they document the risks associated with their everyday activities and the controls in place to mitigate those risks. These programs were expected to continue for another year from September 2023, further stretching employees who already report being overworked. "Each of us is under tremendous stress, whether we acknowledge it or not, and that stress builds over time," one manager wrote to his internal controls team.

In October, Senator Sherrod Brown, Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, sent a letter to Acting Comptroller of the Currency Michael Hsu expressing concerns about unfair labor practices at Wells Fargo. The Senator cited several instances where employees at various Wells Fargo branches filed Unfair Labor Practice charges with the National Labor Relations Board over the past year, and noted that those who attempted to report labor abuses reportedly faced retaliation from the bank.¹⁹⁴

"Wells Fargo's actions towards its employees demonstrate not only a disregard for their workers, but also for corporate governance and risk management," Brown wrote, noting that an effective corporate governance and risk management framework is essential to maintaining the safe and sound operation of the bank. In turn, such a regime promotes public confidence in the bank and the financial system as a whole.

Brown has a history of holding Wells Fargo accountable for its alleged wrongdoings, including accusations of consumer abuses, compliance failures, racial discrimination, and deceptive practices. "Regulators should take stronger actions to change Wells Fargo's culture of noncompliance and account for the troubling unfair labor practice

allegations that could be the bellwether for broader safety and soundness and consumer compliance risks," Brown urged.

As reported by *Bloomberg* in November 2023, Wells Fargo executives anticipated that its \$1.95 trillion asset cap may not be lifted until at least the first quarter of 2025. The Federal Reserve put the cap in place in February 2018 following a string of regulatory issues at the bank.¹⁹⁵

The cap has stifled the bank's growth while its largest competitors — JPMorgan Chase, Citi, and Bank of America — have seen a swell in deposits. Wells Fargo's executives initially predicted compliance with the Fed's requirements by the end of 2018. However, CEO Charlie Scharf has refrained from speculation since he took the helm in 2019.

"We've been very careful not to put dates out there because we have to do our work and then our regulators have to take a look at it and see if it's done to their satisfaction," Scharf told analysts in July 2023. "We don't want to get ahead of that process, but we continue to move forward."

Executives reportedly believe that the first quarter of 2025 is the earliest plausible time for the cap to be removed, considering the timeline of regulatory processes and the presidential election that takes place later this year.

Also in November, it was reported by the *Wall Street Journal* that regulators had sent Wells Fargo several letters ordering it to improve its ability to monitor financial crime. This came as the bank faced a lawsuit for allegedly allowing a \$490 million Ponzi scheme to operate using its systems.¹⁹⁶

Wells Fargo's actions towards its employees demonstrate not only a disregard for their workers, but also for corporate governance and risk management.

SENATOR SHERROD BROWN

Regulators had reportedly chastised the bank several times since early 2022 for improper oversight of criminal activity in its consumer bank. The *Wall Street Journal's* Ben Eisen and Ben Foldy explained that, while the regulatory orders were focused on Wells Fargo's consumer monitoring systems more generally, rather than any single event, the Ponzi scheme case illustrates what can go wrong when a bank's systems are deficient.

Following the initial warnings from the Federal Reserve and the OCC, Wells Fargo replaced the executive responsible for Bank Secrecy Act compliance. However, the bank's efforts to resolve the monitoring shortcomings were ongoing, and regulators had not ruled out further penalties.

Wells Fargo did receive some relief in February 2024, when it announced that the OCC had terminated the consent order it had issued against the bank in 2016 regarding sales practice misconduct.

"Confirmation from the OCC that we have effectively implemented what was required is a result of the hard work of so many of our employees, and I'd like to thank everyone at Wells Fargo involved for their dedication to transforming how we do business," said Charlie Scharf. "We are a stronger, better Wells Fargo for our customers and communities, and we will not lose sight of the remaining work to do. Our risk and control work remains our top priority."¹⁹⁷

Citi

Citigroup has for years been the subject of continued regulatory scrutiny and pressure to improve its risk management systems. For more background on the scandals that have fueled this scrutiny, please refer to past editions of this *Compendium*. We also discuss more recent conduct problems at Citi in the "Discrimination" subsection above.

In late 2020, the OCC levied a \$400 million fine, and Citi was made to agree to a Consent Order to improve its operational risk practices. This fine came shortly after accidentally sending more than \$900 million to one of its client's lenders, rather than the \$9 million interest payment it had intended the lenders to receive.¹⁹⁸ Simultaneously, the Federal Reserve issued a Consent Order to Citibank with very similar requirements to the OCC's.¹⁹⁹

In September 2022, it was reported by *The Wall Street Journal* that Federal Reserve officials were frustrated with the firm's pace of progress in the two years since they reprimanded it for issues with its risk management systems. In a meeting with the firm's board over the previous summer, regulators warned that there could be repercussions for its perceived lack of progress in making the much-needed improvements.²⁰⁰

Our risk and control work remains our top priority.

CHARLIE SCHARF

Later that month, *Reuters* reported that Citi had submitted a comprehensive multi-year plan to the Federal Reserve and the OCC to fix its risk management deficiencies. The plan explained how Citi aimed to improve

its risk infrastructure, data quality and internal governance, according to sources familiar with the matter. About 30,000 of its 213,000 employees were working on the transformation.²⁰¹

In September 2023, Citigroup announced a major organizational restructuring. Under the new model, the leaders of Citi's five businesses would now report directly to the CEO, removing the management layer and adding the business leaders to the Executive Management Team. This was intended to speed up decision making, improve accountability, and strengthen the client focus.²⁰²

"I am determined that our bank will deliver to our full potential, and we're making bold decisions to meet our commitments to all our stakeholders," said Citi CEO Jane Fraser. "These changes eliminate

unnecessary complexity across the bank, increase accountability for delivering excellent client service and strengthen our ability to benefit from the natural linkages that exist amongst our businesses, all with an eye toward delivering on our medium-term targets and our Transformation.”

In a town hall meeting, Fraser urged the bank’s employees to embrace her overhaul of the bank. “Get on board,” Fraser said. “We have incredibly high ambitions for this bank and, the train, it’s gonna move fast. So lean in, help us win with clients, help us deliver the changes, or get off the train.”²⁰³

In January 2024, Citi said that it expected to cut at least 20,000 jobs, as it reported its worst quarter in 14 years. “While the fourth quarter was very disappointing due to the impact of notable items, we made substantial progress simplifying Citi and executing our strategy in 2023,” Fraser said,²⁰⁴ adding that 2024 would be a “turning point.”²⁰⁵

The following month, *Reuters* reported that the Federal Reserve had sent Citi three notices — in the form of Matters Requiring Immediate Attention (MRIAs) — in late 2023 ordering Citi to improve its data and governance around how it handles its capital requirements regarding counterparty risk. The *Reuters* report also included detailed findings of an internal audit review of the firm’s Consent Order remediation program, which determined that the progress had been inadequate.²⁰⁶

“Like any multi-year effort of this scale, progress isn’t linear and there are important learnings along the way that we’re incorporating into our efforts, including in the areas of regulatory reporting, infrastructure and data enhancement,” Citi told *Reuters*.

Bank of America

In July 2023, it was announced that Bank of America (BoA) would pay \$250 million to settle charges of credit card and banking abuses as part of an

agreement with the CFPB and the OCC. The bank would reimburse its customers approximately \$100 million and pay out \$150 million in fines for opening accounts for customers without their consent and charging repeated overdraft fees.²⁰⁷

“These practices are illegal and undermine customer trust,” CFPB director Rohit Chopra said. “The CFPB will be putting an end to these practices across the banking system.”

The CFPB alleged that, as recently as 2022, BoA charged a \$35 overdraft fee multiple times on the same transaction, generating excessive fees amounting to hundreds of millions of dollars. BoA was also accused of failing to deliver on advertised promises for its credit cards and opening credit cards for customers who had not applied, negatively impacting their credit.

This is the second largest settlement that BoFA has reached with the CFPB over abuses in its credit card division. It paid \$727 million in 2014 over the marketing and billing for add-on products and credit monitoring.

UBS

Also in July 2023, the FRB announced a consent order and a \$268.5 million fine against UBS Group AG for misconduct by Credit Suisse, which UBS had officially acquired in June of last year. The sanctions stem from Credit Suisse’s dealings with Archegos, and its failure to manage related risks properly despite repeated warnings.²⁰⁸

“The Board is requiring Credit Suisse to improve counterparty credit risk management practices and to address additional longstanding deficiencies in other risk management programs at Credit Suisse’s U.S. operations,” the FRB wrote in its announcement. The action was taken in conjunction with actions by the

Swiss Financial Market Supervisory Authority and the UK Prudential Regulation Authority. The related fines totalled approximately \$387 million.

City National Bank

In January 2024, City National Bank, one of Royal Bank of Canada's (RBC) US businesses, agreed to a consent order and a \$65 million fine to resolve the OCC's allegations that there were systemic deficiencies in the bank's risk management and internal controls. The OCC ordered that City National Bank undertake "broad and comprehensive" reforms to improve its strategic plan, operational risk management, internal controls relating to money laundering and fair lending, strategic risk management, and investment management practices.²⁰⁹

Morgan Stanley

In January 2024, Morgan Stanley agreed to pay \$249 million to resolve investigations by federal prosecutors into the firm's handling of large stock trades. The investigations uncovered that at least one employee had misused confidential information related to block trades of stocks by customers. While the bank did not uncover or report the misconduct to authorities, prosecutors elected not to file charges against Morgan Stanley on account of its cooperation with the investigations.²¹⁰

However, the prosecutors did enter into a deferred prosecution agreement with Pawan Passi, who was responsible for supervising Morgan Stanley's block trading from 2018 to 2021. Under the deal, the securities fraud charges against Passi would be dismissed in six months so long as he remained in compliance with the terms of the agreement.

JPMorgan

In February 2024, JPMorgan warned in a regulatory filing that it would pay \$350 million to regulators for reporting incomplete trading data to surveillance platforms. The firm said that certain trade and order data from its Corporate and Investment Bank (CIB) was not passed on to its trade surveillance platform. However, the total gap was small in comparison to the overall activity of its CIB, JPMorgan said, and it did not identify any "employee misconduct, harm to clients or the market."²¹¹

In March, the Federal Reserve and the OCC publicly announced the fines of which JPMorgan had warned. The regulators ordered that the firm take corrective actions to improve its trade surveillance program.²¹²

It may be worth noting that there is a clear difference between the cases involving Morgan Stanley and JPMorgan. In one instance, an employee engaged in outright misconduct that harmed customers and markets. In the other, a firm faced a relatively small, though not entirely inconsequential, failure of oversight.

Despite this fundamental distinction, though, the magnitude of the fines and the nature of regulators' actions seem to indicate that they are being treated as similar cases. It is worth questioning whether this contributes to an oft-heard perception that these punitive fines represent an unavoidable cost of doing business and, as such, fail to drive meaningful change in behavior.

Discover Financial Services

In August, Discover Financial Services announced that CEO Roger Hochschild would step down following a long-term underinvestment in compliance. This came after the firm disclosed in a July investor call that it had misclassified certain credit card accounts, beginning in 2007, leaving it liable for \$365 million in remedial costs.²¹³

In that same call, Discover revealed that it had also received a proposed Consent Order from the FDIC, concerning separate consumer compliance concerns. The firm was forced to pause stock buybacks while an internal review of compliance, risk management and corporate governance was pending.

In the announcement that Hochschild would step down, Discover CFO John Greene stated the company had failed to allocate the proper resources to compliance over many years. “The company historically underinvested, and we’re paying the price right now,” Greene said. Discover is now working to ensure it no longer puts profits over compliance.

In September, the aforementioned consent order with the FDIC was finalized. Notably, Discover managed to avoid a financial penalty. In a filing to the SEC, the firm said that it had been “taking significant steps to strengthen the organization’s compliance management system and address the other issues identified in the consent order.”²¹⁴

In February 2024, Capital One agreed to acquire Discover in a \$35.3 billion all-stock deal. The transaction was expected to stabilize Discover after its difficult 2023. “From Capital One’s founding days, we set out to build a payments and banking company powered by modern technology,” said Capital One CEO Richard Fairbank. “Through this combination, we’re creating a company that is exceptionally well-positioned to create significant value for consumers, small businesses, merchants and shareholders as technology continues to transform the payments and banking marketplace.”²¹⁵

In response to analysts’ questions, Fairbank acknowledged that tackling Discover’s compliance issues would require a “significant” amount of work. “It’s a very challenging thing to take on a significant

set of enforcement actions like this and what comes along with that,” Fairbank said. “It’s part of a journey that pretty much every bank has gone through.”²¹⁶

Pressure on the Regulators

As discussed above, financial regulators have increasingly put pressure on firms to attend to both their culture, and the conduct it promotes. However, some financial regulators have themselves faced scrutiny for their culture, as well as their regulatory and supervisory outcomes.

In a November article in *The Wall Street Journal*, journalist Rebecca Ballhaus reported on allegations of a “toxic atmosphere” — rife with partying, harassment, and discrimination — at the FDIC, citing interviews with more than 100 current and former employees.²¹⁷ Many female bank examiners had left

the FDIC because of a work environment they described as a sexualized “boys club,” Ballhaus reported. They also alleged that women were given fewer opportunities for advancement.

In 2020, the FDIC’s inspector general found that the agency’s policies regarding sexual

harassment fell short of expectations and that its processes for tracking misconduct allegations were “decentralized, untimely, incomplete, and inaccurate.” The FDIC agreed to make changes at the time, but disagreed with the inspector general’s conclusions that its programs were inadequate.

Reports of problems with the agency’s work environment go back more than a decade, and the presence of a culture of heavy drinking and partying among examiners was well-known. “Current and former employees across the country described a pernicious culture for staff in the FDIC’s regional offices exacerbated by the relative freedom of

It’s a very challenging thing to take on a significant set of enforcement actions like this. It’s part of a journey that pretty much every bank has gone through.

RICHARD FAIRBANK

bank examiners traveling for days or weeks at a time,” Ballhaus wrote. “Some called life on the road the ‘Wild West.’”

We discussed this scandal in detail in our February 2024 *Deeper Dive* report, “Physician, Heal Thyself.” For more background and analysis, we would encourage you to read that report. ▶ **SEE “PHYSICIAN, HEAL THYSELF” ON STARLING INSIGHTS** Not covered in that *Deeper Dive* was a February 2024 *WSJ* article which reported that leaders in the two departments at the FDIC responsible for addressing harassment complaints have faced several misconduct allegations of their own over the past few years.²¹⁸

Since 2018, at least 12 managers in HR and the Office of Minority and Women Inclusion have faced accusations of harassment and bullying from their employees. Current and former FDIC employees told the *WSJ* that the turmoil within these departments contributed to the widely reported cultural problems that have plagued the agency.

As discussed in “Physician, Heal Thyself,” in November the FDIC’s board of directors formed a Special Committee to oversee the independent investigation of the agency’s culture, chaired by board members Jonathan McKernan and Acting Comptroller of the Currency Michael Hsu.²¹⁹ In March of this year, the Special Committee appointed three non-voting members to advise it in these efforts. The three non-voting members were Elizabeth McCaul, a Member of the Supervisory Board of the European Central Bank ▶ **PAGE 7**, Linda Miller, CEO of Audient Group, and Valerie Mosley, Founder of BrightUp and Valmo Ventures.²²⁰

In May, the FDIC published the results of the independent review of its culture, which labeled the agency a “good ol’ boys club” rife with favoritism and insularity. The report, written by law firm Cleary Gottlieb, highlighted widespread instances of sexual and racial harassment, with over 500 current and former employees interviewed. FDIC Chair Martin

Gruenberg acknowledged the report’s findings in an internal memo, pledging to implement its recommendations. Those recommendations included appointing an internal leader for cultural transition, hiring an external auditor to monitor progress, and implementing various other changes to policies and procedures.²²¹

However, Gruenberg himself faced criticism for his alleged “angry” leadership style and short temper. According to the report, the duration of Gruenberg’s time as Chair and the allegations made against him “may hinder his ability to establish trust and confidence in leading meaningful culture change.” This is made worse, the law firm argued, by his “apparent inability or unwillingness to recognize how others experience certain difficult interactions with him.”

Lawmakers, including Republican Rep. Patrick McHenry and Democratic Rep. Bill Foster, called for Gruenberg’s resignation in light of the report’s findings. “The independent report released today details his inexcusable behavior and makes clear new leadership is needed at the FDIC,” McHenry said.

Gruenberg said he remained committed to fostering a workplace where all employees feel safe and respected. “Hundreds of our colleagues reported painful experiences of mistreatment and feelings of fear, anger, and sadness,” Gruenberg wrote. “I accept the findings and recommendations of this report and thank the special review committee for their exhaustive work.

Ahead of Congressional hearings later that month, many speculated that Gruenberg’s response to questions regarding the investigation and the FDIC’s culture would decide his fate as leader of the agency.²²² However, despite being grilled by Republicans and some Democrats regarding whether he could truly lead the agency through a culture change, the majority of Democrats seemed to stand by Gruenberg.²²³ Some speculated, and indeed some Democrats seemingly confirmed during the hearings,

that their reticence to call for Gruenberg’s resignation was due to his key role in getting the “Basel Endgame” reforms discussed earlier in this section passed before the 2024 election.²²⁴

Nevertheless, on Monday of the following week, a key Democratic Senator and Chairman of the Senate Committee on Banking, Housing, and Urban Affairs, Sherrod Brown, called for Gruenberg to resign. “After chairing last week’s hearing, reviewing the independent report, and receiving further outreach from FDIC employees to the Banking and Housing Committee, I am left with one conclusion: there must be fundamental changes at the FDIC,” Brown wrote in a press release. “Those changes begin with new leadership, who must fix the agency’s toxic culture and put the women and men who work there — and their mission — first.”²²⁵

In an email to staff hours later, Gruenberg promised to resign once a successor had been named.²²⁶ This started a race on the part of Democrats and the Biden Administration to find a replacement nominee to try to get through Senate confirmations ahead of the election.²²⁷

In the meantime, House Financial Services Committee Chair Patrick McHenry demanded that Gruenberg testify before the committee on the culture issues at the FDIC, alongside Michael Hsu and Jonathan McKernan. Those hearings are scheduled for June 12, just after this report goes to print.²²⁸

For more updates on how this story develops over the coming months, we would encourage you to watch for our coverage on Starling Insights.

► **SEE STARLING INSIGHTS**

The scrutiny of regulators has not been reserved for stories that are quite so shocking. The FDIC has also faced some pressure to reform its treatment of innovation in the financial sector over the past year. In a letter sent to FDIC Chairman Martin Gruenberg in February 2024, top US House Financial Services

Committee Republicans questioned the shift in focus within the regulator’s innovation office, which has signaled a potential backtrack in fostering financial sector innovation.²²⁹

House Financial Services Committee Chair Patrick McHenry, alongside Subcommittee Chairs Andy Barr and French Hill, expressed concerns about changes to the FDIC’s “FDITech” office. The office was created in 2019 to encourage banks to embrace fintech advancements. However, it has seen a significant pivot under the current administration. Moving away from its original mission to promote external financial innovation, the FDITech office now focuses exclusively on technology adoption within the FDIC.

Additionally, the FDIC has been active in bringing enforcement actions against bank-fintech partnerships. This regulatory environment, toughened by guidance from other federal agencies, puts banks under pressure to manage risks associated with fintech collaborations more strictly. “We are concerned that the FDIC’s approach could, within the examination processes or otherwise, be used to prevent the development of innovative products and services that benefit consumers and businesses,” the Congressmen wrote.

Expansion of the Regulatory Perimeter

Over the past several editions of this report, we have highlighted how regulators in the US and abroad have sought to expand the regulatory perimeter to include firms that are outside the traditional financial sector, but which have a potential to impact the stability of the financial system as a whole. This has continued over the past year, and in this section we will discuss several related developments.

In August 2023, the Federal Reserve expressed concerns over Goldman Sachs’ partnerships with fintech firms, particularly in its transactional banking

division (TxB), citing such issues as inadequate due diligence and monitoring processes when accepting high-risk non-bank clients.²³⁰

Through TxB, Goldman provides banking infrastructure to fintech firms, including Stripe and Wise. According to people familiar with the matter, the division has shied away from fintech clients since the warning was issued. Notably, some TxB employees had reportedly expressed worries internally over a tendency to minimize risks prior to the Federal Reserve's involvement.

At a 2020 Investor Day, CEO David Solomon emphasized transactional banking businesses, like TxB, as offering promising growth opportunities. The business represented "an opportunity to leverage our pre-eminent corporate franchise, world-class risk management, and innovative culture to build modern digital products and, in the process, diversify our revenues and funding mix," he said then. The recent regulatory criticism is a setback to the bank's expansion efforts in this direction.

In September, the SEC approved a reform package that will significantly affect how the \$27 trillion private fund industry interacts with investors. The reforms, passed by a 3-2 vote, reflect the most substantial changes in over a decade for the lightly regulated and rapidly growing sector.²³¹ While the SEC has long had an oversight role over such non-traditional financial institutions, concerns over investor safety and financial resilience have led it to take a more active role in monitoring conduct and outcomes.

"Economically, our investors, large or small, benefit from greater transparency and integrity," SEC Chair Gary Gensler said after the vote. "These are significant enhancements in the capital markets." Private funds — which include private equity, venture capital, and hedge funds — are now required to furnish detailed quarterly performance reports and increased expense disclosures to institutional and

individual investors. Under the new rules, funds must also disclose the preferential treatment they give some investors and report on previously hidden fees.

In an interview at the Money20/20 Conference in October 2023, Acting Comptroller Michael Hsu discussed how the OCC is adapting its oversight to supervise the new "supply chain" of financial services. Hsu highlighted the increasing trend of banks outsourcing tasks to fintechs and vendors, creating complex, multi-layered relationships.²³²

"It's something we're going have to really grapple with, because I think the trend in banking, especially on payments, is more and more of this chopping up, if you will, of the different activities," he said. US bank regulators, including the OCC, had stepped up their scrutiny of third-party risk, issuing joint guidance in June 2023 that details how firms should monitor relationships with fintechs and other third parties.

"Essentially, they're going to be supply chains," Hsu said. "And I think we need to start thinking about it like a supply chain." While Banking-as-a-Service (BaaS) arrangements are relatively straightforward, more intricate partnerships involving multiple fintechs will receive greater scrutiny. Recognizing the rapid growth and constant change in the fintech space, the OCC has rebranded its Office of Innovation to the Office of Financial Technology.

"This is just part of the landscape," Hsu asserted. "Part of that is to keep up with the growth and complexity. I feel like we do have a pretty good overall sense of what's going on, but as we've talked about, it's complex, it's constantly changing. So just trying to stay on top of it does require a ton of energy."

In November 2023, the US Financial Stability Oversight Council (FSOC), led by the Treasury Department and comprising other major financial regulatory agencies, adopted a stricter oversight regime for non-banks like asset managers and hedge funds to address growing concerns about potential risks in the financial system.²³³



FROM THE Preamble to the 2023 Compendium

by Michael Hsu, US Acting Comptroller of the Currency

“Well-managed large banks support creditworthy households and businesses and the broader economy in invaluable ways. Growth and wealth generation at scale depend on large banks succeeding. At the same time, regulators need to hold them accountable. We have seen what happens when large banks become unmanageable and need government support to avoid disorderly failure.”



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The regulatory changes enabled regulators to designate non-bank firms as “systemically important financial institutions” (SIFIs), subjecting them to Federal Reserve oversight and stricter capital and liquidity requirements. The decision overturns a policy developed under the previous administration that focused on monitoring risky activities rather than singling out specific firms. While FSOC did not name any potential non-bank SIFIs, it is expected to focus on major global asset managers and hedge funds, such as BlackRock and Bridgewater.

In February 2024, Acting Comptroller Michael Hsu announced that regulators are exploring new operational resilience requirements for banks. “The federal banking agencies are considering what changes to our operational resilience framework might be appropriate,” Hsu said at a conference. “This

The federal banking agencies are considering what changes to our operational resilience framework might be appropriate.

MICHAEL HSU

is not a problem that capital or liquidity can solve... Ensuring that critical operations and banking services can withstand or recover from disruptive events requires good planning, prudent investment, well-designed systems and regular testing.”²³⁴

Hsu echoed his earlier arguments that banks now mirror manufacturing supply chains. And they face similar vulnerabilities, Hsu argued, as demonstrated by the banking turmoil of 2023 and cyber attacks against major banks. Banks face other threats as well, such as disruption to the physical data centers upon which their operations rely.

“The sheer magnitude of what can be disrupted has increased significantly—a trend likely to continue for the foreseeable future,” Hsu said. “As the threat surface for disruptions expands, and as authorities in other jurisdictions begin implementing their rules to ensure operational resilience, we are assessing and working with our interagency peers to develop the right approach here in the U.S.”

Also in February, Congressman Patrick McHenry, Chairman of the House of Representatives Financial Services Committee, reintroduced the Financial Services Innovation Act, which aims to promote innovation in the financial sector. The legislation, which was initially proposed in December 2022, would establish federal regulatory “sandboxes” through Financial Services Innovation Offices (FSIOs) within federal financial regulators.

These sandboxes would allow entrepreneurs to test new financial products and services while maintaining consumer protections.²³⁵

Companies could apply for enforceable compliance agreements with FSIOs, enabling them to operate under alternative compliance plans. “Technology has radically changed how consumers interact with the financial system, as well as how financial institutions

interact with regulators,” said McHenry. “This commonsense legislation will give entrepreneurs an opportunity to test legal and regulatory waters before taking new products and services to market.”

The bill mandates the creation of a FSIO Liaison Committee to facilitate cooperation among FSIOs and consultation with state regulatory entities. Additionally, the FSOC would be required to report on the impact of enforceable compliance agreements, identify burdensome regulations, and recommend measures to reduce regulatory overlap. “Innovators have long flocked to American markets because we strike the right balance between fostering innovation and consumer protection—this bill will help ensure the United States continues to lead the world in financial innovation,” McHenry added.

In a speech delivered the following month, Travis Hill, Vice Chairman of the FDIC, discussed the potential for tokenization to transform the financial system and emphasized the need for regulators to support innovation.²³⁶ Tokenization involves representing real-world assets, such as commercial bank deposits, on distributed ledgers, such as a blockchain. Hill outlined several potential benefits of tokenization, while also acknowledging the challenges and risks involved, such as regulatory uncertainty and concerns about bank runs.

“I recognize that sometimes it can be difficult for regulators to issue broadly applicable policy in areas where the technology is evolving quickly, but I think our goal should still be to provide as much clarity as is feasible regarding what is permissible and what we consider safe and sound,” he said.

Hill’s criticism of the regulatory approach to tokenization included a broader concern about financial regulation. In his speech he advocated

for a more transparent and responsive regulatory framework that fosters innovation while ensuring safety and soundness in the banking sector. He highlighted the need for policymakers to carefully consider the implications of their decisions on struggling banks and the broader financial system.

In April, the US House Financial Services Committee reported 13 pieces of legislation to the House of Representatives for consideration. Included in the package was the “Fostering the Use of Technology to Uphold Regulatory Effectiveness in Supervision (FUTURES) Act.” The FUTURES Act would require the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), Office of the Comptroller of the Currency (OCC), Consumer Financial Protection Bureau (CFPB), and National Credit Union Administration (NCUA) to assess the challenges and risks resulting from their outdated supervisory technologies (SupTech). The regulators would report their findings jointly to Congress, and again every five years thereafter.²³⁷

Technology has radically changed how consumers interact with the financial system, as well as how financial institutions interact with regulators.

CONGRESSMAN PATRICK MCHENRY

In a May 2024 speech, Michelle Bowman explained how regulators can “get comfortable with innovation” and better support industry efforts to innovate while minimizing risks to financial stability and consumers. “As a first principle, I would offer

‘understanding’ as a necessary predicate to promoting innovation,” Bowman said. “Before we craft a useful public policy around innovation in banking, we need to understand the various dynamics involved with particular innovations.”²³⁸

Innovation can take many forms, to include new technology, new business models, and enhancing existing infrastructure and processes. Regulators must understand the new technology that is being developed if they are to promote innovation effectively, Bowman argued. They must also

understand the players in the space and the “why” behind the innovation in order to assess any risks and tradeoffs.

“As a second principle, regulatory openness is a critical ingredient to fostering innovation in the financial system,” Bowman said. “The first reaction of regulators to proposed innovation in the banking system is often not one of openness and acceptance, but rather suspicion and concern.” There are certainly questions regulators must ask when considering the intended and unintended consequences of innovation, she acknowledged. And clear and consistent guardrails are needed to govern such activity. However, these concerns must be confronted if innovation is to flourish.

“Understanding and openness can go a long way to promoting innovation, but I think there are opportunities to do more,” she concluded. “This leads to my final principle, which is that regulators can do more to promote innovation. Regulators can do more than simply tolerate innovation, they can promote it through transparency and open communication.”

The crypto currency sector has also faced increased scrutiny from US financial regulators over the past year. Following a string of high-profile scandals, the industry has struggled with widespread skepticism and mistrust. In October 2023, the *Wall Street Journal* reported that this reputational crisis has made it difficult for firms to attract the very people who could help resolve it: legal and compliance personnel.²³⁹

Prior to the downturn in crypto enthusiasm in 2023, firms could easily poach legal professionals from other industries with higher pay and better perks. However, the collapse of FTX and a general distrust of the industry have made these roles much less appealing.

In November 2023, the CFTC announced that it had reached a settlement with Binance, alongside its founder and former CEO Changpeng Zhao, for charges of operating an illegal digital assets derivative

exchange. The proposed consent order would require that Binance pay a \$2.7 billion penalty, and that Zhao pay a \$150 million civil monetary penalty. The order also required that Binance improve its compliance controls and to demonstrate such improvements to regulators.²⁴⁰

“Binance’s activities undermined the foundation of safe and sound financial markets by intentionally avoiding basic, fundamental obligations that apply to exchanges, all the while collecting approximately \$1.35 billion in trading fees from U.S. customers,” said CFTC Chairman Rostin Behnam. “American investors, small and large, have demonstrated eagerness to incorporate digital asset products into their portfolios. It is our duty to ensure that when they do so, the full protections afforded by our regulatory oversight are in place, and that illegal and illicit conduct is swiftly addressed.”

Also in November, Zhao pleaded guilty to a felony for his failure to prevent money laundering through his crypto currency platform, as Binance agreed to pay \$4.3 billion to settle charges of violating the Bank Secrecy Act. “Using new technology to break the law does not make you a disruptor, it makes you a criminal,” US Attorney General Merrick Garland said of the case.²⁴¹

In December, a federal court approved the CFTC consent order against Binance and Zhao.²⁴² And, in April 2024, Zhao was sentenced to 4 months in prison, and was ordered to pay a previously agreed-to \$50 million fine. US District Judge Richard A. Jones credited Zhao for taking credit for his wrongdoing, but was troubled by the brazenness with which Zhao seemed to flaunt US banking requirements. “Better to ask for forgiveness than permission,” Zhao told his employees, according to prosecutors.²⁴³

“No person — regardless of wealth — is immune from prosecution or above the laws of the United States,” Jones said.

AI Fever

In recent years, AI has become ubiquitous across the financial sector and the corporate world more broadly. Herein, we will review some of the ways in which the technology is being utilized to manage risks and improve performance, discuss how some government agencies have sought to encourage such innovation, and how others appear more occupied with concerns regarding the risks these new technologies may present.

In an October 2023 interview with *Bloomberg*, Jamie Dimon, Chairman & CEO of JPMorgan Chase, asserted that AI will drastically impact the workplace, especially so at JPMorgan. Dimon said that AI has the potential to replace human roles in various sectors, as has occurred with several technological revolutions in the past. At JPMorgan, Dimon said that affected employees would be redeployed in different capacities. “We expect to be able to get them a job somewhere local in a different branch or a different function if we can do that, and we’ll be doing that with any dislocation that takes place as a result of AI,” Dimon said.²⁴⁴

AI also has the opportunity to drive massive improvements in productivity and efficiency and, as such, Dimon argued that AI will be integrated into every JPMorgan work process. But Dimon also called for regulatory guidelines to govern AI usage and prevent misuse by bad actors in the ecosystem. This comes as regulators and legislators globally are considering how to develop and administer such rules to minimize risk without stifling innovation.

In JPMorgan’s 2023 third-quarter earnings call, CEO Dimon expressed the bank’s ambition to become a global leader in the development and use of AI. In this direction, Dimon had recently appointed Teresa Heitsenrether as the Chief Data and Analytics Officer, overseeing AI initiatives across the organization, with a seat on the firm’s Operating Committee.

Dimon also stressed AI’s usefulness in risk, fraud, marketing, and improving customer service. “[T]he management team is getting better and better at saying, how can we use data to do a better job to reduce errors? To serve clients better? To have a salesperson have copilots, that they know why even the client’s calling or something like that,” Dimon said. “And so we simply have to do it. Does it create opportunity for disrupters to come in? Yes, of course. That’s always the truth of technology and — but we’ll be quite good at it.”²⁴⁵

JPMorgan is not alone in these ambitions. Banks are increasingly turning to AI to augment their capabilities across the organization. In June 2023, Google Cloud launched “Anti Money Laundering AI,” a new product that utilizes artificial intelligence to help financial services firms identify potentially risky transactions and customers.²⁴⁶

The tool aims to replace the rules-based programs typically used for anti-money laundering (AML) surveillance. Instead, it leverages machine learning to help financial institutions to comply with regulations and to identify potentially suspicious activities. Such AI tools can work with a speed, scale, and rigor far in excess of that which human beings can achieve. The outputs of such machine learning tools can therefore better inform the exercise of human judgment.

One notable user is the global bank HSBC. According to Jennifer Shasky Calvery, HSBC’s group head of financial crime risk and compliance, the technology developed by Google Cloud represents a “fundamental paradigm shift in how we detect unusual activity in our customers and their accounts.”

Traditionally, financial institutions’ AML tools flag either too little or too much activity, depending on how they are calibrated. Both extremes have a significant and often negative impact on the company. Google Cloud’s AI-first approach reduces the number of alerts while increasing accuracy. HSBC, for

example, experienced a 60% reduction in the volume of alerts and two to four times more accurate positive identifications.

In another example, Workday, one of the world's largest HR software providers, announced in late 2023 that it would introduce AI-driven products to assist banks in streamlining the annual review process. These tools use generative AI to automate tasks such as writing job descriptions and evaluating employee performance to enhance efficiency and reduce costs for financial institutions.²⁴⁷

The performance appraisal process has long been derided as time-consuming, and many HR executives consider it an ineffective use of managers' time. "You have 100 employees and it takes seven hours to write a job description, so 700 hours, now it takes two minutes," said Workday co-CEO Carl Eschenbach in an interview with Bloomberg. "There's quantifiable impact you can have through the use of AI."

The move aligns with industry efforts to leverage technology for operational efficiency. Citigroup is among the banks exploring AI's potential for increasing workforce productivity. For example, it is planning to enable its 40,000 coders to experiment with AI by the end of the first quarter of 2024. "We are conservatively thinking we'd expect to see at least 10% productivity uplift from them," CEO Jane Fraser said at a Conference in Hong Kong in November.

The US government has also announced several initiatives that seek to facilitate the adoption of AI, and to ensure that government agencies are able to use it to its fullest potential.

In August 2023, the Office of Management and Budget (OMB) and the Office Of Science and Technology Policy (OSTP) issued a memorandum detailing the Biden administration's research and development priorities to guide federal agencies as they formulate their budget submissions for the fiscal year 2025.²⁴⁸

"Because Federal research and development (R&D) is integral to the just, vibrant, and ambitious future that America seeks, President Biden is prioritizing R&D funding and mobilizing America's powerful R&D ecosystem," the OMB and OSTP wrote. "To make its vital contribution to our future, federal R&D must sustain America's leadership position in science and technology."

The memorandum highlighted that federal R&D is crucial for driving innovation and creating new opportunities across different sectors. It also stresses that this investment must translate into tangible outcomes such as new products, industries, jobs, policies, regulations, or practices.

A key priority of the Biden administration is advancing reliable AI technology that safeguards individuals' rights and safety while leveraging its potential to expedite national progress. "AI is one of the most powerful technologies of our time," the memorandum read.

The federal government has the potential to fill multiple essential roles, including mitigating AI risks and using AI technology to better deliver on the wide range of government missions, advance solutions to the nation's challenges that the private sector will not address on their own, and tackle societal challenges.

In October 2023, President Biden issued an Executive Order aimed at ensuring that the US can seize the promise and manage the risks associated with AI. The executive order included a number of provisions aimed at achieving six main objectives: establishing standards for AI safety and security, protecting users' privacy, advancing equity and civil rights, standing up for consumers and workers, promoting innovation and competition, furthering the US' leadership position, and ensuring responsible and effective government use of AI.²⁴⁹

However, not all government authorities have such a rosy view of the potential of AI to be a force for good. In December 2023, the SEC Examinations Division reportedly requested information from several investment advisers on how they are utilizing AI in marketing, portfolio management, compliance training, and other areas. The agency's sweep came as its chair, Gary Gensler, had repeatedly expressed skepticism about the technology and warned that it could lead to a financial crisis.²⁵⁰

However, many top banks and investment advisers have already deeply integrated AI into processes across their organizations. For example, Blackrock, Fidelity, and JPMorgan have all made substantial investments in advanced AI research. "The use of these kinds of technologies is already so widespread that I think it would be quite difficult for the commission to put the brakes on," Amy Jane Longo, a Partner at law firm Ropes & Gray, told the *Wall Street Journal*.

That same month, the FSOC identified the growing use of AI as a significant risk to financial markets in its annual report. However, the group of regulators also acknowledged the potentially transformative benefits of AI if these risks are managed effectively.²⁵¹

Treasury Secretary Janet Yellen, who leads the FSOC, called AI an "emerging threat" but also expressed confidence in existing regulations to manage potential risks. "Supporting responsible innovation in this area can allow the financial system to reap benefits like increased efficiency, but there are also existing principles and rules for risk management that should be applied," she said.

In its "Annual Regulatory Oversight Report," published in January 2024, the Financial Industry Regulatory Authority (FINRA) labeled AI as an "emerging risk." While briefly acknowledging the promise of AI, the self-regulatory authority urged firms to exercise caution before jumping headlong into adopting the new technologies.²⁵²

"As in other industries, broker-dealers and other financial services industry firms are exploring and deploying these technologies—either with in-house solutions or through third parties—to create operational efficiencies and better serve their customers," FINRA wrote. "While these tools may present promising opportunities, their development has been marked by concerns about accuracy, privacy, bias and intellectual property, among others."

FINRA emphasized the implications AI could have on firms' regulatory obligations, including in matters related to anti-money laundering, business continuity, model risk management, research, and other areas. "The use of AI tools could implicate virtually every aspect of a member firm's regulatory obligations, and firms should consider these broad implications before deploying such technologies," FINRA added.

FEDERAL RESERVE BOARD

In November, the Fed released its semi-annual supervision and regulation report. Therein, the Board outlines its regulatory and supervisory efforts throughout 2023. In the report, the FRB explained that it was taking steps to enhance the "speed, force, and agility" of its supervision to "reflect lessons learned from the recent large U.S. bank failures and its supervision of Silicon Valley Bank."²⁵³

While the report gave examples of these efforts regarding the supervision of financial risk management, it is unclear if these efforts also target the supervision of non-financial risks, which have been widely acknowledged as central among the root causes of the 2023 bank failures.

The report also showed that outstanding supervisory findings at large financial institutions, representing unresolved issues raised through supervisory activity, had increased over the last year. Notably, approximately two-thirds of these outstanding findings related to governance and controls deficiencies. An ability to take effective supervisory

action must be complemented by a *readiness* to do so and, as many of the post-2023 turmoil studies have reported, such a readiness to take escalating supervisory action is itself a culture factor that warrants attention.

As the Barr report observed, in the lead up to the collapse of SVB, “Individual examiners and supervisors often identified core issues but then failed to take collective action.” In itself, this suggested “an opportunity to shift the culture of supervision toward a greater focus on inherent risk, and more willingness to form judgments that challenge bankers with a precautionary perspective.”²⁵⁴

In this connection, the Barr report also noted that “supervisors in other jurisdictions have developed approaches based in behavioral science that incorporate data on institutional attitudes and norms related to risk factors, such as complacency, overconfidence, short-term focus, and lack of effective challenge that can reveal institutional blind spots and contribute to vulnerabilities like those seen at SVB.” The Fed, the report suggested, might benefit by investigating the value of such tools through a pilot program.

Innovation

In December 2023, Michael S. Gibson, Director of the Division of Supervision and Regulation at the FRB, testified before the US House of Representatives Subcommittee on Digital Assets, Financial Technology, and Inclusion. In his testimony, Gibson stressed the regulator’s dedication to fostering responsible innovation in the financial sector.²⁵⁵

“We recognize that innovation can reinforce the safety and soundness of banks and the stability of our financial system, increase operational efficiencies, and reduce costs,” he said.

We recognize that innovation can reinforce the safety and soundness of banks and the stability of our financial system, increase operational efficiencies, and reduce costs.

MICHAEL S. GIBSON

However, innovation also inherently creates new risks. The FRB and other bank regulatory agencies adhere to overarching principles in their approach to supervising and regulating innovation in banking, Gibson explained. These principles include treating activities with fundamentally similar risks equally, irrespective of the technology or terminology used. The Federal Reserve also emphasizes transparency in expectations and approaches to supervision, communicating through various channels to guide responsible innovation.

Gibson explained that the Federal Reserve has instituted a Novel Activities Supervision Program (NASP) focused on overseeing risks associated with technology-driven activities, including crypto-assets, distributed ledger technology, and complex bank partnerships with nonbank fintechs. The program aims to provide clarity and feedback to supervised institutions, encouraging them to harness innovations while maintaining safety and soundness.

“The Federal Reserve is committed to supporting responsible innovation so that the financial system and the public can enjoy the many benefits innovation can offer,” Gibson concluded. “At the same time, we are mindful of our mission to keep the financial system safe and sound and so are focused on ensuring that any risks associated with novel financial products and services are properly managed.”

FEDERAL RESERVE BANK OF NEW YORK

In December 2023, the Federal Reserve Bank of New York released a new season of its Bank Notes podcast entitled “Banking Culture Reform: Building Cultures of Curiosity and Learning.” The four-episode series explored various techniques for cultivating

organizational cultures that encourage curiosity, enable employees to speak up, and address factors hindering optimal performance.²⁵⁶

In a speech delivered at an industry conference in March 2024, James Hennessy, Head of the Governance and Culture Reform Initiative at the NY Fed, highlighted the progress made in addressing organizational culture within the financial services industry over the past decade.²⁵⁷

“Culture has evolved from a somewhat nebulous topic to one that is considered a central component of risk management and business success,” Hennessy said. “Looking ahead, technological advances promise to enhance how culture data are collected and interpreted, thereby supporting better diagnosis and interventions, and more desirable outcomes.”



FROM OUR 2020 Compendium

Culture & Governance Reform Initiatives at the NY Fed

by **James Hennessy**,
Senior Vice President,
New York Fed

“The New York Fed’s efforts have raised and sustained awareness among industry participants of the relevant issues related to culture and behavior in financial services firms and led to broader partnerships supporting better practices. Yet, as long as major instances of misconduct persist, the New York Fed will continue to shine a spotlight on the issues and find ways to fuel greater progress.”



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Hennessy discussed the NY Fed Governance and Culture Reform Initiative’s three strategic pillars: Awareness & Dialogue, Education & Research, and Supervision & Governance. In its work in these areas over the previous year, the Initiative gathered several key insights around driving effective culture change. These include:

- The role of culture assessments, and especially those involving real-time data, in facilitating culture transformation;
- How communicating clear expectations for culture helps employees understand the benefits of culture change;
- Why psychological safety is essential to facilitate bottom-up communication;
- What managers can do to serve as “culture carriers” to normalize these speak-up behaviors; and
- The importance of non-financial incentives — including gratitude, respect, and purpose — in promoting desired behavior.



FROM OUR 2022 Compendium

Education and Ethics

by **James Hennessy**, Senior
Vice President, and **Thomas
Noone**, Counsel and Assistant
Vice President, New York Fed

“In this article, we will introduce you to the [Education and Industry Forum]. 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.”



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**FROM OUR
2021 Compendium**

**Organizational culture:
One central bank
lawyer’s perspective**

by **Michael Held**
**Past-General Counsel,
New York Fed**

“Although we did not know for certain what the root causes of misconduct were, we had credible suspicions — many of which were shared by others in central banks, government, academia and even the private sector — that organizational culture played a material role.”



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“I am heartened that so many members of the industry see culture as an important component of its success,” Hennessy concluded. “I encourage your efforts to make progress and build healthier cultures in finance on a global scale.”

In a blog post published in April, NY Fed researchers Beverly Hirtle and Anna Kovner explored the impact of supervision on banks, the financial system, and the economy. “In March of 2023, the U.S. banking industry experienced a period of significant turmoil involving runs on several banks and heightened concerns about contagion,” Hirtle and Kovner wrote. “While many factors contributed to these events—including poor risk management, lapses in firm governance, outsized exposures to interest rate risk, and unrecognized vulnerabilities from interconnected depositor bases, the role of bank supervisors came under particular scrutiny.”²⁵⁸

Culture has evolved from a somewhat nebulous topic to one that is considered a central component of risk management and business success.

JAMES HENNESSY

Many discussions surrounding banking regulation and supervision use the terms interchangeably, but Hirtle and Kovner emphasized that these are distinct activities. Regulation involves setting the rules under which banks will operate. Supervision, on the other hand, involves monitoring banks to ensure they comply with those rules and act in a safe and sound manner more generally. “[S]upervision also involves qualitative assessments of banks’ internal processes, controls, governance and risk management—and taking enforcement actions when weaknesses are discovered,” they wrote.

While much less research has been conducted on the impact of supervision than regulation, a growing body of empirical research shows that — within reasonable boundaries — supervision reduces excess risk-taking without impacting performance or growth. “These findings suggest that supervision reduces the risk of bank failure, with little cost to bank profitability,” Hirtle and Kovner wrote. Some research has found that increased supervision does reduce loan origination or loan growth. However, the magnitude of this effect is unclear.

“One important caveat to these findings is that they were estimated at levels of supervision prevailing at the time of the analysis,” they cautioned. “It is possible (and even likely) that the free lunch suggested in the positive relationship between supervision and risk without significant impact on growth may not hold if supervision were dramatically increased from those levels.”

OFFICE OF THE COMPTROLLER OF THE CURRENCY

In June 2023, the OCC requested comment on a proposed annual survey that seeks to understand, measure, and track public trust in banking and bank supervision. The OCC invited customers, academics, industry participants, other regulators, and others to comment on the scope of the survey, the drivers of trust, and how trust can be assessed and tracked over time.²⁵⁹

“The OCC recognizes the public’s trust in banks is an important aspect of a thriving and stable banking system,” the request read. “By surveying the public, the OCC can use the results to identify areas where trust can be further enhanced and gain insight into the many aspects that are important to consider in working to maintain and enhance trust in banking and bank supervision.”

The OCC recognizes the public’s trust in banks is an important aspect of a thriving and stable banking system.

In an interview with the *Wall Street Journal* in July, Hsu repeated his previously expressed concern that some US banks had become “too big to manage,” stating that they must demonstrate their ability to address risk management issues or face potential breakup.²⁶⁰

According to Hsu, the burden falls on the banks themselves to prove their viability by resolving long-standing problems. “What we’ve experienced is that some large banks can’t do that well,” Hsu said. “That’s a sign that management either needs a new strategy, or there needs to be new management, or if neither of those works, the firm needs to be simplified.”

Hsu stated that his office does not have a definitive list of banks facing potential action, but added that they closely monitor institutions and maintain constant communication to assess their progress and remediation efforts. He emphasized the importance of proportionate measures based on the severity of the issues.

The growth of banks can lead to a state of being “too big to manage,” where individual problems may seem small due to the sheer size of the bank’s capital base, necessitating systematic and comprehensive approaches to address weaknesses. “If you double the size of your firm, every problem becomes half as big,” Hsu lamented. “That’s not right. And I think the banks that are well managed know that that’s not right.”

In its Fall 2023 “Semiannual Risk Perspective,” the OCC reported that the overall strength of the federal banking system remains robust, but cautioned firms to remain vigilant and adhere to prudent risk management practices. In that connection, the OCC identified AI as an emerging area of risk and opportunity for banks and the financial system as a whole.²⁶¹



FROM THE Preamble to the 2023 Compendium

by Michael Hsu, US Acting Comptroller of the Currency

“A well-calibrated enforcement framework gives banks sufficient opportunities to address deficiencies. A bank’s repeated failures to do so then become, by themselves, presumptive evidence that it is at the limits of its manageability.”



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“Developments in the technology may reduce costs and increase efficiencies; improve products, services, and performance; strengthen risk management and controls; and expand access to credit and other banking services,” the OCC wrote. “Widespread adoption of AI, however, may also present significant challenges relating to compliance risk, credit risk, reputation risk, and operational risk.”

Consistent with its supervisory guidance for other matters, the OCC emphasized the importance of managing AI use in a safe, sound, and fair manner. “It is important for banks to identify, measure, monitor, and control risks arising from AI use as they would for the use of any other technology,” it asserted. “Advances in technology do not render existing safety and soundness standards and compliance requirements inapplicable.”



FROM OUR 2021 Compendium

An Interview with
Brian Brooks, past-
Acting Comptroller
of the Currency

“A healthy risk culture is critical to the safe and sound operation of a bank and that culture starts at the top. The OCC’s heightened standards for large banks make it clear that executives are responsible for fostering a healthy risk culture. It’s something examiners are trained to look for, and it something the agency discusses with the executive teams and directors of the institutions it supervises at every opportunity.”



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Entities have a
responsibility to assess
the character and
fitness of executives.

ADRIENNE A. HARRIS

The OCC’s report also explored the other key risks facing the banking system. This includes heightened operational and compliance risks, which made up 42% and 23%, respectively, of the OCC’s open supervisory actions in the form of matters requiring attention (MRAs).

NEW YORK DEPARTMENT OF FINANCIAL SERVICES

In January 2024, the New York Department of Financial Services (NYDFS) issued final guidance on how banks and other financial institutions in New York State should review the character and fitness of their directors and executives.²⁶²

“New York consumers and businesses should feel confident that their money is being managed by ethical and law-abiding individuals,” said Superintendent Adrienne A. Harris. “Entities have a responsibility to assess the character and fitness of executives not just upon hiring, but on an ongoing basis to protect consumers and ensure the safety and soundness of the institution.” ▶ **PAGE 183**

The final guidance included expectations that financial firms:

- Update their policies and procedures to require vetting of Designated Persons at onboarding and on a regular ongoing basis;
- Inform the NYDFS promptly if they determine that a previously vetted Designated Person is no longer fit to perform their current function;
- Vet each Designated Person at the time that they become a Designated Person; and
- Define indicators that warrant additional scrutiny; for example, if the individual held a senior position at an institution subject to a regulatory action or proceeding.

The NYDFS also provided suggested questions that firms can use when assessing character and fitness. The proposed questions range from asking about the person's professional history to inquiring about their personal indebtedness and legal problems.

"Protecting the safety and soundness of regulated entities is core to the Department's mission and mandate, and a compromised director, officer, or manager can threaten an organization's safety and soundness at any time during that individual's service," the NYDFS wrote in its guidance. "Regular and rigorous character and fitness assessment of key personnel is an important tool for regulated institutions to control and mitigate this risk."

SECURITIES AND EXCHANGE COMMISSION

In a speech delivered to the New York City Bar Association in October 2023, Gurbir S. Grewal, the Director of the Division of Enforcement for the SEC, discussed declining public trust in institutions and how it affects the financial sector.

"It undermines the investor confidence needed for the fair, efficient, and orderly operation of our markets and for capital formation," he said. Grewal highlighted the SEC's role in enhancing trust and pointed to its 2023 fiscal year-end results, which indicated a productive year for the Enforcement Division in protecting investors.

Grewal stressed, however, that reversing the trust deficit requires collaborative efforts, emphasizing the need to build a "culture of proactive compliance." Compliance professionals, consultants, attorneys, and others are the first line of defense against misconduct, he argued.

According to Grewal, there are three key components of a culture of proactive compliance: education, engagement, and execution. He also stressed the importance of continuous efforts as businesses

evolve, enforcement priorities change, and new regulations emerge. Additionally, he encouraged cooperation and self-reporting when securities law violations are detected, which can result in substantially reduced penalties.

Audit Culture

In a December 2023 interview with the *WSJ*, Paul Munter, Chief Accountant at the SEC, explained the Commission's focus on the culture of audit firms and how it can drive audit quality and conduct outcomes. "The culture of the firm has to be one that cascades throughout the firm," Munter said. "It can't be just that the audit practice is responsible for auditor independence."²⁶³

Several high-profile conduct scandals in the audit industry in recent years have brought the importance of culture to the forefront, Munter explained. "Someone might characterize each one of these as one-offs," Munter said, "but when you see a number of these happening in close proximity to one another, it's troubling, and we thought it was an appropriate time to reinforce messaging about the importance of firm culture and that being a question not just with the audit practice, but for the entire firm, and network for that matter."

Munter also pointed to risk assessment processes as a primary area of concern for the SEC, both for audit firms and their clients. "You can't think about that separate and apart from financial reporting because obviously financial reporting is trying to inform investors about your business and what the risks are and obviously what the financial consequences of the business are," Munter said. As such, auditors must think about the effectiveness of their clients' risk assessment processes, which will help them to analyze the risk of material misstatement in financial reporting more accurately.

PUBLIC COMPANY ACCOUNTING OVERSIGHT BOARD

In a December 2023 speech, George R. Botic, a Board Member at the PCAOB, emphasized the importance of audit quality and the need for a sense of collective responsibility among all stakeholders — including audit firms, audit committees, public companies, regulators, and academics — in maintaining it.²⁶⁴

“I submit to you that each one of these candidates represents a unique link of the financial reporting chain and each has a duty to ensure the performance of high-quality auditing,” Botic said. “A few have a more clear and direct responsibility for audit quality, such as the auditing profession and audit committees, while other links in the chain are more indirect. But make no mistake, each plays a part in ensuring the auditing profession’s ability to execute high quality audits year after year.”

Botic highlighted the role of audit firm culture in driving the employee behavior necessary to ensure consistent, high-quality effort. A sound culture would also help prevent other misconduct concerns plaguing audit firms globally, such as exam cheating, Botic asserted. “Without maintaining a keen unrelenting focus on the importance of audit quality, a firm’s culture may not embody what the organization wants to project nor what investors expect,” he said.

Botic pointed to employee behavior, management decisions, and formal systems as key aspects of the “written and unwritten” rules that make up culture. Firm leadership, he asserted, should periodically assess the state of their organization’s culture to determine if it is supportive of high-quality audits and other desired outcomes.

“Unfortunately, I suspect what many firms will likely find, particularly regarding the unwritten rules, is that audit quality is not front and center,” Botic said.

I suspect what many firms will likely find, particularly regarding the unwritten rules, is that audit quality is not front and center.

GEORGE R. BOTIC

“Ideally, a firm’s culture inspires every member of each audit engagement team to start their day with an objective that they will do one thing to improve the quality of the audit. Consider the power of that.”

That same month, the PCAOB published its “Staff Priorities for 2024 Inspections and Interactions With Audit Committees.” Therein, the audit regulator laid out its plans to increase scrutiny of audit firms’ cultures in the coming year.²⁶⁵

“Audit firms continue to face challenges delivering quality audits as evidenced by (1) the increasing trend of audit deficiencies in recent years, and (2) deficiencies identified that have recurred for numerous years,” the PCAOB wrote. “We are interested in why these deficiency trends are not improving and whether audit firms’ cultures are playing a role in this failure to improve.”

In this direction, the PCAOB established a small team to evaluate the culture across US Global Network Firms, comprising the Big Four, BDO, and Grant Thornton. “This initiative includes interviewing firm personnel and evaluating other documentation, as deemed necessary, as part of our [quality control] procedures,” the regulator wrote. The information gathered through these inspections will inform the PCAOB’s understanding of firm culture and how it impacts audit quality outcomes. The aggregated results will also be included in a future publication.

In April 2024, the PCAOB proposed a set of Firm and Engagement Performance Metrics, previously called Audit Quality Indicators, which would require that auditors report more data to allow companies and investors to make an informed decision when choosing and ratifying an external auditor.²⁶⁶

“Sound and consistent information bolsters confidence in our capital markets, and can drive audit quality,” PCAOB Chair Erica Williams said. “Informed by extensive study and stakeholder input, today’s proposals would strengthen PCAOB oversight and equip investors, audit committees, and others with clear, consistent, and actionable data related to the audit.”

Some of the proposed metrics, which focus on both firm- and engagement-level data, include:

- partner and manager involvement;
- workload;
- audit personnel experience;
- audit hours and risk areas (engagement only);
- quality performance ratings and compensation (firm only); and
- restatement history (firm only), among others.

In May, the PCAOB published a staff report discussing how undertaking root cause analyses (RCAs) when audit deficiencies are uncovered could improve audit quality. Developing an understanding of why a deficiency occurred can allow firms to incrementally improve their systems of quality management, the PCAOB argued, which in turn drives improved audit quality.²⁶⁷

The report provided several characteristics of a well-designed RCA process, which include a dedicated team, relevant guidance and training, and effective data gathering and tools. “The PCAOB strongly encourages firms to assess the underlying root causes of a deficiency so that the deficiency can be effectively addressed and ultimately remediated and eliminated,” the PCAOB said. “RCA is an important procedure that many audit firms use to evaluate the adequacy of and compliance with their quality control system.”

That same month, the PCAOB’s board voted to bolster the requirements for firms’ audit quality control systems, which will come into effect in December

2025 pending SEC approval. Under current audit quality control rules, auditors are required to have policies and procedures to cover such areas as ethics and audit-engagement performance. The PCAOB then inspects the firms’ approaches to audit quality control amid its other supervisory work.²⁶⁸

Under the new requirements, audit firms will be required to take a risk-based approach, assessing the risks to their audit quality controls and designing procedures to address those risks. Firms will then be required to report on its audit quality control policies and procedures, with the oversight and certification of two leaders in the organization, to the PCAOB.

“Simply designing elaborate processes on paper won’t be enough,” Chair Erica Williams said. “Firm leadership will have a personal stake in delivering results and additional incentives to fix problems quickly.”

However, some have expressed concern at the lack of specificity surrounding the risk-based approach. The PCAOB’s Investor Advisory Group worried that it would allow firms to design ineffective systems that are easily certified, while the Center for Audit Quality, an industry-led audit quality advocate, argued that the PCAOB should provide more specific audit quality objectives for firms to meet.

DEPARTMENT OF JUSTICE

In a September 2023 speech, Marshall Miller, Principal Associate Deputy Attorney General at the Department of Justice (DOJ), announced the appointment of the DOJ National Security Division’s first Chief Counsel for Corporate Enforcement, Ian Richardson. This appointment is part of the Department’s heightened focus on punishing sanctions evasion and other corporate crimes that have national security implications.²⁶⁹ In his new role, Richardson will oversee cases involving corporate crimes impacting US national security.

“We’ve determined that it’s necessary for the department to infuse significant amounts of resources into national security, corporate investigations, and prosecutions,” said Marshall Miller, principal associate deputy attorney general at the Justice Department.

The National Security Division is also in the process of enlisting 25 new prosecutors who will be tasked with tackling sanctions evasion and export control violations. Additional resources will be added to the money laundering and asset-recovery section’s bank integrity unit.

Miller emphasized the growing nexus between national security concerns and corporate misconduct.

Recent cases, such as French cement firm Lafarge’s involvement with terrorist groups²⁷⁰ and British American Tobacco’s sanctions violations,²⁷¹ highlight this trend. “We’re looking at all kinds of different ways that that’s happening, from cybercrime, to export control violations to intellectual property crime,” he said.

In a speech delivered in October 2023, Deputy Attorney-General Lisa Monaco announced that companies which voluntarily disclose misconduct committed by businesses they are acquiring would not face charges. The disclosure must, however, occur within six months of the deal’s closure, and the acquiring company must rectify the misconduct within a year, with specific timelines subject to prosecutors’ discretion. “We want to incentivise that type of responsible corporate behaviour,” Monaco told the *Financial Times*.²⁷²

The DOJ’s move reflects a heightened focus on corporate malfeasance with national security implications in an era of greater complexity and geopolitical risk for multinational corporations. The policy formalizes measures previously implemented on a case-by-case basis and follows a 2008 advisory opinion related to Halliburton’s acquisition of a UK company.

“We’ve seen a real uptick in the number of our major corporate criminal resolutions that implicate our national security,” Monaco said. She has spearheaded broader enforcement reforms, emphasizing voluntary self-disclosure, considering historical misconduct, holding individuals accountable, and limiting deferred prosecution agreements.

In March 2024, Deputy Attorney General Lisa Monaco announced that the DOJ would introduce a pilot program offering financial rewards to whistleblowers who report corporate crimes. Aiming to enhance cooperation with tipsters, the initiative will utilize funds from defendants’ forfeited assets.²⁷³

Monaco cited the success of similar programs, such as the one run by the SEC, which awarded nearly \$600 million to whistleblowers in 2023. “Going back to the days of ‘Wanted’ posters across the Old West, law enforcement has long offered rewards to coax tipsters out of the woodwork,” Monaco said. “Now’s the time to expand our use of this tool in corporate misconduct cases and apply it to reward whistleblowing.”

While such programs exist in other agencies like the Commodity Futures Trading Commission (CFTC) and the Internal Revenue Service, the Justice Department aims to tailor its program to address gaps in existing frameworks, particularly concerning business corruption and private companies not overseen by the SEC.

The DOJ has also made clear that it intends to reward companies for self-reporting misconduct. These programs put a premium on firms’ ability to establish a speak-up culture, where employees feel safe to raise issues internally rather than reporting them to regulators.

In April, the DOJ announced a pilot program through which it would offer immunity to executives and lower-level employees who provide information about corporate misconduct in which they themselves

participated. To be eligible, an individual must voluntarily provide original information, cooperate fully, and forfeit any profit they earned from the scheme. "The department is upping the ante...by increasing the incentives for others to come forward," said Nicole Argentieri, Head of the DOJ's criminal division. "Call us before we call you."²⁷⁴

Innovation

In February, the DOJ named Jonathan Mayer, a Princeton University computer scientist and lawyer, as its first Chief Artificial Intelligence Officer and Chief Science and Technology Adviser. Mayer will lead the Department's efforts to build out its technological capacity and advise leadership on issues related to technology and AI.²⁷⁵

"Jonathan's expertise will be invaluable in ensuring that the entire Justice Department —including our law enforcement components, litigating components, grantmaking entities and U.S. Attorneys' offices — is prepared for both the challenges and opportunities that new technologies present," said Attorney General Merrick Garland.

Canada

OFFICE OF THE SUPERINTENDENT OF FINANCIAL INSTITUTIONS

In recent past years, the Office of the Superintendent of Financial Institutions (OSFI) has emerged as a global leader in the regulation of culture and conduct concerns in the financial sector — innovating in ways few other agencies are. For example, in February 2023, OSFI published its "Culture and Behaviour Risk Guideline," a principles-based, outcomes-focused set of guidance for how firms can manage the risks associated with culture and behavior more effectively.²⁷⁶

Given the importance of culture to shaping behavior, and thus to safety, soundness, and reputation, OSFI wrote that it expects firms to define their desired culture, to work continually to improve culture in support of organizational purpose and strategy, and to evaluate and respond to behavioral risks. The Guideline set forth three principal outcomes towards which firms should aim:

- Culture and behavior are designed and governed through clear accountabilities and oversight;
- Desired culture and expected behaviors are proactively promoted and reinforced; and
- Risks emerging from behavioral patterns are identified and proactively managed.



FROM OUR 2022 Compendium

An Interview with Peter Routledge, Superintendent of Financial Institutions

"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."



[CLICK HERE to READ MORE](#)

To govern culture properly, OSFI suggested that these structures should be proportional to the size, nature, scope, complexity of operations, strategy, and risk profile of the institution. They should also support the design and development of culture, apply consistently

across the institution, and remain current through reviews and updates. OSFI expects institutions to utilize “leadership, talent and performance management practices, and compensation and incentive plans to promote and/or reinforce their desired culture and expected behaviours.”

Lastly, to assess for behavioral risks, OSFI wrote that firms should identify behavioral patterns, and when these patterns do not match expected behaviors, firms should work to uncover root causes, potential impacts, and unintended consequences, and to discover whether the behavior is widespread. Once understood, firms should work to mitigate those deviating behavior patterns.

In October 2023, OSFI issued two consultative guidelines aimed at improving the resilience and security of the country’s financial system by addressing non-financial risks, including those stemming from culture and behavior.

The first new guideline seeks to mitigate the likelihood of integrity and security failures, which can impact the safety and soundness of financial institutions and undermine public confidence. “Failure to comply with ethical standards, regulations, and the law may increase the risk of a physical or electronic security breach,” OSFI writes. “In turn, failure to appropriately protect physical or electronic security may be rooted in a lack of integrity and constitute not only a security failure, but breach of ethical standards, regulations, or the law.”²⁷⁷

OSFI expects that financial firms enhance integrity by:

- Ensuring employees are of good character;
- Promoting a corporate culture conducive to ethical behavior;
- Assuring sound governance in connection with decision-making, actions (and omissions); and
- Verifying that these are in keeping with relevant standards, regulations, and laws.

The second guideline, Enhanced Guideline E-21 on Operational Resilience and Operational Risk Management, focuses on business continuity, crisis management, change management, and data risk concerns. Here, too, OSFI stresses the importance of culture. “Senior management should promote and reinforce behaviours supporting operational resilience and proactively manage culture and behaviour risks influencing resiliency, as an institution’s culture can impact its ability to withstand and mitigate operational disruptions,” OSFI writes.²⁷⁸

In January, the agency published its final guideline on Integrity and Security. The guidance laid out the regulator’s expectations for how financial institutions can protect themselves against threats to their integrity and security and maintain public trust. “Resilience and trust in the financial system depend upon the integrity and security of financial institutions,” said Peter Routledge, the Superintendent of Financial Institutions. “Though much work remains, this guideline serves as an important, initial step towards enhancing integrity and security in the financial system.”²⁷⁹

In February, OSFI published its new Supervisory Framework, which it said was the largest change to its supervisory approach in 25 years. Some of the most substantial reforms include expanding the risk-rating scale from four to eight points, allowing for an earlier warning to firms when OSFI’s risk assessment changes, and introducing new risk assessment categories. These new categories are: business risk, financial resilience, operational resilience, and risk governance. The risk assessment also integrates climate change considerations.²⁸⁰

Notably, through its aforementioned reforms, OSFI has made it clear that it sees culture as a key contributor to good outcomes in both operational resilience and risk governance. And, indeed, OSFI made clear in its new supervisory framework that

a key aspect of its risk governance assessment will be firms' adherence to the "Culture and Behaviour Risk Guideline."

"We are launching a new supervisory framework on April 1, 2024, to ensure a faster, more effective response to critical risks faced by federally regulated financial institutions and private pension plans," Superintendent Peter Routledge wrote in a related press release. "The new framework will enhance the transparency of OSFI's risk assessments and thereby deepen the resilience of the Canadian financial system."

In an interview with *Banking Risk and Regulation* in April, Ben Gully, Deputy Superintendent at Canada's Office of the Superintendent of Financial Institutions (OSFI), discussed the regulator's focus on non-financial risks in its new supervisory framework. "On the risk front, we've moved from a classic financial risk approach to one where we are in the arena of non-financial risks — climate, technology, cyber and geopolitical," Gully said. "This view of financial strength and control needs to be augmented with broader notions of resiliency, both operational and financial. It is an approach that is more focused on outcomes, rather than on inputs alone."²⁸¹

While effective measurement of non-financial risk remains a challenge, OSFI's framework seeks to address management, strategy, contingency, and adaptability regarding these risks. Measurement and modelling are important, but they have limitations. "It's very hard to forecast what will come," Gully said. "So what you're in the business of [doing] is being able to adapt, resolve, triage — and hopefully have the tools, data infrastructure, capabilities, the people, the contingency plans... to allow the organisation to adapt and respond."

He also cautioned that capital requirements and regulation are necessary, but not sufficient, for ensuring the soundness of institutions. "You still need the judgement," Gully concluded. "You still need risk

management in the institutions [getting] to good outcomes. Certainly for OSFI we're doing our best to make sure that we've got supervisors equipped to adapt and respond because we know there will be surprises — and we need to be able to manage that."

CANADIAN PUBLIC ACCOUNTABILITY BOARD

In its 2023 annual report, the Canadian Public Accountability Board (CPAB) said that the number of flaws in audits conducted in the country remained "unacceptably high." However, firms that take their audit quality obligations seriously had much better results. "We have observed a strong correlation between the firms that invest in a robust system of quality management to support the consistent execution of quality audits and a lower level of significant findings at those firms," the CPAB wrote.²⁸²

Therein, the regulator also reported on its progress against its four key strategic priorities for 2022-2024:

- Advancing a quality-driven culture across auditors of Canada's public companies;
- Tackling emerging audit quality challenges head on;
- Assessing and adapting to the evolution of the audit; and
- Attending to the CPAB's own team and culture.

It is notable that two of these priorities are directly tied to culture and its impact on organizational outcomes.

In Focus

Cornerstone Questions

By: CHARLES RANDELL



Charles Randell

After the Global Financial Crisis, everyone agreed it should never happen again. This gave birth to mammoth changes in prudential and conduct regulations, which have helped to make the financial system safer, while giving more protection to consumers.



The Crisis also gave birth to work on “culture”. Many of the financial services businesses that

failed had a toxic culture, and it is now accepted that a healthy culture is the cornerstone of a safe and sound financial services business that serves its customers well. That work has also been a mammoth undertaking — not least in terms of the volume of reports, policies, professional advice and regulatory and board time devoted to the subject. However, compared to more specific and tangible prudential and conduct rules, “culture” is a woolly mammoth — not an easy creature to define or bring to life.

More recent failures of regulation and supervision — the crises among US regional banks and at Credit Suisse last year — have shifted the lens to the culture of financial regulators themselves, and

Without measurement of impact over the medium to long term, the regulator cannot hold itself to account — and neither can others.

revelations about the culture of the US Federal Deposit Insurance Corporation (FDIC) have intensified this focus.

So, with that, what are the top three questions financial regulators should ask themselves about their own culture in 2024?

Do we engage with those we are here to serve?

Regulators may need to get out more.

The greatest privilege of my time as Chair of the Financial Conduct Authority was the opportunity to visit the nations and regions of the UK in order to meet groups of people who needed the regulator’s help: sheep farmers in West Wales who were missing the support and community of a bank branch; elderly consumers and the people caring for them in Leeds who were finding online and call centre services inflexible and difficult to navigate; and victims of paramilitary loan sharks in Belfast who needed access to affordable credit and to debt advice — to mention only a few.

Meeting the people whom the regulator exists to serve is not just informative: it is highly motivating. It gives purpose and urgency. It’s the antidote to complacency. So it is important, not just for leaders,

but also for as many colleagues at the regulator as possible, to get out and engage directly with the people they exist to serve.

It is also important to bring those people in. That includes making diverse appointments to the board and senior management of the regulators and using panels of “experts by experience” to test policies in the real world. It also includes not just visiting but being present in different parts of the

UK. There has been good progress on these issues at the Financial Conduct Authority as part of a broader policy on Diversity and Inclusion.

Engagement is an important part of getting things right. However, when things go wrong, the regulator must also engage with those affected and with others who provide constructive challenge, learning lessons and turning them into action.

Engagement is vital for a consumer protection body such as the FCA. However, it is also vital for prudential regulators. They need to understand the needs, opinions and behaviour of investors, businesses large and small, and retail consumers, whose choices will determine the health of the institutions they regulate.

What impact are we making?

The regulator needs to make a positive impact. If not, a defensive and inflexible culture can follow, spiralling downwards as the regulator becomes more and more embattled and hostile to challenge and change.

A healthy culture is one where colleagues not only feel that they must make an impact, but where they are also impatient to see that impact and empowered to make it happen. Many regulatory processes inevitably take time, but unless there is impatience and empowerment, they can take even longer than they should.

Regulators should also expect to be judged against evidence of their impact. It is difficult to measure regulatory performance over the short term: because outcomes vary with the economic cycle; because the world is constantly changing in other ways the regulators cannot control; and because the consequences of poor regulation may take time to emerge. However,

Many regulators (financial or otherwise) would probably admit that they have not always held themselves to the standards they require of the businesses they regulate.

without measurement of impact over the medium to long term, the regulator cannot hold itself to account — and neither can others.

It's great to have colleagues with a strong sense of public duty — but that is simply not enough, and confronting a regulator with evidence of its impact (or lack of it) can help to move the culture from feeling good to doing good. When colleagues see that evidence, it motivates them to continue to act quickly and assertively, creating a virtuous circle.

At the Financial Conduct Authority, we set ourselves the target of publishing a range of performance metrics. They include not just measures of regulatory activity but also measures of outcomes, such as the number of consumers who are declined an essential financial product, the size of consumer losses to certain types of financial fraud and the financial burden which failed financial firms impose on the financial sector. These metrics will be affected by factors outside the FCA's control, and they will never present a complete picture, but they will enable the FCA and its various stakeholders to have much richer discussions about what success looks like.

Do we do what we say?

Many regulators (financial or otherwise) would probably admit that they have not always held themselves to the standards they require of the businesses they regulate. The reasons are partly philosophical, partly political and partly practical.

Philosophically, not all regulators accept that the Three Lines of Defence (3LoD) model should apply in full to them in the same way it applies to commercial organisations. There is sometimes a view that, because regulators do not have a profit motive, they are at less risk of control failures. There

is sometimes a view that regulatory staff straddle the first and second lines (or all three). Either view can result in failure to establish and invest in a rigorous 3LoD system.

It is noteworthy that when Michael S. Barr, the Vice Chair for Supervision of the Board of Governors of the Federal Reserve System, produced a report on the failure of the Silicon Valley Bank, he called out failures in SVB's 3LoD system but had much less to say about how to change the Fed's own 3LoD system. Similarly, the Swiss Financial Market Supervisory Authority's ("Finma") report on "Lessons Learned from the Credit Suisse Crisis" covers deficiencies in Credit Suisse's 3LoD system quite extensively, but does not suggest how Finma's own 3LoD system could be improved.

Politically, following up regulatory policy with assertive regulatory action is not always welcome. Calls from politicians to be "proportionate," and to "support risk-taking and innovation," with a view to growing the financial sector, may cause regulators to hold back when they should be speaking up about risk and acting on it. Strong governance in a regulator requires speaking truth to power. Without it, first culture and then performance will suffer.

Practically, regulators may become overwhelmed by the scale of their task when compared to their resources. This can cause them to resort to limited and tactical interventions rather than embracing the strategic and fundamental change which may be necessary to build the systems and processes required to get on top of the job. It can also divert second and third line resources to dealing with crystallised risk, leading to less horizon-scanning.

Financial regulators generally put the largest businesses they supervise through a carefully structured annual assessment, which includes the control environment, governance and culture. The board of a financial regulator could work

towards subjecting the regulator itself to the same assessment in order to answer the question: "Do we do what we say?"

Conclusion

Culture assessments often start with how an organisation feels. That is important, but I prefer to start with how it acts. If a regulator can show that it engages with those it exists to serve, that it is making a positive impact, and that it holds itself to the standards it requires of the businesses it regulates, then there is every chance that the assessment will go on to find that it has a sound culture.

This article originally appeared in Starling Insights' ["Physician, Heal Thyself"](#) Deeper Dive.

Charles Randell served as the Chair of the UK Financial Conduct Authority from 2018 to 2022. He was previously a member of the Bank of England's Prudential Regulation Authority since its founding in 2013. Prior to this, he practiced corporate finance law at Slaughter and May, where he returned after public service.



In Focus

An Interview with Bob Wigley



Bob Wigley



industry in the UK. We promote a safe, transparent and innovative banking and finance industry by offering research, training, policy expertise, thought leadership and advocacy.

For 2024, we have five advocacy priorities:

- **Delivering a high growth economy:** To help ensure that the financial services sector is as competitive as possible, contributing to the success of the UK
- **Enabling digital innovation:** As financial services moves towards a more digital approach, assisting customers, making it easier to access financial services and helping to grow the sector
- **Making the financial system safe:** To reduce the level of economic crime in the UK and ensure that the financial services sector in the UK is resilient

Q: For our readership outside the UK, would you please provide some background on UK Finance? Who are your members? What are the primary goals your organization seeks to achieve?

A: UK Finance is a trade association that represents more than 300 firms across the banking and finance

Embracing technological advancement and innovations in our capital markets will be key to our future success.

- **Supporting consumers and businesses:** Where possible, to assist customers facing financial difficulties and help improve the reputation of the sector with government and the wider public
- **Transitioning to net zero:** To ensure the industry transitions towards net zero in a just and sustainable way

Q: In the last few years, we've heard prominent policy debates regarding banking regulation and related legislation in the UK, turning on tensions between promoting the "competitiveness" of the UK market and the "safety" of consumers, markets, and the financial system as a whole. What's your view on these debates and what should we anticipate in 2024?

A: Four years of reflection have produced a broad package of targeted reforms designed to strengthen UK capital markets. These range across Lord Hill's proposed reforms to the UK listings regime, HMT's Wholesale Markets Review and the Edinburgh Reforms. Examples include improvements to market transparency, the introduction of a UK consolidated tape and accelerated settlement, among other changes.

These reforms add up to a material evolution of the UK's regulatory framework which now need effective implementation. It is important for reforms not to be looked at in isolation but for a holistic approach to be taken to regulation and its implementation in practice.

The breadth of reforms across both primary and secondary markets is extensive, for example, the proposed listing reforms, the review of disclosure and corporate governance requirements to make it simpler for companies to access public markets and easier for investors to support them, the short selling review and improvements to secondary market transparency.

Embracing technological advancement and innovations in our capital markets will be key to our future success: measures such as incorporating digital ledger technology into the operation of UK capital markets, digitising share ownership, accelerating settlement times and delivering greater price transparency for investors through a consolidated tape will increase UK competitiveness and growth.

One of the most notable trends over the last ten years has been the withdrawal of UK savers from our equity markets, both directly and indirectly. A risk averse regulatory culture is often a reflection of the societal context. Regulators that face undue criticism when an informed adult or company loses money on an investment will always be incentivised to squeeze risk out of the system. Individuals have an expectation of long-term financial security. However, these expectations will only be met in a political culture that supports them in taking informed risk. Protecting consumers must also mean ensuring they have the resources for long-term financial security, otherwise we risk a society that has not build up enough wealth for retirement.

Political leadership is needed to ensure regulators are empowered to balance consumer protection and a culture of informed risk-taking.

Q: There has also been a heightened focus on the proper role of financial sector regulators, with many questioning their ability to oversee non-financial risk matters effectively without creating unintended consequences. The Consumer Duty that came into force last year, for instance, seeks to ensure that firms produce “good outcomes” for customers. Was this necessary to prompt consumer-centric thinking into firms’ strategies and business models?

Good formal governance structures and well-designed policies and procedures are necessary but not sufficient to ensure the financial resilience of firms and good customer treatment.

A financial services firm cannot function or be successful without its customers.

A: The majority of firms already have consumers at the heart of their businesses — a financial services firm cannot function or be successful without its customers! However, I think the Consumer Duty regulations give a clearer sense of what the regulator thinks ‘good looks like’ and will help ensure customers get value for money products and services that meet their needs, clearer communications and simpler, more tailored support when they need it.

Q: Financial sector regulators, in the UK and elsewhere, are increasingly of the view that firm culture is a matter of supervisory interest, at least in as much as it is believed to play an important role in ensuring that organisations achieve positive business and consumer outcomes. Are they right?

A: Yes, good formal governance structures and well-designed policies and procedures are necessary but not sufficient to ensure the financial resilience of firms and good customer treatment. Supervisors develop an understanding of the culture of a firm from their interactions and tone from the top, an embedded commitment to good practice at operational level and values and behaviors throughout protects the integrity of the business. Of course, cultures can be a legitimate source of differentiation and cannot be prescribed by the regulator but warning signs indicating a poor culture ought to invite further enquiry.

Q: Regulators have endeavored to drive culture change in the industry through the [Senior Managers and Certification Regime](#), which aims to hold executives individually accountable for conduct and compliance matters. Has the Regime been successful

in shifting industry culture and establishing a sense of ownership and accountability regarding non-financial risk matters?

A: Our members are fully supportive of the SM&CR which has brought clarity to who is responsible for what within a firm as well as a pervasive change in culture and behaviours.

Individual accountability doesn't just relate to financial risk but extends to non-financial risks, such as financial crime, internal audit, compliance and IT system resilience and this is now fully embedded amongst our members.

Q: In 2023, the Financial Conduct Authority and Prudential Regulation Authority issued a call for evidence regarding diversity and inclusion in the financial sector. Responding to this, UK Finance offered the view that its members, "recognise the benefits of a diverse and inclusive sector to the industry and the customers and communities it serves." Would you expand upon this? Do you see diversity and inclusion impacting on firm culture and its ultimate performance?

A: Banking and finance firms see benefits in a wider pool of skills and talent, the engagement of staff in workplaces where colleagues have confidence in fairness and inclusion, decision making that is less prone to group think and better insight into customer needs through diversity. Ultimately, this should lead to greater commercial success and economic contribution. That's why so many firms are committed to initiatives such as the Women in Finance Charter and the Investing in Women code. There is also evidence of progress in representation and positive outcomes in many other aspects of diversity.

AI also brings opportunities to improve practices and make improvements in areas like diversity and inclusion.

Q: We've heard lively debates in the last year or so, calling for regulatory agencies themselves to be held accountable for their own cultures and the outcomes they promote. In its [response](#) to the House of Lords' Inquiry into Regulators, UK Finance argued that a focus on competitiveness, as required by the newly introduced "[secondary objective](#)," would necessitate a "cultural change" among financial sector regulators, underpinned by "appropriate programmes of training and development, internal controls and board governance." Would you kindly expand upon this?

A: It is encouraging to hear of the commitment by the leadership of regulators to the competitiveness objective which is entirely appropriate for one of the most important industries for the UK. However, if this is to inform the approach to policy development and supervision the understanding needs to be put into

practice at all levels of regulatory organisation. Much like credit risk assessment, it is easy to avoid bad debts by declining to lend, but the optimal management of a lending book is to balance risk and return. Similarly, proportionate regulation based on an assessment of how

the UK compares with other international centres and the reasonable expectations of commercial returns ultimately ensures that the industry can offer the innovative and competitive services that customers need and drive economic growth.

Q: Late last year, you published a report entitled "[The Impact of AI in Financial Services](#)," addressing the risks and opportunities these new technologies present and recommending that the industry "aim for a rapid adoption of AI tools to deliver efficiency, a better customer experience, and a more robust sector." Might these new technologies present any opportunities regarding the culture and other non-financial risk matters we've discussed here?

A: AI brings risks such as unfair bias, which have rightly attracted considerable public attention and which firms are focused on managing carefully. But — if we get it right — AI also brings opportunities to improve practices and make improvements in areas like diversity and inclusion. If designed and monitored carefully, data-driven analysis has the potential to make decisions in areas like recruitment fairer by reducing the impact of human biases.

On top of this, firms are setting up new governance mechanisms like AI Ethics Boards to review and carefully consider potential new AI applications. These can help strengthen the cultural norm of thoroughly reviewing tradeoffs, ethical grey areas and potential unintended consequences for different groups of customers and employees.

Bob Wigley is the Chair of UK Finance. Prior to this, he spent a career in finance, rising to be EMEA Chairman of Merrill Lynch and a member of the board of the Bank of England during the 2008 financial crisis. He also previously led a group of industry Chairman and Chief Executives to author a report on the competitiveness of London as a global financial center, “London, Winning in the Decade Ahead,” and chaired the Green Investment Bank Commission.

United Kingdom

INDUSTRY AND REGULATORY BACKGROUND

Competitiveness and Culture

In our 2023 *Compendium*, we discussed an increasing insistence that UK financial regulators work to support the competitiveness of the country's financial sector. Herein, we will provide some background, and review how the conversation has developed over the past year.

In 2021, former Prime Minister Boris Johnson's Government introduced a set of measures that aimed to encourage regulators to "facilitate" London's competitiveness as a global financial center.²⁸³ 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 attractiveness rather than its presumed stability.²⁸⁴

In May 2022, 58 leading economists wrote an Open Letter to then-Chancellor Rishi Sunak and John Glen, Economic Secretary to the Treasury. It outlined concerns regarding proposals that make Britain's "competitiveness" a greater focus in financial regulation.²⁸⁵

The economists argued that this was an "inappropriate objective" for financial regulators. Not only could it risk slowing economic growth and incentivizing excessive risk-taking, they argued, but it also offered a vague objective that could lead to a regulatory "race to the bottom."

"The UK instead needs clear regulatory objectives that promote economy-wide productivity, growth and market integrity, and also protect consumers and taxpayers, advance the fight against climate change, and tackle dirty money to protect our collective security," the letter read.

In September 2022, the Prudential Regulation Authority (PRA) and Financial Conduct Authority (FCA) called for their continued independence from political influence, and stressed the importance of such to maintaining effective financial regulation. They also warned that pursuing short-term growth by lowering regulatory standards could threaten financial stability.²⁸⁶

"This is important not only for the pursuit of safety and soundness and financial stability, but also because the independence of the regulators is an important foundation of our international standing and therefore part of the UK's ability to remain at the forefront as an international financial centre," argued Sam Woods, PRA chief and Bank of England Deputy Governor.

In December of that year, UK Chancellor of the Exchequer, Jeremy Hunt, announced a package of more than 30 reforms to the legislative and regulatory framework governing the financial sector. Dubbed the "Edinburgh Reforms," the package aimed to loosen many of the rules put in place after the Global Financial Crisis in hopes of driving growth in the financial industry and improving economic competitiveness.²⁸⁷

As a part of the Edinburgh Reforms, the Government would review the UK's Senior Managers and Certification Regime (SMCR), which seeks to hold senior bankers and executives personally accountable for risk management failures that take place on their watch. Hunt also announced that, as a "secondary objective," financial regulators would be expected to help deliver growth and competitiveness.

In March 2023, the FCA and Bank of England launched a review of the SMCR, requesting input from stakeholders on the effectiveness, scope, and proportionality of the regime. "The reviews aim to understand stakeholders' views on the functioning of the SM&CR and to identify ways to improve

the regime to help it work better for firms and regulators, while preserving its underlying aims,” the regulators wrote.²⁸⁸

In late June 2023, following agreement from both Houses of Parliament, the Financial Services and Markets Act 2023 (“the FSMA”) received royal assent. The bill, among other things, codified a secondary objective for the FRC and PRA to support financial sector competitiveness.²⁸⁹

The next month, the FCA issued a statement on how it would seek to fulfill this new mandate. “This is not about lowering the standards that underpin trust in our work and the reputation of the UK financial sector more widely; it is about facilitating the new secondary objective when advancing our primary objectives of consumer protection, market stability and effective competition in the interest of consumers,” the regulator wrote.²⁹⁰

In September, the PRA published a report entitled, “How to Measure the Contribution of Prudential Regulation to Competitiveness and Growth.” Therein, the PRA laid out three pillars by which it would measure success in setting high prudential standards while supporting industry competitiveness: maintaining trust in the PRA and UK prudential framework; effective regulatory processes and engagement; and tailoring rules to UK circumstances.²⁹¹

The PRA provided examples of a number of metrics it might use to track its success in meeting these objectives. These include gathering industry feedback, analyzing the complexity of the regulatory framework, and engaging directly with the industry to ensure rules fit the specifics of the UK financial sector.

In October 2023, The Bank of England and the FCA formally lifted the cap on banker bonuses that the EU had introduced after the 2008 financial crisis. The cap, established in 2014, limited banker bonuses to twice their annual salaries. The move to scrap it was

initiated by the UK Government to attract investment and to shed EU regulations post-Brexit. The decision followed a lengthy consultation process.²⁹²

The FCA said the new rules would apply to “current and future performance years,” and emphasized that pay packages should support a healthy culture and positive outcomes for consumers. Nevertheless, some expressed great disappointment. “This is an obscene decision,” said Paul Nowak, General Secretary of the Trades Union Congress. “City financiers are already enjoying bumper bonuses. They don’t need another helping hand from the Conservatives.”

In a speech in April 2024, Sarah Pritchard, the FCA’s Executive Director for Markets and International, explained why “promoting competitiveness is a juggling act.” Regulators cannot successfully promote competitiveness by focusing on any one facet of their mandate, Pritchard argued. Rather, it requires a holistic view encompassing a number of factors, including accountability, transparency, international collaboration, proportionality, and openness.²⁹³

“As with juggling, keeping your eye on a single ball will mean you drop them all,” Pritchard said. “So, by focusing on one narrow contributor to the competitiveness of the UK’s financial services you can lose sight of the bigger picture, or the longer-term. Only by considering all the elements that create the right foundation for investment and growth will we succeed.”

Audit Reform

Over the past several *Compendium* reports, we have discussed the perpetually-imminent and yet never-enacted audit reforms that have long been discussed in the UK. Before we address how that conversation has developed over the past year, we’ll offer some background.

In 2018, the UK Government launched an independent review of the UK Financial Reporting Council (FRC).²⁹⁴ Leading up to this, the FRC had faced scathing criticisms, including from Parliamentary Select Committees, for failing to crack down on incidences of poor audit work.

This came to a head when several large companies collapsed amidst numerous accounting irregularities, including retailer BHS in 2016²⁹⁵ and construction company Carillion in 2018.²⁹⁶

A review headed by Sir John Kingman, then Chair of UK Research and Innovation, found that the FRC had several serious constraints on its ability to set effective standards for governance and audit. These included a lack of statutory base, government direction that it delegates to industry bodies wherever possible, and little practical regulatory power over the industry.²⁹⁷

As a result, Kingman recommended the creation of a formal regulatory body to succeed the FRC, which was to be 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 said. “It should also have a duty to promote competition; a duty to promote innovation; and a duty to apply proportionality to all its work.”

Then 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.”²⁹⁸

In 2019, the UK Government announced that it would be taking up Kingman’s recommendations 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 then Business Secretary Greg Clark.²⁹⁹

Yet, more than four years later, it is still unclear precisely when (or whether) ARGA will come to be — even after senior figures at the FRC agreed with suggestions that the incumbent regulator was not fit for purpose. In early 2022, the then-incoming chair, Jan du Plessis, told the UK parliament’s business committee: “The governance situation at the FRC today is in a pretty poor state... It’s really really not a way to run the regulator that should be setting the tone for the whole of British business.”³⁰⁰

In early October 2023, it was reported by the *Financial Times* that the UK was set to exclude a long-awaited overhaul of the country’s audit and corporate governance regulations from the King’s Speech in November. The King’s annual speech outlines the Government’s agenda for the following year, and the audit reforms’ expected absence suggested that change would be delayed until after the next general election, to be held sometime before January 25, 2025.³⁰¹

In an opinion piece published shortly thereafter, *FT* journalist Helen Thomas reviewed progress made since the 2018 collapse of Carillion and lamented that the shortcomings in audit quality and corporate governance that had been revealed in the course of the scandal have yet to be resolved. “Carillion was an epic financial failure, no doubt,” Thomas wrote. “It had just paid a record £79mn dividend yet collapsed with £7bn in liabilities and £29mn of cash. But it was also the clearest possible demonstration of how failings in the dry, dusty worlds of audit and corporate governance have real-world effects. The lessons of that have yet to be acted upon.”³⁰²



FROM OUR 2022 Compendium

Regulating a Cultural Shift in Audit

by **Sarah Rapson**
Executive Director of
Supervision, Financial
Reporting Council

“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. ”



[CLICK HERE to READ MORE](#)

Later in October, a cross-party group of Members of Parliament and Members of the House of Lords in the UK sent a letter to Prime Minister Rishi Sunak, urging the Government to include the long-anticipated Audit Reform Bill in the King’s Speech on November 7th.³⁰³

“We are writing to express our strong support for the inclusion of the Audit Reform Bill in the forthcoming King’s Speech,” it read. “This long-awaited legislation is vital to restoring trust in audit and corporate governance.” The reforms were needed to equip the FRC with new legal powers to give it the teeth it needs to hold audit firms and company directors to account when there are corporate failures, the letter argued.

The cross-party letter, coordinated by the Chartered Institute of Internal Auditors, emphasized the urgency of audit reform, citing high-profile corporate collapses such as Carillion, Patisserie Valerie, Thomas Cook, and Wilko. It also referenced the then recent findings, reported by the FRC, that a quarter of major company audits contained deficiencies.

The Parliamentarians asserted the importance of establishing a robust audit and corporate governance framework to manage risks effectively and promote investor interests. They stressed that the UK needs an audit regulator with statutory powers, which the FRC currently lacks and which can only be granted through primary legislation.

In an interview with *Financial News* around that same time, Sir Keith Skeoch, former Chief Executive of Standard Life Aberdeen (now Abridn) and past-Interim Chair of the Financial Reporting Council, stressed the importance of implementing audit reform before another corporate collapse.

“The thing I’m disappointed about is the slow pace with which we seem to be moving towards legislation that gives the power to the FRC that it needs to make a difference,” Skeoch said. “We would have been in a lot better place if the FRC had been given the powers it needs and deserves.”³⁰⁴ The primary driver of the delay of these much-needed reforms, Skeoch lamented, is politics. “The question for politicians is: how important is this fix for you?” He argued. “Let’s hope we don’t have to wait for the next corporate crisis to recognise this is an issue.” **▶ PAGE 93**

Despite these calls, the long proposed audit reforms were, indeed, omitted from the King’s speech in November 2023, leaving their fate in question. Some expressed grave disappointment at this. “Government inertia on audit reform is in danger of resulting in inadequate rules, an underpowered regulator and a reduced capacity to anticipate and address the next Carillion,” wrote the Institute of Chartered Accountants in England and Wales.

That same month, UK Secretary of State for Business and Trade Kemi Badenoch urged the FRC to consider the impact of its rules on the country’s competitiveness and growth. This comes as Britain aims to strengthen the global influence of its financial sector amid competition from New York and EU centers post-Brexit.³⁰⁵

“At a strategic level, in fulfilling its core purpose to enhance public trust and confidence in corporate governance, financial reporting and audit, the FRC should contribute to promoting the competitiveness and growth of the UK economy, embedding its growth duty across its work,” Badenoch wrote in a letter to FRC CEO Richard Moriarty. Badenoch emphasized the need for proportionality in new requirements and removing or streamlining outdated rules. She also encouraged a flexible approach in the FRC’s stewardship code for asset managers.

“I would ask that you report back in a year’s time on the steps that the FRC has taken in promoting competitiveness and growth,” Badenoch wrote in her letter. Moriarty said he welcomed the new remit and that the FRC would focus on completing the review of the corporate governance code, followed by a fundamental review of the stewardship code, ensuring proportionality and removing unnecessary requirements.

Industry debate continued, however. In a February 2024 letter, the Chartered Governance Institute (CGI) urged Badenoch to revive the audit reforms, claiming that their long delay had “undoubtedly contributed to the persistence of the delisting problem which plagues the London market.”³⁰⁶

“The Government’s capricious abandonment of the long-planned White Paper represented a colossal waste of Government time and public money, sent a bad signal about this Government’s commitment to responsible capitalism, and left business leaders and investors in a state of uncertainty,” wrote Sara Drake, CEO of CGI. “I reiterate our strong support for legislation in this field, and I urge you to deliver on the proposals which were promised.”

Later that month, the FRC announced that it was “undertaking a fundamental review” of its Stewardship Code for institutional investors, with a focus on how it might support “growth and the UK’s competitiveness.” The FRC indicated that it aimed to

ensure that the Code was driving good stewardship outcomes for investors without creating undue burden for businesses. A key aspect of the review would involve analyzing how the Code “supports long term value creation” by encouraging engagement that improves issuers “prospects and performance.”³⁰⁷

The review was to be undertaken in three phases: targeted outreach to issuers, asset managers, asset owners, and service providers; a public consultation on any updates that come out of that review; and publication of the finalized code, aiming for completion in early 2025.

FRC chief Moriarty has insisted that his stance favors *smart* regulation rather than “light-touch” regulation. The priority is ensuring that regulation is targeted, proportionate, and does not add unnecessary burden.³⁰⁸ A focus on culture, he suggests, may help regulators to achieve this.

But Moriarty has also been clear that smart regulation cannot make up for the lack of a legal mandate. In his testimony before Parliament’s Business and Trade Committee on March 26, he lamented the fact that the FRC is “sheriff of only half a county,” relying on accountants for funding and data. While the regulator has made improvements in its regulation and supervision in recent years, there remains “serious gaps” that would require legislative action to fill.³⁰⁹

Business minister Kevin Hollinrake contested this view, arguing that reforms were unnecessary, and that the FRC had made substantial progress utilizing current powers. “Legislation is a last resort, rather than a first resort, I would say. We are not in a crisis situation,” Hollinrake argued.

Sir John Kingman, who had conducted the review which concluded with the recommendation that the ARGAs be established to replace the FRC, disagreed with Hollinrake’s position, instead contending that any strides the FRC had made would prove unsustainable without a heightened legal mandate. “The peril of

that is they are up against large vested interests, and they have to operate through suasion and not by power,” he argued.

Legislative and Legal Reforms

In June 2023, the UK Treasury published a consultative document outlining a potential structural overhaul of anti-money laundering and counter-terrorism financing (AML/CTF) regulation and supervision, potentially reappropriating the related mandates from the FCA and other regulators to one ‘mega supervisor.’^{310, 311} In its current state, UK AML/CTF oversight is fragmented among many disparate authorities, which can lead to inconsistent enforcement and gaps in coverage.

The Treasury proposed four options to address these shortcomings:

- Leave the current structure in place, but give enhanced powers to the Office for Professional Body Anti-Money Laundering Supervision (OPBAS), which was created in 2017 to ensure supervision is robust and consistent across Professional Body Supervisors (PBSs) — private bodies that oversee legal and accountancy firms;
- Consolidate the 22 PBSs into between two and six bodies to reduce complexity and inconsistency;
- Replace the PBSs with a single, public body to be operationally independent but accountable to the Treasury; or
- Create a single body to undertake all UK AML/CTF regulation and supervision, commandeering this responsibility from the FCA, PBSs, and the Gambling Commission (GC).

Under the fourth proposal, which some have referred to as the “nuclear option,” the FCA and several other bodies would retain their supervision of firms’ conduct within their respective remit, but lose their statutory mandate relating to AML/CTF. The success of the chosen model would depend on

its powers, independence, resources, expertise, and accountability. The transition would impact banks, potentially causing uncertainty as they adapt. Any short-term challenges, however, are likely to be outweighed by the beneficial innovation and improved outcomes stricter supervision would spur.

Separately, in October 2023, the “Economic Crime and Corporate Transparency Bill” received royal assent after passing both houses of Parliament. Among other reforms, the legislation established “failure to prevent fraud” as a criminal offense for organizations.³¹²

Under previous legislation, a company could only be convicted of fraud if a person identifiable as possessing the “directing mind and will” of the firm was involved in the alleged misconduct. It was difficult in practice to identify specific such individuals. And even where a “directing mind and will” could be established, which is not trivial in a large company, such individuals very rarely had demonstrably direct involvement in the related illicit conduct.³¹³

Under the new standard, prosecutors must prove only that an organization lacked “reasonable” or “adequate” controls to prevent wrongdoing. If companies are found guilty of failing to prevent fraud, the size of any potential fine would be determined by the Court, with no legal limit thereto, and could be expressed as a multiple of the company’s profits.³¹⁴

There is, however, no mechanism by which individual executives are to be held personally liable or prosecuted for their failure to prevent fraud. A fact sheet explains that the Government “does not see it as proportionate to prosecute an individual where they did not consent or know of the offence happening.”

Conduct Issues

As we have discussed in past reports, there seems to be a never-ending deluge of conduct scandals in the financial sector. However, regulatory action in the UK decreased in 2023. It is unclear if this is reflective of a decrease in misconduct, or of the seemingly anti-regulatory environment discussed earlier in this section. In 2023, the FCA levied a total of £52 million in fines against firms and individuals, down 75% compared to 2022.³¹⁵ And the PRA issued just over £87 million in fines — though, nearly the entire amount was concentrated in one fine, at Credit Suisse, discussed later in this section.³¹⁶

However, as we have also discussed, misconduct concerns are present in organizations of every stripe. As such, we will begin this section by delving into such issues in other sectors, including in government and in the audit sector. We will then discuss several of the big themes and major stories that have come out of the financial sector in the past year in this regard. These include a heightened focus on sexism and discrimination, a potentially costly review into misconduct in the auto lending sector, and a widely-reported story involving politically-motivated debanking. To close, we will round up some more general fines and scandals that have occurred over the past year.

Government Under Scrutiny

There have been several high-profile culture scandals involving government agencies and offices in the UK over the past 12 months.

In September 2023, the *Financial Times* reported that London's Metropolitan Police was investigating approximately 1,600 of its staff and police officers for alleged violence and sexual abuse. This shocking revelation exposed a potential long-standing failure to root out predators and serious cultural shortcomings within the ranks of London's police force.³¹⁷

A sweeping internal review aimed to purge those guilty of misconduct or criminal acts and to restore public trust, which had already been eroded by a spate of scandals involving officers assaulting civilians. According to Stuart Cundy, the deputy assistant commissioner leading the review, 100 officers had been dismissed for gross misconduct over 12 months, and more than 1,000 officers were suspended while investigations into a variety of allegations were undertaken.

Several high-profile incidents cast a harsh spotlight on a culture of misogyny and violence within certain segments of the police force. The Metropolitan Police is now diligently scrutinizing its ranks, uncovering a growing number of offenders and leaving no stone unturned. However, the process has been plagued by delays, with police misconduct hearings deemed “too slow.”

London's Metropolitan Police might benefit by a 2022 study on misconduct-committing officer crews in the Chicago police department, from researchers Andrew Papachristos, Akshay Jain, Rajiv Sinclair, found that any solution must recognize these problems as systemic, not individualistic. Nearly all police work is group-based, and officers' formal and informal networks shape individual behavior, good or ill, to spread. Simply punishing “problem officers” without addressing group-level cultural problems is unlikely to prevent future instances of misconduct.³¹⁸

Turning to a different story, at a November 2023 hearing for the UK Government's inquiry into its handling of the COVID-19 pandemic, Helen MacNamara, who served as Deputy Cabinet Secretary between 2020 and 2021, criticized the Government's response to the crisis, citing a “macho” culture “contaminated by ego.”³¹⁹

MacNamara claimed that senior officials had a misplaced confidence that the UK would easily handle the pandemic, even laughing at Italy's early lockdown measures in 2020. MacNamara noted an “absence

of humanity” in the Government’s approach, and the then-Prime Minister Boris Johnson’s belief that the country would “sail through” the crisis. MacNamara also revealed that Downing Street didn’t follow its own social-distancing rules, with numerous civil servants and ministers breaching guidelines. “I would find it hard to pick one day when the regulations were followed properly,” she said.

MacNamara’s testimony followed a series of damaging revelations about the Government’s handling of the pandemic, including comments from Dominic Cummings, the former Chief Adviser to Johnson, who criticized a “widespread failure” and “dysfunctional system.” McNamara also expressed concerns about the lack of diverse perspectives among senior decision-makers, suggesting that it may have resulted in inadequate consideration of issues like domestic abuse during the pandemic. “Women who had worked in the Cabinet Office and Number 10 reported feeling as if they had become invisible overnight,” she contended.

Audit Sector Troubles

In recent past years, the audit sector has struggled with culture and conduct issues similar to those that have plagued the financial sector. Over the last several editions of this report, we have discussed these concerns and, in spring 2023, we published a *Deeper Dive* — “Renal Failure” — discussing these topics in more detail. Problems have not let up since, especially in the UK.³²⁰

The Financial Reporting Council imposed record-level fines on auditors during the 2022/23 financial year, totaling £33.2 million. This represents a small increase from the £32.8 million seen in the previous year, and a significant increase on the £19 million seen in 2020/21. We will discuss several examples of the scandals that led to these fines here.

KPMG

KPMG was the subject of four of the FRC’s five completed investigations in 2023, and faced several large sanctions. In April 2023, for instance, the firm was fined £875 thousand — and a former employee was fined £35 thousand — for failures in its audit work for lighting firm Luceco plc in 2016. “The breaches included failures in the design and performance of audit procedures, failures to adequately review and critically assess the audit evidence obtained, failure to document the audit work and failures by the Respondents to apply professional scepticism,” the FRC wrote in a related statement.³²¹

Later that same month, KPMG was again fined just over £1 million for deficiencies in its audit for retailer TheWorks.co.uk plc. A former partner was also fined £43 thousand. “The admitted failings, which critically undermined KPMG’s approach to the audit of inventory at a retail entity, were rudimentary and should not have occurred,” said Claudia Mortimore, Deputy Executive Counsel at the FRC. “The financial and non-financial sanctions, which include measures intended to enhance KPMG’s second line of defence function, are aimed at preventing a repetition of such failings in the future.”³²² In June, KPMG faced another penalty, of £877 thousand, with a former partner paying nearly £45 thousand, for its work auditing Eddie Stobart Logistics plc.³²³

However, by far the largest fine against KPMG — and, in fact, the largest the FRC has ever issued — came in October 2023. In our past *Compendium* reports, and in our “Renal Failure” *Deeper Dive*, we have discussed at some length the scandal surrounding Carillion, a prominent UK construction and facilities management firm that collapsed in 2018 amid accounting irregularities.³²⁴ For more on the scrutiny KPMG has faced for its audit work for Carillion, we’d urge you to review those reports.

In the culmination of this long-running crisis, the FRC fined KPMG a total of £21 million for an “unusually large number of breaches” which ultimately meant that Carillion “was not subject to rigorous, comprehensive, and reliable audits in the three years leading up to its demise.” Two former partners were also fined a total of £420 thousand, one of whom was banned from the industry for 10 years.³²⁵

“Many of the breaches involve failing to adhere to the most basic and fundamental audit concepts such as to act with professional scepticism and to obtain sufficient appropriate audit evidence,” said Elizabeth Barrett, Executive Counsel at the FRC. “The breaches in relation to the 2016 audit even include failing to ensure that the audit process itself was properly managed and that the audit file was a reliable record. These requirements lie at the heart of proper auditing.”

KPMG’s troubles did not end in 2023. In March of this year, the firm faced a £1.4 million charge for further audit failings. Here again, the audit partner involved was personally penalized, paying £49 thousand. Among other deficiencies, the FRC pointed out a lack of “professional scepticism” among the audit staff.³²⁶

PwC

In March 2023, the FRC fined PwC £5.6 million for deficiencies in its audit work for two separate companies, and levied penalties totaling nearly £200 thousand on two former partners. “The quality of these audits fell far short of the standards expected of statutory auditors,” said Claudia Mortimore. “Of particular concern is the lack of scepticism applied and the failures to follow some basic audit requirements. This robust package of sanctions seeks to deter future breaches and encourage improvement by the firm.”³²⁷

PwC was fined another nearly £2 million in June for “numerous serious failures” in its audit of logistics firm ESL. The partner who led the ESL engagement

was fined £51 thousand. The deficiencies in this case included a lack of challenge and professional judgment on the part of the auditors, as well as a failure to identify risks of material misstatement relating to ESL’s property transactions.³²⁸

The Big Picture

Taken together, these cases paint an interesting picture. It is clear that the FRC has sought to emphasize professional skepticism, judgment, and a readiness to raise challenge as some of the most important contributors to quality auditor work. When these cultural elements are not present, the regulator is clearly willing to take action against firms and the audit partners accountable. This means that both parties should have interest, and certainly do have responsibility, for looking to new tools and techniques that may help them to ensure these professional habits are present amongst their staff.

Discrimination

There has been much discussion surrounding discrimination, and particularly sex-based discrimination, in the UK’s financial sector over the past year. These concerns were amplified by several widely reported scandals involving sexual harassment and assault, including most prominently at the Confederation of British Industry³²⁹ and Odey Asset Management.³³⁰

We will not retell these stories herein. However, we will discuss what has been done to address what some believe to be widespread discriminatory practices in the financial services industry.

In July 2023, the UK House of Commons Treasury Select Committee launched an inquiry into “Sexism in the City” to investigate the obstacles faced by women in the financial sector. The inquiry was to serve as a sort of progress report following the Committee’s

2018 report, “Women in Finance,” which identified a number of barriers to women’s career progression in the industry.

According to MP Harriett Baldwin, Chair of the Committee, the investigation would seek to uncover whether “enough work has been done to build more supportive workplace cultures, how harassment and misogyny can be addressed, and the role the government and regulator should play in role modelling behaviours.”³³¹

In September 2023, the FCA and the PRA published a proposed Diversity & Inclusion (D&I) regulatory framework. Under the new framework, certain firms would be required to:

- Report their average number of employees on an annual basis;
- Collect, report, and disclose certain D&I data;
- Establish, implement, and maintain a D&I strategy;
- Determine and set appropriate diversity targets; and
- Recognize a lack of D&I as a non-financial risk.³³²

“Greater diversity and inclusion can create better outcomes for consumers and markets by supporting healthy work cultures, reducing groupthink, unlocking talent and improving understanding of diverse consumer needs,” FCA CEO Nikhil Rathi wrote in the foreword to the proposal.

The proposal also introduced new guidance on addressing “serious instances of harassment and bullying” and incorporated non-financial misconduct into the FCA’s “fit and proper” test for financial services employees.³³³

“Financial services workplaces need to be safe places for women,” Rathi said in an interview at the time. “Companies that do not have an environment where serious issues like that are dealt with and addressed are unlikely to be companies that have an

environment which is healthy from a risk management perspective. We want to make sure that we are proactive around that.”

Predictably, the regulators faced pushback on these initiatives. Many companies objected to the mandatory disclosure requirements, citing concerns about infringing on employees’ privacy and forcing individuals to share personal information.³³⁴

“There’s a tension if people don’t want to share that . . . you can’t force a person to respond,” said one industry executive. Furthermore, some firms have expressed worries that disclosing detailed metrics about their leadership teams could inadvertently violate data privacy rules if individuals in these groups are identifiable. “The proposals do indeed seem to want to force disclosure from employees that we don’t think it’s right to enforce,” another bank executive said.

In response, the FCA has said that safeguards to address these concerns have been implemented, and it has outlined methods by which firms may combine data sets so as to protect individual identities. The regulators have encouraged firms to participate in the consultation and to propose alternative approaches. The consultation period for these proposals ended in December 2023, with final rules expected in 2025.

During the first hearing for the “Sexism in the City” inquiry in October, Baroness Helena Morrissey, chair of the Diversity Project, raised concerns about the FCA’s consultation paper, “Diversity and Inclusion in the Financial Sector.”

The paper proposed incorporating non-financial misconduct into conduct rules as well as fitness and probity assessments, but stipulated that only “serious misconduct” would qualify as a violation. Morrissey worried about the lack of clear definition and scope for “serious misconduct,” urging the FCA to strengthen disciplinary sanctions so as to deter misconduct more effectively, emphasizing a call for potentially “career-ending” consequences.³³⁵

Witness testimonies also identified key issues impeding change, including a ‘fear factor’ that prevented victims and witnesses from reporting, due to potential career repercussions and concern that their claims would be met with disbelief. Such fear-induced silence impedes both investigative and disciplinary procedures, often resulting in victims leaving firms instead of perpetrators being removed. Morrissey suggested that independent investigations might be necessary to eradicate such fear and restore confidence in reporting mechanisms.

As a part of its efforts to improve diversity and inclusion in the financial sector, the FCA unveiled plans to investigate sexual harassment and bullying complaints in the financial industry in January 2024. The exercise was to include a particular focus on the use of non-disclosure agreements (NDAs) to conceal misconduct.³³⁶

Sarah Pritchard, Executive Director for Markets and International at the FCA, revealed the regulator’s intensified efforts before Parliament’s Treasury Select Committee. In a hearing relating to the Committee’s “Sexism in the City” inquiry, Pritchard explained that financial firms would be asked to provide data on the number of non-financial misconduct complaints in their businesses, and detail regarding how those issues are detected and resolved.

“One of the reasons that we’re going out with the piece of work . . . will be so that we can see how cases of non-financial misconduct are resolved,” she said. “If we see, for example, use of NDAs alongside non-financial misconduct coming through that data . . . we will be able to take that into account in our future supervisory work.”

In February, the FCA directed over 1000 banks, insurers, and brokerages to disclose how many cases of sexual harassment, discrimination, and other non-financial misconduct they have recorded since 2021, and to offer detail as to how those cases were ultimately resolved.³³⁷

In March, the UK House of Commons Treasury Committee issued a report detailing the findings of its inquiry into sexism in the financial sector, concluding that efforts to resolve these issues were moving at a “snail’s pace.”³³⁸

“Firms must take responsibility for improving their culture,” said Harriett Baldwin, Chair of the Treasury Committee. “There have been several high-profile cases which show the existential risk to firms who don’t tackle sexual misconduct... Regulators and the Government also have a role to play but they need to think carefully about what will deliver the best outcomes and avoid introducing tick-box exercises.”

Many respondents to the inquiry emphasized establishing inclusive cultures as the most important factor for improving diversity. “If I had to pick out the overarching driver of what needs to change, it is culture,” Karen Northey, Director of Corporate Affairs at The Investment Association, told the Committee. “A lot of that is culture within individual firms. It starts at the beginning of someone’s career.”

Despite these observations, the recommendations in the report focus instead on updates to systems, policies, and procedures, areas that constitute formal management structures in an organization. These include:

- Legislation to ban the use of non-disclosure agreements (NDAs) in sexual harassment cases;
- Stronger protections for whistleblowers; and
- Reducing the size threshold for gender pay gap reporting.

In April, UK Secretary of State for Business and Trade Kemi Badenoch came out publicly against the FCA and PRA’s proposal to require firms to report data based on “gender” or “gender identity.” Badenoch argued that the regulators were looking to go beyond their equality duties as public sector bodies, which would be detrimental to competition and innovation.³³⁹

Also in April, *Financial News* reported that hundreds of firms, about one in five, had missed the deadline for the FCA's non-financial misconduct probe.³⁴⁰ At the time of this writing, it remains to be seen what the outcome of that investigation will be.

Auto Lending Probe

In January 2024, the FCA launched a probe into auto lenders' use of "discretionary commissions" that incentivized finance brokers and dealers to raise interest rates on auto loans until the practice was banned in 2021. "These motor finance firms were historically offering discretionary commission whereby they set a rate and gave the broker an opportunity to determine which rate is given to the customer," Kate Robinson, Principal at regulatory consultancy Avyse Partners, told the *FT*. "If you're a customer, you could have been charged a higher rate for the lending in order to increase the broker's commission."³⁴¹

Analysts estimate that the total cost imposed upon the industry from the investigation, which will look as far back as 2007, could reach £16 billion.³⁴²

In February, it was reported that Close Brothers had lost one-third of its value since the start of 2024, due to its exposure to the auto lending probe and another FCA review into insurance premium financing, whereby a loan is taken out to pay the premium on an insurance policy. The FCA has called insurance premium financing a "poverty premium," indicating its intention to crack down on the practice. RBC Capital downgraded the bank's ratings due to its exposure to these scandals.³⁴³

"Management are under pressure here," said RBC analyst Benjamin Toms of Close Brothers. "They will have to weigh up keeping income investors happy against making sure that capital is robust enough to potentially take a large hit from motor finance."

Later that month, Lloyds Banking Group set aside £450 million to cover costs related to the probe into auto financing practices, as reported by the *Financial Times*. Lloyds said its provision included operational and legal costs and any restitution it would have to pay customers. However, the bank cautioned that there remains "significant uncertainty" about the scale of the related misconduct and the losses it created for customers.³⁴⁴

In April, *Reuters* reported that the FCA had sent letters to banks instructing them to ensure they were prepared to meet potential costs of customer complaints arising from its auto financing probe. The regulator said it plans to set out next steps by September 2024.³⁴⁵

Debanking

In July 2023, Nigel Farage, a prominent Conservative commentator, accused Coutts, a high-end private bank owned by NatWest, of dropping him as a customer because of his political views. Farage published a 40-page dossier to support these claims, with internal documents he obtained through a subject access request, including a memo from Coutts which said that Farage's publicly proclaimed views were "at odds with [its] position as an inclusive organisation."³⁴⁶

However, this evidence conflicted with a *BBC* news story that said the account closure was "purely commercial." Alison Rose, then CEO of NatWest, subsequently admitted to speaking to the *BBC* reporter and giving him the impression that the decision was solely a business-driven one. Rose called the conversation a "serious error of judgment." Officials close to Prime Minister Rishi Sunak and Chancellor of the Exchequer Jeremy Hunt reportedly said they were "significantly concerned" about the situation.³⁴⁷ Rose soon resigned as NatWest CEO.³⁴⁸

However, unsurprisingly, that was not the end of the scandal for NatWest or its regulators.

In July 2023, a group of prominent conservatives and former financial industry figures wrote a letter urging Jeremy Hunt, Chancellor of the Exchequer, to investigate the FCA to “restore integrity” in the wake of NatWest’s de-banking scandal.³⁴⁹ The letter expressed concerns that the FCA may have inadvertently encouraged a banking culture that led to Nigel Farage losing his account. The authors pointed to the FCA’s emphasis on ESG, which encourages companies to act responsibly, and cited the regulator’s “vague” rules as open to varied interpretations.

The letter also noted concerns surrounding an FCA source’s comments expressing “a real sense of disquiet” inside the regulator over Dame Alison Rose’s departure as CEO of NatWest Group after the Nigel Farage account closure. The letter called for an investigation into the FCA’s culture as part of the effort to restore integrity in the banking system.

In September, the FCA published the results of a review into bank account closures that was spurred by this scrutiny. In an examination of 34 banks, payments companies and building societies, the regulator did not find a single instance in which an account was closed “primarily” due to a customer’s political views.³⁵⁰

However, some expressed skepticism in the results of the review, as it relied on banks self-reporting that they had not de-banked customers for political reasons. And the FCA itself acknowledged that there had been gaps in its methodology. “While no bank, building society or payment firm reported to us that they had closed accounts primarily due to someone’s political views, further work is needed for us to be sure,” said Nikhil Rathi, CEO of the FCA.

In an opinion article published in the *Financial Times*, Rathi explained that many banks had, however, closed accounts for “reputational” reasons. These concerns may be legitimate, as banks have long declined to service businesses that violate company policy.

However, the FCA would undertake further reviews to ensure that these reputational criteria are not being “stretched too far.”³⁵¹

In October 2023, NatWest published an initial review into its treatment of Farage, in which it identified “serious failings” in how it reached the decision to close Farage’s account, how it communicated with him thereafter, and in how it handled his confidential information. Despite this, the bank also asserted that it had acted “lawfully” and primarily on commercial grounds.³⁵²

Following the release of this report, the FCA announced that it was undertaking a review into the governance, systems, and controls at both NatWest and Coutts, as it believed that the review identified potential regulatory breaches and areas for improvement. “This supervisory work will include use of our statutory information gathering powers, interviews with relevant bank staff and reviews of appropriate policies or procedures,” the FCA wrote in its announcement.³⁵³

In December, NatWest published the results of the second phase of its internal review, with a focus on its bank closure practices more widely. While it said it had found potentially regulatory breaches and areas where its “exit” processes could be improved, it had not uncovered evidence of discrimination over peoples’ political views. The FCA said that NatWest’s review would be considered as a part of its probe.³⁵⁴

As of this writing, the FCA has not published the results of its review, or announced any related enforcement actions.

Other Conduct Issues

In July 2023, the PRA fined Credit Suisse £87 million for significant deficiencies in risk management and governance relating to its exposure to Archegos Capital Management.

“Credit Suisse’s failures to manage risks effectively were extremely serious, and created a major threat to the safety and soundness of the firm,” said Sam Woods, CEO of the PRA. “The seriousness and widespread nature of those failures has led to today’s fine, which is the largest ever imposed by the PRA.”³⁵⁵

In its press release related to this fine, the PRA explained that Credit Suisse had, among other shortcomings, failed to:

- Instill a culture within the investment banking division that appropriately balanced the considerations of risk against commercial reward;
- Evaluate and take due account of the risks to the Firms, and the Credit Suisse group, arising from their exposures in relation to Archegos’ portfolio; and
- Have a governance framework that adequately scrutinised or discussed the risks posed to the Firms by Archegos’ portfolio;

The severity of these breaches was reflected in the magnitude of the fine, which remains the PRA’s highest on record. For more background on the Archegos crisis, one of the many Credit Suisse faced in the years leading up to its collapse, please feel free to refer to our past *Compendium* reports. ► **SEE BRAD KARP ON STARLING INSIGHTS**

In January 2024, the PRA fined HSBC £57 million for failing to implement the requirements relating to depositor inspection, and for failing to notify the PRA over an approximately 15-month period about problems identified in its identification of accounts as eligible for the Financial Services Compensation Scheme (FSCS). Over that period, 99% of accounts eligible for the scheme were mismarked. The fine is the PRA’s second largest ever.³⁵⁶

“The serious failings in this case go to the heart of the PRA’s safety and soundness objective,” said Sam Woods, CEO of the PRA. “It is vital that all banks comply fully with our requirements around

preparedness for resolution. [HSBC] fell far short of its obligations in this area, and failed to disclose its failings to us in a timely manner. These failures led to today’s action, including the significant fine.”

In February, the *Financial Times* reported that Iran had used accounts at Lloyds and Santander to secretly transport funds around the world. Documents reviewed by the *FT* allegedly showed that the two banks had provided accounts to British front companies that were secretly owned by an Iranian government-owned petrochemicals firm which was under sanction.³⁵⁷

“This is, frankly, a shocking failure to act in lockstep with our allies to shut down the financing of a hostile regime,” said MP Liam Byrne, chair of the House of Commons Business and Trade Committee. “It beggars belief that a business sanctioned by the US is freely trading in London.”

However, Santander said that its internal investigation had not found any evidence of a breach of US sanctions.³⁵⁸

Notably, prior to this, it was reported by the *FT* in September 2023 that Santander had terminated a consulting contract with EY regarding a project aimed at resolving shortcomings in the bank’s financial crime and anti-money laundering systems. After EY’s work for Santander “went badly wrong over an extended period,” the consulting firm agreed to refund the bank approximately £15 million. EY was just one of several consultancies that Santander had brought in amid regulatory scrutiny on its anti-financial crime processes, including a £108 million fine levied by the FCA in December 2022.³⁵⁹

Non-traditional financial firms in the UK have also continued to face scrutiny of their management of similar culture and conduct issues. For instance, the UK’s most valuable fintech company — Revolut — has faced much criticism for the allegedly toxic work environment it had allowed to prevail. Hoping to

win a UK banking license, in January 2023 Revolut announced intent to establish a new behavioral team, charged with driving shifts in the company's culture.³⁶⁰

The new "CultureLab," was to house a team of behavioral and data scientists, working to help drive a more "human" approach to management within the firm. Reports suggest that this culture change program would revolve around inculcating a set of "values-based" behaviors among employees, to include being "inclusive, approachable" and "respectful at all times." Performance reviews and recruiting efforts were also to reflect the priority of desired culture fit.

Revolut has denied that this effort was explicitly aimed at improving its chances of receiving a UK banking license. Rather, the initiative was described as an attempt to allow the "human" element of work to catch up after a period of rapid growth. "I wouldn't say this is a straight reaction from regulatory discussions," said Hannah Francis, the Head of People Experience at Revolut. "This is more linked to our growth and how we're changing and the feedback we were getting from our people. We really needed to shift and change."

It is unclear how this initiative has progressed since it was announced. However, it is clear that Revolut has continued to face public setbacks that some believe have threatened its ability to obtain the banking license it so badly needs.

In July 2023, for example, the *FT* reported that a flaw in Revolut's payment systems in the US had allowed criminals to steal more than \$20 million over a few months in 2022.³⁶¹ The fintech has also filed its previous two annual reports belatedly,³⁶² and, in 2023 — when reporting on the company's long-delayed 2021 results — auditor BDO said it could not verify £477 million of the firm's £636 million in revenue due to deficiencies in its IT systems. While Revolut

claimed that the overall revenue figure was "not in question," BDO said that some of the information in the report may have been "materially misstated."³⁶³

Individual Accountability

There has been a continued trend toward individual accountability in the UK in the past year. In January 2024, for instance, the PRA imposed a nearly £119 thousand fine on Iain Mark Hunter, former CEO of Wyelands Bank, for violating the regulator's conduct rules. This action marks only the second instance where the PRA has issued a fine under the Senior Manager and Certification Regime since its introduction in 2016, highlighting a trend of intensified individual accountability within the financial industry.³⁶⁴

"The PRA has taken significant action against Mr Hunter because his management created prudential risks for the firm, threatened its safety and soundness and contributed to the firm's breaches of a number of PRA rules and regulations," said Sam Woods, CEO of the PRA. "If senior individuals fail to meet the conduct rules, as Mr Hunter did, it undermines the trust in financial institutions and the wider financial system."

Hunter was sanctioned for allegedly failing to act with "due skill, care and diligence" while running Wyelands Bank, and neglecting to take "reasonable steps to ensure that Wyelands had adequate systems and controls in relation to the large exposures regime and PRA record keeping requirements." Hunter was also accused of violating his firm's policies surrounding conflicts of interest.

The following month, Mohammed Zina, a former Goldman Sachs analyst, was convicted of insider dealing and fraud in London's Southwark Crown Court, receiving a 22-month sentence.³⁶⁵

Zina was accused of utilizing inside information gathered from his role in the conflict resolution group at Goldman to make illegal trades, concealing

them under the names of his family members. The trades were financed by bank loans he claimed were to be used for home improvements. The case is the first insider trading conviction the FCA has secured since 2019.

The FCA hoped the case would send a message that these offenses are being taken seriously. “There are many successful professionals across the City who are also in positions of trust and this outcome should be a wake-up call to them that trust is there for a reason, it is not there to be abused,” Therese Chambers, Joint Executive Director of Enforcement and Market Oversight at the FCA, said in an interview with the *Financial Times*.

However, some have argued that regulators are not doing enough to hold individuals accountable. In a February 2024 report, *Spotlight on Corruption*, a UK-based research and advocacy group, argued that the country’s regulators have failed to hold executives accountable for corporate misconduct.³⁶⁶

“After every corporate scandal... there are rightly calls for senior executives to face accountability — but this rarely happens,” said Susan Hawley, the group’s Executive Director. “This lack of accountability is bad for British business, bad for the UK economy and bad for the British people.”

The report revealed that just 6% of investigations under the Senior Managers and Certification Regime (SMCR) have resulted in any enforcement action since it was established in 2016. It also showed that the number of actions taken against individuals by the FCA had decreased substantially since 2013, with bans down 62% and fines issued down 50%. And, where the FCA had taken action against individuals, only 6% involved senior executives.

That same month, the FCA fined Floris Jakobus Huisamen, a former director of London Capital & Finance (LCF), £31,800 and banned him from working in the financial services sector. The regulator

claimed that Huisamen had signed off on the promotional strategy for the company’s mini-bonds that made them seem more attractive than they were, despite having his own concerns about the company’s strategy.³⁶⁷

“Mr Huisamen should have ensured LCF’s financial promotions were ‘fair, clear, and not misleading,’” said Therese Chambers, Joint Executive Director of Enforcement and Market Oversight at the FCA. “However, under him, the approval process became an ineffective tick-box exercise — as a result, thousands of investors were persuaded to invest on the basis of highly misleading statements. His failings contributed to thousands of retail investors losing significant amounts of money. It is right that he can no longer work in financial services.”

LCF was the center of a massive scandal after it collapsed in 2019. The firm had marketed unregulated mini-bonds to private investors — 11,000 of whom lost £236 million when the company failed. In the wake of the LCF’s collapse, a Treasury review determined that the FCA “did not effectively supervise and regulate” LCF. This is just one example of a growing trend of regulators being criticized publicly for their own culture, conduct, or performance.³⁶⁸

Name and Shame

In February 2024, the FCA announced that it was planning to start naming firms that were under investigation more frequently and at a much earlier stage as an effort to increase the deterrence effect that such probes have on misconduct. “More transparency around our enforcement work at an earlier stage is going to enable firms to start putting their houses in order where they need to at an earlier date than they’re currently able,” Therese Chambers, Joint Executive Director of Enforcement and Market Oversight at the FCA, told the *Financial Times*.³⁶⁹

Unsurprisingly, the FCA's proposal did not go without criticism. In April 2024, Miles Celic, Chief Executive of advocacy group TheCityUK, said that the industry was opposed to the FCA's plan to "name and shame" companies before the conclusion of investigations. "This contradicts the fundamental legal principle of 'innocent until proven guilty' and risks undermining trust and confidence in the wider industry and the UK's competitiveness," Celic told the *Financial Times*. "It would significantly and pointlessly damage a firm's reputation and value, especially given that FCA investigations take four years on average and many conclude without requiring any action."³⁷⁰

The FCA also reportedly faced pressure from senior parliamentarians, ministers, and others to drop the proposal.³⁷¹ In April, the House of Lords Financial Services Regulation Committee said that it had written the FCA urging it to halt its plans to name firms under investigation earlier until a more thorough analysis had been conducted. "The FCA has not carried out a cost-benefit analysis of its proposal or even assessed its likely impact," the Committee wrote in a statement. "That's why we're calling on the regulator to pause implementation until our committee has had a chance to gather evidence and scrutinise its proposal."³⁷²

However, in its response to the House of Lords Committee, the regulator made clear its intention to push forward with the plan. "We will consider all responses very carefully and we plan a further round of discussion and engagement to ensure we have understood all points raised and to share our initial thinking," the FCA wrote. "We also plan to do more work with stakeholders on a granular level to be clear about the process we might follow, the matters we might take into account and — importantly — what announcements might look like."³⁷³

Also in April, Chancellor of the Exchequer Jeremy Hunt joined the voices opposing the FCA's plan. "Last year the law changed in the financial services market and [the FCA] have a secondary growth duty," Hunt

told the *FT*. "On the basis of that I hope they re-look at their 'naming and shaming' decision because it doesn't feel consistent with that new secondary growth duty that they have."

In early May, the FCA CEO Nikhil Rathi and Chair Ashley Alder were due to appear in front of the House of Commons Treasury Select Committee for the regular "Work of the Financial Conduct Authority" hearing. "MPs are likely to ask witnesses how the regulator would like to respond to the criticism from stakeholders, as well as whether their plans are likely to be affected by the backlash," the Committee said ahead of the hearing.³⁷⁴

In that Hearing, Alder said that the FCA was surprised by the level of backlash the proposal received. "In truth, I think we weren't, at the time we put this [consultation] out, expecting such a stern reaction from the industry," he said.³⁷⁵

Accountability for Regulators

Just as regulators have sought to hold banks and bankers accountable for culture and conduct shortcomings in recent years, so too have regulators been held to account when management of their *own* culture or performance has been perceived to have been deficient. This was the focus of our February 2024 *Deeper Dive* report, "Physician, Heal Thyself."

Items contributed to that report by US Federal Reserve Board Governor Michelle Bowman ► **PAGE 179**, past Chairman of the UK Financial Conduct Authority Charles Randell ► **PAGE 243**, and past Chairman of the Australian Prudential Regulation Authority Wayne Byres ► **PAGE 317**, are reproduced here. For a more fulsome discussion of these themes, please see that report. Below, we offer discussion of notable examples, arising in the past year, when their own cultural predilections left regulators facing criticism.

In December, the Treasury named Rachel Kent, a partner at law firm Hogan Lovells, as the new Financial Regulators Complaints Commissioner. Kent, who started her five-year term in January this year, is responsible for independently reviewing complaints about regulators and the Bank of England.³⁷⁶

We have not seen a corollary role in other markets, and indeed in the UK Kent's function is perhaps not widely understood. But it is one that holds a unique promise. Utilizing information gained from received complaints, Kent is empowered to recommend changes to the regulators, including that they remedy complaints where complaints are upheld.

"The financial services regulators have a significant impact on millions of consumers and firms and it is important that they are subject to effective scrutiny," Kent said. "I look forward to working with the regulators to ensure that complaints are handled efficiently and that there is transparency around how they operate."

Kent is the first Commissioner to be appointed by the Treasury rather than by the regulators themselves, as had been past practice prior to reforms in the Financial Services and Markets Act of 2023. The change was just one of the ways the legislation sought to enhance the independence and accountability of regulators.

In a further move in that same direction, in January 2024, the House of Lords launched a new committee to oversee the country's financial regulators, as reported by the *Financial Times*. According to Lord Michael Forsyth, a former cabinet minister and investment banker, there was "unanimity" in the House of Lords that action was needed to enhance Parliament's ability to hold regulators accountable. The House of Lords Committee is to work alongside

the House of Commons Treasury Select Committee, which launched a subcommittee to oversee regulators in 2022.³⁷⁷

Parliament's heightened focus on regulatory accountability stems from the expansion of powers enjoyed by the FCA and PRA following Brexit. Last year, the regulators were also given the secondary objective of promoting economic growth and international competitiveness. "It is vital we are accountable to parliament for the role it has given us. We look forward to engaging with the committee," the FCA said in response to the formation of the new oversight committee.

In February 2024, the House of Lords issued a report entitled, "Who Watches the Watchdogs? — Improving the Performance, Independence and Accountability of UK Regulators." The report

was the culmination of an inquiry launched in October 2023 by the House of Lords Industry and Regulators Committee. It was based upon input from industry participants, parliamentarians, current and former regulators, regulatory agencies, and governmental departments.³⁷⁸

"[A]mid a series of high-profile failures, there are growing concerns about the functioning of the three-way relationship between the regulators, the Government, and Parliament, particularly the role and performance of regulators, their independence, and their accountability," the report read. "If the integrity and legitimacy of the UK's regulators are to be preserved, these concerns must be addressed."

The Committee provided many recommendations for doing so: clarifying regulators' duties, strengthening regulatory independence, and providing adequate resources for agencies to fulfill their mandate, among others. Perhaps the most substantial suggested reform was the formation of an "Office for Regulatory

"Who Watches the Watchdogs? — Improving the Performance, Independence and Accountability of UK Regulators."

THE HOUSE OF LORDS
FEBRUARY 2024

Performance” to “advise and support Parliament and its select committees in holding regulators to account for their performance in a routine and systematic manner.”

In May 2024, the UK Department of Business and Trade published a whitepaper entitled, “Smarter Regulation: Delivering a Regulatory Environment for Innovation, Investment and Growth,” outlining a set of 23 reforms aimed at supporting regulators in meeting their competitiveness objective, and holding them accountable for doing so.³⁷⁹

In the foreword to the report, Secretary of State for Business and Trade Kemi Badenoch and Lord Johnson of Lainston, the Minister of State for Investment and Minister of State for Regulatory Reform, wrote:

Regulators should see themselves as enabling great businesses to deliver fabulous products and services at competitive prices. We stress the importance of a ‘service culture’ where regulators need to be transparent in how they operate and in what they are doing to ensure companies can innovate and grow. Regulators should be enablers not blockers, their first answer should be ‘yes if’ not ‘no because’ and the broader ‘body politic’ needs to scrutinise their activities more effectively to ensure they are doing this.

Several of the reforms laid out in the report aim at inculcating a “culture of a world-class service” among the UK’s regulators. The paper proposed several measures to support these efforts:

- Creating a set of ten principles of smarter regulation, including requirements to avoid unnecessary risk aversion, act proportionately, and build a skilled regulatory workforce ;
- Enabling Ministers to monitor how regulators apply those principles; and
- Creating a register of regulators to establish a “one stop shop” of regulatory information, among others.

In addition, the Government will establish a Regulators Council to improve strategic dialogue between regulators and Government and to monitor the effectiveness of policies and strategic guidance. Notably, the Government intends to lead by example by adopting many of these same reforms, including by adhering to the ten principles.

The whitepaper did not propose the creation of an “Office for Regulatory Performance,” as suggested in the House of Lords report. However, in a list of responses to the recommendations made in that report, the Government wrote that it would work with Parliament to consider how such an office would be best implemented.

In the short-term, the Government instead put forth a new “Growth Duty Performance Framework,” to encourage transparency on how regulators are supporting innovation, investment, and economic growth. In a separate document published alongside the whitepaper, the Government provided a set of metrics and questions against which regulators will be required to report. For example, regulators will be asked to provide information on how they have sought to simplify regulation to remove outdated guidance and regulatory barriers, on what innovations they have implemented that may foster economic growth, and on what steps they have taken to reduce the number of data requests made of the businesses they regulate.³⁸⁰

It remains to be seen how these reforms will impact regulatory effectiveness, whether they will truly improve economic growth, and how such programs will influence hard-earned improvements in the management of culture and conduct risks in the financial sector.

Industry Efforts to Drive Change

In November 2023, the Institute of Directors (IoD) launched a commission to develop a voluntary code of conduct for corporate board members to improve

standards and rebuild trust following the widely publicized collapses of construction firm Carillion and retailer BHS. The commission is being led by former Labour Party General Secretary Iain McNicol.³⁸¹

“Directors make key decisions across a variety of organisations, and it is essential that they are seen as both competent and ethical actors,” said Jonathan Geldart, Director General of the IoD. The code of conduct is distinct from the governance code administered by the FRC and directors’ legal duties under UK law. While these typically focus on large companies, the IoD’s efforts target individual conduct and behavior. “A code of conduct would, therefore, be complementary to the existing governance code framework and directors’ fiduciary requirements,” said Roger Barker, Director of Policy and Governance at the IoD.

FINANCIAL CONDUCT AUTHORITY

We have already discussed much of the FCA’s work from the past year, including its efforts to address sexism in the financial sector, to enforce its regulations and sanction firms that commit misconduct, and to hold executives accountable when they fail to ensure their firms manage any of these issues effectively. The FCA has also undertaken substantial efforts in a few other key areas: stepping up its supervisory capabilities, supporting innovation internally and within the financial sector, bolstering its scrutiny of financial crime, and collaborating with regulators in other jurisdictions to aid in each of these efforts. Below, we discuss those initiatives in more detail.

Supervision

In a “Dear CEO” letter, sent in September 2023, the FCA warned wholesale bank leaders against reducing risk controls amidst challenging economic conditions and other external pressures.³⁸² The FCA stressed that regulatory obligations should not be compromised

for short-term revenue gains, despite the difficulties posed by inflation, weak growth, rising interest rates, and geopolitical tensions.

The FCA indicated that it expects banks will enhance their risk management practices in response to these challenges, and stressed the importance of improved oversight in light of 2023’s bank failures. “Our concern is that the external environment may impact the management of these risks through cuts in the control framework,” the FCA wrote.

To address these concerns, the regulator is increasing its supervision of banks and plans to conduct more in-person visits. The FCA will also undertake supervisory testing to determine whether firms have made improvements to risk management processes. And, during periods of market stress, the regulator intends to increase its engagement with firms.

“As CEO, the Senior Managers and Certification Regime makes you responsible for ensuring that relevant staff at your firm understand our rules and principles for businesses and for ensuring that your firm complies with them,” the FCA wrote. “If you are not meeting those rules and standards, you must notify the FCA immediately, setting out what you are doing to remedy any breaches.”

In a speech at a November 2023 conference, Sheree Howard, Executive Director of Risk and Compliance Oversight at the FCA, emphasized the importance of fostering an environment where employees feel empowered to speak up and challenge their superiors. Howard argued that such a culture, which some would describe as having “psychological safety,” is essential to stop companies from failing.³⁸³ She urged leaders to create an atmosphere of fearlessness rather than fear, allowing for open communication and the ability to question decisions. “Being able to challenge — even the boss — is crucial,” Howard argued. “Employees should feel free to speak up and even more importantly, bosses should feel compelled to listen up.”

Howard also stressed the need to address non-financial misconduct, as such behavior may discourage employees from speaking up and undermine faith in fair consideration of concerns. “A culture that tolerates nonfinancial misconduct is unlikely to be one in which people feel able to speak up and challenge decisions,” she said.

Howard contended that organizations lacking diversity are at a greater risk of having an unhealthy culture. “Diversity of perspectives and thought, when part of an inclusive culture, reduces group think, and results in stronger and better governance, decision making and risk management,” she argued. “Finally, we know times are tough and that you are all under ever greater pressure but right now, is exactly the time to maintain and to resist any temptation to lessen standards or let things slide,” Howard concluded. “Good risk management protects profitability.”

In an article published that same month in the *International Banker*, WilmerHale Investigations Group Partner Richard Burger, Senior Associate Chris Ladusans, and Paralegal Katy O’Connor examined the FCA’s efforts to make its supervision and enforcement more effective over recent years.³⁸⁴ According to the lawyers, Nikhil Rathi, CEO of the FCA, has been steadfast in his vision for a more robust and expeditious enforcement approach since his appointment in 2020.

In October 2023, Rathi reiterated the goal of “fewer, faster Enforcement investigations.” In this direction, the FCA has appointed Therese Chambers and Steve Smart as Co-Executive Directors of the Enforcement and Market Oversight Division. Chambers, drawing on her two decades of FCA experience, has emphasized the need for firms to “get their ducks in a row now” as “there really is nowhere to hide.”

A culture that tolerates nonfinancial misconduct is unlikely to be one in which people feel able to speak up and challenge decisions.

SHEREE HOWARD

But the FCA’s efforts have not gone without criticism. Upper Tribunal judgments have exposed shortcomings in the regulator’s enforcement and supervisory practices. The Upper Tribunal is a superior court of record that is empowered to make formal recommendations in its judgments regarding the FCA’s “regulating provisions or its procedures.” In exercising this power, the Tribunal has criticized the regulator for repeated “failings in its disclosure obligations” and for delaying investigations when it cannot commit the necessary resources. “There are only so many times that the [FCA] can apologise for its failings, insist that lessons have been learned and then expect that those affected should simply move on,” the Tribunal said.

In its above cited article, counsel at WilmerHale advised firms to prepare for assertive supervision, as engagement with the FCA can be rigorous even before a case reaches the enforcement stage — particularly since a proactive and considered response when approached by the FCA may influence whether a matter is escalated to the enforcement team at all. “Forewarned is forearmed,” WilmerHale reminds. “Firms, particularly their senior managers, should know how to prepare and respond to regulatory enquiries.”

Consumer Duty

Over the past few years, the FCA has worked to implement the Consumer Duty, a regulatory regime which requires firms to focus on supporting customers in making good financial decisions and avoiding foreseeable harm at every stage. Following several consultative periods, the regulator published the final Consumer Duty Policy in July 2022.³⁸⁵ While it was originally slated to come into effect in the spring of 2023, the regulator delayed the deadline to July 2023 after the industry pleaded for extra time.³⁸⁶



FROM OUR 2021 Compendium

Outcomes Based Regulation

by **Chris Woolard,**
past-Interim CEO,
Financial Conduct Authority

“There will be risks and multiple trade-offs that regulators, governments, firms and ultimately consumers will need to navigate and resolve. But by establishing clearly defined outcomes we aim for, and agreed principles by which they are to be achieved, we will enable the detailed rules that many firms will need in order to act with confidence.”



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In a June 2023 speech, Emily Shepperd, COO and Executive Director of Authorisations at the FCA, emphasized the importance of transforming culture to rebuild trust, ensure better outcomes for consumers, and create a more resilient and sustainable financial system.³⁸⁷ Culture remains central to the FCA’s supervisory model, as it underpins outcomes, conduct, and business performance, Shepperd maintained. “Culture is not just the slogan on your website,” she argued. “It is the very essence of what your organisation stands for, embodied by how it conducts itself.”

Cultural considerations are embedded in the FCA’s Consumer Duty, which was due to come into full force the following month. “Firms’ boards and senior management, if they haven’t already, will have to embed a culture in which good outcomes for consumers is central,” Shepperd stated. “People

Culture is not just the slogan on your website. It is the very essence of what your organisation stands for, embodied by how it conducts itself.

EMILY SHEPPERD

management policies and practices, including performance management, pay and bonuses will be critical to doing so.”

Another key aspect of improving culture, Shepperd contended, is preventing the recruitment of “bad apples.” She urged companies to be more vigilant in considering past misconduct when hiring new employees. Firms that fail to evaluate adverse information in regulatory references may expose themselves to entirely foreseeable and preventable risks. “Getting your culture right, is about increasing your chances of growing as a business — and attracting the next generation of recruits,” Shepperd concluded.

In February 2024, the FCA published “Consumer Duty Implementation: Good Practice and Areas for Improvement,” a review of firms’ implementation of the Consumer Duty and their frameworks for setting fair values for products and services. The FCA laid out both good practices and opportunities for improvement in six key areas: culture, governance and monitoring; consumers in vulnerable circumstances; products and services; price and value; consumer understanding; and consumer support.³⁸⁸

As an example of good practice, the FCA identified that some firms have sought to embed consumer-centrism into their purpose. Others have also sought to develop new metrics, and appropriate governance structures, to better understand their customers. However, others have not been so successful. For instance, some firms’ Consumer Duty efforts are siloed within their risk or compliance teams, and are not discussed by their boards.

“Firms need to ensure that the focus on good customer outcomes is understood at all levels, in their strategies, leadership, and people policies,” the FCA wrote.

Innovation

Speaking at a November 2023 Culture and Conduct forum, the FCA's Emily Shepperd highlighted the regulator's focus on improving consumer outcomes, and explored how an emphasis on culture and the safe adoption of AI may present opportunities to do so more effectively.³⁸⁹



FROM OUR 2021 Compendium

On Company Purpose & Culture

by **Jonathan Davidson,**
past-Director, Financial Con-
duct Authority

"Diversity and inclusion are often paired together and referred to as 'D&I' for ease, but they are two distinct characteristics of a healthy culture that each require urgent attention. The constant reference to 'D&I' is not always helpful, as we risk reducing these important topics down to an acronym that is used without giving thought to what it really means, and so it becomes just more corporate jargon."



[CLICK HERE to READ MORE](#)

Shepperd pointed to the FCA's Consumer Duty as a critical part of its relevant efforts. "The duty raises the bar on how firms should treat their customers, with greater focus on acting in customers' best interests and putting them in a position to make effective decisions." And she argued that firm culture would be a key determinant of its successful implementation of the Consumer Duty and the delivery of its intended

good outcomes. "A healthy culture on its own may not equal profit, but a poor culture can certainly lead to calamity," she said.

In order to build a "healthy culture," Shepperd suggested that firms start by cultivating a diverse and inclusive environment, which is in line with the FCA's September 2023 proposal to increase diversity in the financial sector. "The aim is to deliver better internal governance, decision making and risk management, ultimately strengthening the safety and soundness of firms with better outcomes for markets and consumers," she said.

Shepperd explored areas where the adoption of AI, and generative AI specifically, could yield future results for the regulator, including coding support, summarisation, and deep retrieval search capabilities. "To do this we are making sure to build strong controls or governance, including ensuring appropriate levels of human or technical validation appropriate to the very different models, and associated novel threats, emerging," she stipulated. Recognizing the concerns surrounding AI, and a key strand of the FCA's work is examining how AI will affect consumers and how it can make them aware of any risks to which they may be exposed.

In a Speech delivered in April 2024, the FCA's Nikhil Rathi announced that the regulator would examine how Big Tech's access to large data sets could unlock better products and more competitive prices for financial services customers and businesses. "Big Tech's growing emergence in financial services has already made life easier for consumers, but it is still unclear how valuable their data will become in financial markets," Rathi said. "That's why we want to work with Big Tech to examine how their data could be most helpful for financial firms and their customers in future, and to ensure competition evolves effectively."³⁹⁰

Financial Crime

In February, the FCA provided an update on its three-year strategy to reduce and prevent financial crime, calling for public-private collaboration across sectors to bring new tools to bear. Enforcement remains a key priority for the regulator. In 2023, losses from scams were reduced by 40%, and a record 15 individuals were charged with fraud offenses.

However, the FCA acknowledged that enforcement alone is not sufficient to solve the problem of financial crime.³⁹¹ As part of its strategy, the FCA has also invested in fraud prevention initiatives, such as issuing warnings about scams and partnering with social media platforms to ban unauthorized financial service advertisements.

In a blog post published at the same time, Mark Francis, the FCA's Director of Wholesale and Unauthorised Business Investigations, stressed the importance of collective action across sectors. "We've identified four areas where we believe further collaborative effort can help shift the dial decisively on reducing and preventing financial crime," Francis wrote. These areas include data and technology, awareness, collaboration, and metrics.³⁹²

The FCA has established an outcomes and metrics framework to measure the effectiveness of its financial crime work, urging firms to implement similarly robust measures. "Our message is clear — it is up to all of us to take action to protect our consumers, our firms and our markets," Francis concluded. "Together, we can shift the dial decisively to reduce and prevent financial crime."

Global Collaboration

In a speech in February 2024, Ashley Alder, Chair of the FCA, argued that global collaboration among regulators is essential for effectively managing cross-border risks. "More broadly we see a cooperative approach as a necessary condition for

the collective effort required to tackle the challenges and opportunities posed by the climate crisis, developments in Fintech and the growth of financial intermediation outside banks," Alder said.³⁹³

International cooperation among regulators on Fintech can allow firms and consumers to benefit from new technologies, while also enabling regulators to mitigate novel risks. "Many of us have launched successful regulatory and digital sandboxes and have set up mechanisms to learn from each other as innovation develops," Alder said. "But we must also be alert to new risks where the development of common international approaches to protect financial stability and competition is essential." As an example, Alder pointed to the bank failures in 2023, whereby technology allowed for the bank run on Silicon Valley Bank to occur with unprecedented speed.

Alder also discussed the necessity of collaboration between the UK and EU, as their financial markets remain intertwined. "We may have left the EU, but the ties that bind the UK and Europe together — economic, cultural and relationships forged over decades — remain incredibly strong," he argued. "By strengthening our partnerships, enhancing our cooperation and upholding our shared values, we can build a more prosperous future for generations to come."

PRUDENTIAL REGULATION AUTHORITY

In July 2023, the PRA published a document outlining its approach to supervision. Therein, the PRA emphasized governance and culture as key supervisory concerns.³⁹⁴ "It is the responsibility of each firm's board and management to manage the firm prudently, thereby contributing to the continued stability of the financial system," the regulator wrote. As such, the board should articulate a desired culture that encourages ethical behavior among employees. The board must also hold management accountable for embedding and maintaining this culture.

While the PRA does not look for any specific culture in particular, it will look to ensure that accepted practices are challenged and that risks are addressed quickly. “In particular, we want to be satisfied that designated risk management and control functions carry real weight when challenging the business decisions made within firms and that consideration is given to the wide range of risks facing firms,” the PRA explained.

When boards and executives fail in these responsibilities, the PRA may take supervisory action to compel firms to resolve cultural shortcomings. “[I]n certain cases, we will choose to deploy formal powers at an early stage and not merely as a last resort,” the PRA wrote. “This can include addressing serious failings in the culture of firms.”

In an October 2023 speech, Sam Woods, Deputy Governor at the Bank of England and Chief Executive Officer of the PRA, argued that the failure of Credit Suisse made clear that “money isn’t everything.” The bank’s collapse into a government-led forced rescue by rival UBS resulted from a long history of shortcomings in governance and risk management, not insufficient capital or liquidity.³⁹⁵ “CS ultimately failed because investors lost confidence in its ability to sustainably make profits into the future,” he said. “This reflected persistent low profits, a business model that was arguably ill-suited to the post-crisis landscape, repeated and highly damaging misconduct cases and very costly risk management failures.”

The experience at Credit Suisse highlights the importance of non-financial risk and supervision, and concerns related to governance, culture, and operational resilience. “The best regulatory framework in the world would be useless without effective supervision,” Woods asserted.

Regulators and supervisors cannot fix broken business models, and poorly-run firms must be allowed to fail, Woods maintained. “But it re-emphasises the need for

robust, forward-looking supervision so that we are not often taken surprise by failures, and can contingency-plan appropriately,” he said.

FINANCIAL REPORTING COUNCIL

Corporate Governance Reform

In May 2023, the Financial Reporting Council launched a consultation on a revised Corporate Governance Code for the first time in five years, aiming to bolster board accountability and improve internal controls.³⁹⁶ “Good corporate governance contributes to long-term company performance by helping to build an environment of trust, transparency, and accountability necessary for fostering long-term investment, financial stability, and business integrity,” said Sir Jon Thompson, then FRC Chief Executive.

The revisions focus primarily on five key areas:

- Dealing with the need for a framework of prudent and effective controls to provide a stronger basis for reporting on and evidencing their effectiveness;
- Reflecting the responsibilities of the board and audit committee for sustainability and ESG reporting and appropriate assurance in accordance with a company’s audit and assurance policy;
- Taking account of the new Audit Committee Standard (and the External Audit Minimum Standard);
- Improving the functioning of Comply-or-Explain practices where current reporting seems weak; and
- Ensuring that the Code aligns with changes to legal and regulatory requirements, including strengthening reporting on malus and clawback arrangements.

“Enhancing the Corporate Governance Code will meet the needs of all corporate stakeholders, including investors, employees and suppliers, and boost the resilience of the UK economy, ensuring it continues to attract talent and investment,” said Thompson.

Responding to the proposed changes to the Code, in September 2023, the Institute of Chartered Accountants in England and Wales (ICAEW) expressed concerns about a potential decline in the UK’s global reputation for best practice in corporate governance.³⁹⁷

According to ICAEW, the proposed changes to the Code fell short of incorporating essential aspects of the new G20/OECD Principles for Corporate Governance. “We would have liked to have seen a more joined-up review of the Code and associated guidance as that would have given a clearer picture of what the proposed changes are likely to mean in practice,” said Peter van Veen, Director of Corporate Governance and Stewardship at the ICAEW.

ICAEW did welcome the plans to emphasize director accountability and the role of audit committees in governance reforms, but it cautioned that many proposed changes might impose heavy implementation burdens, leading to a reduced level of compliance. The organization called on regulators to ensure that an updated Code exemplifies global best practices while making it both feasible and desirable for businesses to comply.

“Going forward, we believe the development of a one-stop-shop of relevant resources and guidance to help companies understand their reporting requirements would be highly beneficial and we would be happy to work with the FRC to develop this,” van Veen said.

In November, the FRC’s new CEO Richard Moriarty announced that the final version of the Code would drop over half of the 18 initially proposed reforms. The scrapped proposals include heightened diversity reporting requirements and new audit committee responsibilities for environmental, social, and governance (ESG) issues.³⁹⁸ “The UK rightly enjoys a strong reputation for high governance standards but it’s important that we don’t burden our best and brightest companies to the extent that it’s not a level playing field versus our international competitors,” Moriarty said.

This move is seen as aligning with the Government’s aim to reduce red tape on businesses and bolster London’s standing as a financial hub. The FRC’s decision was labeled “pragmatic and proportionate” by City Minister Andrew Griffith, emphasizing the importance of maintaining a level playing field with international competitors. However, some have criticized the softening of the proposed governance requirements. Roger Barker, Director of Policy and Governance at the Institute of Directors (IoD), said the FRC’s decision was “the latest stage in the unraveling of the government’s corporate governance reforms.”

In Focus

An Interview with Andrea Enria



Andrea Enria



Q: You were among the first to highlight culture and governance in the context of last spring's banking sector "turmoil," as we've taken to calling it. What informed your views in this regard?

A: The spring 2023 turmoil confirmed a strongly held belief of mine, that the post-crisis regulatory reforms have been fundamental in strengthening the

banking sector, but are not enough in the absence of strong internal governance and healthy risk culture within the firms.

Stronger capital and liquidity requirements, a better calibration of risk weights, and constraints to the use of internal models for regulatory purposes, set important guard rails and definitely reduce the probability of banking crises. Tougher requirements for systemically important banks and resolution tools contain the impact of failure at larger, internationally active players.

But poorly run banks, with a lack of proper internal checks and balance, without an effective functioning of the three lines of defence, with an internal culture that does not adequately constrain excessive

risk taking and repel misconduct, will continue to fail and generate turmoil and potential for systemic damage.

Culture and governance should be more and more the key focus of our debates, and the challenge is to design effective supervision to address shortcomings in these areas, rather than new regulatory reforms that further fine tune minimum requirements without addressing the fundamental drivers of excessive risk taking and misconduct at firms.

Q: At the NY Fed's annual Governance and Culture Reform [conference](#) last June, the Fed's Vice Chair for Supervision, Michael Barr, suggested that "governance is another word for culture." Do you agree? Or would you draw a distinction between these terms?

A: Michael Barr is right that the methodologies of prudential authorities generally bundle cultural aspects into the assessment of governance. In the supervisory methodology developed by the ECB, for instance, risk culture is a module of the internal governance assessment, and includes the analysis of remuneration policies.

However, I would acknowledge that the culture of an organisation is something broader and more encompassing. It includes all the explicit and implicit norms and values that drive behaviour at different levels of the organisation, from risk taking, to relationship with customers, the role played in the communities where the bank operates, the attention paid to avoid any involvement with financial crime, tax evasion and money laundering, to quote a few aspects.

Supervisors need to understand broader cultural aspects that may well affect the viability of the firms under their responsibility. And if they see something wrong, they have a duty to increase the pressure on

Culture and governance should be more and more the key focus of our debates.

management and boards for cultural change, even though the traditional supervisory toolkit might not be well suited to deal with cultural issues.

Q: Since the failure of SVB and Credit Suisse, you and many others have argued that supervisors need to develop greater ability to ensure that firms are able to demonstrate “robust governance” and a “sound risk culture.” What responsibilities does this imply for boards of directors? And how would you expect them to provide supervisors with adequate assurance in this connection?

A: Sometimes I perceive a reluctance of firms to engage with their supervisors on governance and cultural issues. Supervisory initiatives in these areas are often seen as excessively intrusive, as internal governance is at the core of the private autonomy of firms to organise and direct their own business.

But the crises at SVB and Credit Suisse showed that serious shortcomings identified by the supervisors and, in the case of Credit Suisse, even by the firm itself — I am referring here to the issues identified in the independent report on the Archegos case published by the bank in the summer of 2021 — are not remediated fast enough.

I think boards should be more receptive and open to dialogue on issues raised by the supervisors and take more direct ownership of the necessary adjustments.

In the successful cases supervisors show boards what they observe in the functioning of their bank’s governance and culture, basically putting the bank in front of a mirror.

Reactive boards understand that there are areas in which action is needed. In some instances, however, boards — especially dominant figures within boards

Supervisors need to understand broader cultural aspects that may well affect the viability of the firms under their responsibility.

There are issues of culture also at supervisory authorities, which need to be openly discussed and addressed.

— reject most of these observations and deny any validity with regard to supervisory exercises in the area of governance and culture. The latter cases may prove much more difficult, of course, as any successful change in governance and culture needs to be driven first and foremost by the firms themselves.

Q: Since the 2023 banking “turmoil” many in the industry and the regulatory community have consoled themselves that the underlying risks were idiosyncratic; isolated to the firms involved. And related supervisory failures have also been viewed as idiosyncratic in nature. Do you agree?

A: I believe the turmoil of last year raised important questions for all supervisors.

In the European Union, a very positive reading of events has prevailed, as no bank in our jurisdiction defaulted or needed assistance from the authorities. And, indeed, it was positive to see that after a long journey to repair banks’ balance sheets, the sector had achieved a stronger level of resilience.

But many issues identified in the candid reports published by our colleagues in the US and Switzerland resonated with me. Surely SVB had a peculiar, unbalanced business model and massive shortcomings in risk management. And Credit Suisse repeatedly failed to show an ability to repair weaknesses in risk management and convince investors that its business model was sustainable. But similar, less extreme shortcomings in governance and culture have been clearly identified by supervisors in a number of banks in the EU and often remediation has not been fast enough.

The issue of supervisory effectiveness came out very strongly from those cases: supervisors should get better at prioritising issues, having an effective escalation ladder, and use of enforcement tools that ensure that relevant shortcomings are promptly addressed. There are issues of culture also at supervisory authorities, which need to be openly discussed and addressed.

Q: To date, culture and conduct risk have been considered matters for conduct regulators, with a view to guarding against potential consumer harms. But in 2015, then Chairman of the Financial Stability Board [Mark Carney](#) argued, “Misconduct in financial institutions has the potential to create systemic risks by undermining trust in financial institutions and markets.” Do you agree? Do banking system misconduct issues warrant the attention of prudential regulators?

A: Misconduct issues in the last 15 years had a major capital impact on a number of banks, as court decisions or administrative sanctions reached very high levels, north of 300bn dollars. Besides that, the series of conduct issues and scandals generated huge reputational impact, which questioned the sustainability of the business model at a number of banks. And we have a number of cases proving that banks that are unable or unwilling to prevent misconduct are more likely to fail.

Since the failure of ABLV Bank, which was triggered by accusations of money laundering by the US Department of Treasury, the ECB started paying much greater attention to anti-money laundering and conduct issues in its prudential assessments, enhancing cooperation with the competent authorities in those fields. Finally, when a bank, however small, unexpectedly fails, markets start chasing for the next weak link and the channels for contagion could be difficult to predict and contain, determining disturbances of systemic relevance.

All the banks that failed during the turmoil of the spring 2023 shared major weaknesses in risk management, internal governance and culture.

So yes, I definitely agree with the statement of Mark Carney.

Q: Amidst debate in the US and elsewhere around capital requirements, you have suggested that a focus on capital to offset operational risk is perhaps misguided. In a [speech](#) last September, for instance, you said, “Industry and supervisors need to move on from the capital calibration discussion.” Rather, you argued, “supervisors need to focus more on the effectiveness of supervisory action.” Can you elaborate?

A: The tightening of capital requirements was an absolute necessity after the Great Financial Crisis (GFC). The Basel Committee devoted a lot of efforts and analyses to calibrate the requirements, taking into account transitional and long-term effects on the financing of the economy. Personally, I would have supported a more conservative calibration, as I was never convinced by the industry claims that higher capital requirements would have a major adverse impact on lending, growth, and employment.

But the international standards are now in the final stages of implementation in all G20 jurisdictions and have already contributed to enhancing the resilience to macroeconomic shocks. I regret that, in the EU, the implementation process has brought deviations from the international standards defined in Basel, and I hope these deviations will be subject to future review. I understand now this debate is on-going in the US, and I am fully supportive of the efforts of supervisory authorities to have rulebooks fully aligned with international standards and to use this opportunity to fix issues they have identified in their jurisdiction.

But once the implementation process is completed across the G20, we should move on from the debate on calibration of capital requirements and focus more

on the issue of effective supervision. All the banks that failed during the turmoil of the spring 2023 shared major weaknesses in risk management, internal governance and culture, and the supervisors have not always been able to promptly identify shortcomings and, especially, drive prompt remediation.

This topic came out strongly also in an independent report of international experts on the ECB's supervisory review and evaluation process¹, published in the spring of 2023, but initiated well before the crises of US regional banks and Credit Suisse.

Another important lesson of the turmoil of last year is that markets can rapidly shift from a balance-sheet view of banks, which largely focus on the same indicators used by regulators, to a mark-to-market view, almost entirely focused on current valuations. Banks whose business model is not perceived as sustainable may end up under tremendous pressure, as also uninsured depositors use market triggers to decide to withdraw their funds.

This means that supervisors should sharpen their analysis of business model sustainability — for instance, with a more creative use of stress testing and more effective tools to foster rapid adjustments where necessary. All these themes seem to me fundamentally important and are well within the remits of supervisors, without any need for changes in legislation. Focusing our limited resources here would give us more bang for our buck.

A lot of work is being done on data analytics, which I think is the most promising frontier for SupTech tools.

Q: In its post-mortem of the 2023 banking sector travails, the IMF [argued](#) that “supervisory judgement depends upon a holistic understanding of the financial institution, including non-quantifiable elements such as risk management culture and corporate governance.” Do you agree that these matters are non-quantifiable? I’m reminded of the adage, “If you can’t measure it, you can’t manage it.” If we accept the IMF’s formulation, are we essentially resigned to the view that culture and governance are not manageable?

A: In regular supervisory assessments, authorities do attribute scores for governance. So, it is possible to develop quantitative measures and to rank banks according to the effectiveness of their governance. But it is essential that the scores are not mechanistically derived from a set of indicators. This is how I interpret the point raised by the IMF: any metric we develop should leave enough room for supervisory judgment and fully exploit the profound knowledge of the firm developed by the supervisors through years of close observation and personal interaction.

I also believe in the value of peer comparisons across firms in the internal challenge of supervisory assessments — as any human judgement could be affected by bias. In my view, a robust supervisory assessment needs to be the outcome of a balanced blend of quantitative indicators, supervisory judgment, and peer comparisons, and this applies also in the area of governance and culture.

Q: In a [speech](#) last June you said, “Developing a supervisory culture that promotes judgement and challenge is crucial... We need to be unafraid to escalate where we detect deficiencies.” How did you go about establishing such a supervisory culture at the ECB?

A: The first and most important ingredient is creating safety for supervisors: they need to know that the leadership of the authority is empowering them to make difficult choices and will not blame them if mistakes are made. This should be made clear in words and deeds, otherwise supervisors will grow very cautious in exercising their responsibilities and they will therefore be less demanding on firms.

A complementary element is the creation of robust checks and balances within the authority. As they ask of banks, supervisors too should endow themselves with an effective system, based on three lines of defence. The reorganisation of the supervision area at the ECB during my tenure was aimed at fostering judgement by line supervisors, promoting horizontal functions to ensure consistency of supervisory assessments across firms, introducing a strong second line of defence, and establishing a risk appetite framework and monitoring compliance with it.

Finally, you need to have a strong, independent legal function supporting the decision making at board level, with a clear identification of the legal risk in supervisory decisions. Central banks generally don't like losing in court but, in the conduct of supervisory functions, they need to accept legal risk: when supervisors identify something that doesn't look right, they need to be able to act, within a fair and transparent process, accepting that sometimes their decisions will be challenged in courts.

Q: In our recent Deeper Dive report, "Physician, Heal Thyself," past-Chair of the Australian Prudential Regulation Authority, Wayne Byres, lamented that, "Attention to culture within firms has not flowed into similar international efforts to strengthen the mindset and culture of financial supervisors." He calls for a joined-up international effort in this direction. Do you agree?

A: As always, I fully share Wayne Byres' views and consider his call particularly important given the role he played in the Basel Committee.

International efforts have been for a long while focused on standard setting, and reviewing the implementation of those standards across jurisdictions. I think this was the right thing to do in a post-GFC setting. Now, it would be important to focus on culture at supervisory authorities.

Such an effort would also increase the credibility of supervisors when challenging governance and culture at banks. Supervisors rightly put a lot of emphasis on diversity among boards, on the need to avoid groupthink, and to nurture challenge and open debates within boards. They also require banks to strengthen the effectiveness of the three lines of defence in their organisation. I believe supervisors should also abide by the same principles in their own internal governance.

As I mentioned before, there could be mindsets at supervisory authorities that inhibit effective challenge of firms' behaviour, delaying necessary interventions; or inadequate internal safeguards to ensure due process and consistency of supervisory actions across firms. I believe we should collect examples of good organisational features and internal practices at supervisors to foster a culture that empowers supervisory judgment, develops a risk appetite framework for line supervisors, and ensures checks and balances, fairness and transparency of processes.

I am currently conducting an independent review of the fitness and probity framework of the Central Bank of Ireland, and I started by looking at the practices developed by other authorities, which could be useful to enhance processes in this delicate area of supervision. There is a wealth of information that can be usefully gathered and disseminated amongst authorities to support strong supervisory judgment within fair supervisory processes.

Q: Others in this report call for the greater adoption of AI-powered Supervisory Technology (SupTech) tools to improve supervisory capabilities. The ECB has been a [real leader](#) in this regard. What are your thoughts on the promise of SupTech in the context of our discussion here?

A: I believe the ECB has done a good job in developing SupTech tools. Each year the ECB hosts a Supervision Innovators conference, inviting supervisors from several jurisdictions, and it has always been an event brimming with ideas and triggering enthusiastic feedback in the rank and file of supervisory staff. So far, the tools have focused on the use of AI to support administrative work, by easing the burden of repetitive tasks, summarising bulky applications, identifying key issues across a large set of documents. But a lot of work is being done on data analytics, which I think is the most promising frontier for SupTech tools.

Supervisors and central banks have access to a huge amount of data, but they are not always able to pool information across different databases, access to information is often segmented, and collaboration between different authorities takes place mostly via obsolete tools.

Hence, the first milestone is to achieve better and wider data-pooling — respecting, of course, all the rules on privacy and confidentiality. Then the next step will be to develop AI-based analytical tools helping supervisors to achieve an earlier identification of risks and take effective preventive action.

For instance, the stress test exercises that are currently run by many supervisory authorities are testing one or two macroeconomic scenarios, with severe methodological constraints to ensure comparability across banks. AI tools could enable supervisors to test several different scenarios, more tailored to the specific business model and risk profile of each bank, and thus providing more valuable input in the supervisory process.

Of course, while developing these tools we should always be mindful that supervisors, and their judgment, remain at the fore. AI tools can help in the preparation of on-site inspections, but they cannot substitute for them.

Andrea Enria was Chair of the Supervisory Board of the European Central Bank (ECB) from 2019 to 2024. Before that he was the first Chairperson of the European Banking Authority from March 2011. He previously served as Head of the Supervisory Regulations and Policies Department at the Banca d'Italia and Secretary General of the Committee of European Banking Supervisors. He also held the position of Head of the Financial Supervision Division at the ECB. Before joining the ECB he worked for several years in the Research and Supervisory departments of the Banca d'Italia.

ENDNOTES

1 [LINK](#)

In Focus

An Interview with Sharon Donnery



Sharon Donnery



Banc Ceannais na hÉireann
Central Bank of Ireland
Eurosystem

Q: In its recent “Regulatory & Supervisory Outlook Report,” the CBI argued that a sound culture and effective governance are consistent “mitigants” across all risk areas. Can you expand upon this? What provides your conviction in this view?

A: Our supervisory experience tells us that

firms with good governance, culture and controls are much better set up for success — both in terms of growing safely as well as dealing with the risks facing them and their customers. And on the other hand, we have seen what happens when external shocks or major change coincide with poor management behaviour — not to mention how the risks of consumer or investor detriment rises when poor business practices and weak business processes are allowed to persist within a firm.

As such, we see sound culture and effective governance as consistent mitigants to risks facing firms, the system and consumers/investors. And, in a rapidly changing world, and an environment of heightened external risks, the need for effective governance underpinned by a strong culture and robust systems of delivery is becoming all the more essential.

Firms with good governance, culture and controls are much better set up for success.

Q: How does the CBI suggest that firms ensure their culture and governance structures will effectively support the management of their organization in a “prudent, proper, forward-looking and consumer-centric way,” as the CBI calls for? What does ‘good’ look like?

A: The key thing for us is that it is ultimately the firms themselves that are responsible for managing the risks they face. We want to see firms taking more ownership for their governance and risk management and proactively managing the risks and uncertainties facing their organisations and their customers.

While different firms can have different structures, “good” generally looks the same — in terms of ‘you know it when you see it’ (or indeed when you do not). For me it is all about a focus on having the expertise, experience, systems and governance structures in place to run a firm well. It is about ensuring your firm is acting prudently, doing the right thing by your customers or investors and proactively scanning the horizon for potential new risks.

This does not just happen throughout an organisation — but rather it takes time, thought, investment and commitment from leaders to deliver, along with a clear setting of culture by the Board — who play a key role from the top-down in ensuring accountability and driving the right culture in firms.

Q: Culture and behavioural risk are usually seen as matters for conduct regulators charged with safe-guarding consumers. But some argue that culture-related risks have systemic implications and, as such, that they should be viewed as prudential risks. What’s your own view?

A: Unlike some countries where different institutions are responsible for different types of supervision (e.g. “prudential” or “conduct” regulation), the Central

Bank of Ireland has a very broad mandate including being an integrated central bank and regulator of the financial sector.

In that regard we see our overall mandate as focused on four safeguarding outcomes: financial stability; safety & soundness; consumer and investor interests; and integrity of the system — which are all highly inter-related and often inter-dependant.

Culture and behavioural risks are a perfect example of this. What may manifest itself in the first instance as poor conduct, or weak anti-money-laundering controls, often leads to — or is also uncovered as representing — prudential risks in the firm.

It is not for nothing that we focused on strengthening the governance framework in the aftermath of financial crisis, or that governance remains a key focus of all supervisors, including prudential ones. We only have to look back to last March to see the risks to capital and liquidity — and indeed the very survival of firms, with potentially systemic implications — that can emanate from badly run entities or historic instances of poor risk management and governance.

Q: On that very topic, many of the post-mortems that followed last year's "banking sector turmoil" pointed to the need to improve supervision of governance, risk management, and culture. Has this informed the CBI's supervisory work? What lessons did you draw from the events of last spring?

A: I totally agree that the importance of supervising governance, risk management, and culture is one of the key takeaways from the banking turmoil last year. However, as I have alluded to so far, I see this more as re-learning old lessons, rather than revealing anything new. And so from our point of view the

fall-out merely confirmed, and re-enforced, the focus and importance we have placed on governance, risk management, and culture.

For me it was also a reminder to guard against any reverting to the behaviours of the past. History has shown that, as crises recede, memories can fade. And that is why, for me, it is essential for regulators to retain their focus on the fundamentals of resilience, governance and risk management.

I think this will be increasingly important over the coming years, as the wider focus of policy-makers

turns more towards many of the key issues facing us in a rapidly changing world — including competitiveness, geopolitical tensions, industrial policy and the twin transitions of digital innovation and climate change.

The importance of supervising governance, risk management, and culture is one of the key takeaways from the banking turmoil last year.

Q: Another key takeaway was the need for regulators and supervisors to attend to their own culture, and to ensure that it supports desired performance outcomes. What are your views in this regard? How does the CBI seek to cultivate a supervisory culture that supports its objectives?

A: The importance of supervisory culture, and tone from the top within regulators, is certainly another key takeaway — and these very much stood out to me when reading the Barr report last year.

Both at the Central Bank of Ireland, as well as part of ECB Banking Supervision, supervisory effectiveness and a strong supervisory culture is something we are always seeking to cultivate and uphold — with the effectiveness of our supervisory framework already a focus of the ECB Supervisory Board prior to the events last March.

For me, to deliver "state of the art supervision," our supervisors need to have the right skills, the right mind-set, the right tools and the right data to

do their jobs. But they also need to be adaptable, robust and indeed at times intrusive — with enough empowerment and escalation options to deliver truly effective outcomes.

From where I am sitting, achieving this is about making sure frontline supervisors have the right training, technology, autonomy and flexibility to do their jobs, and to do it right.

But it is also about ensuring they know that we have their back — to be risk focused, and to use their toolkit to get traction within supervised entities.

Q: There is some tension between calls for regulators to facilitate growth and competitiveness and the need to ensure financial system safety and soundness. How does the CBI attempt to strike that balance? What role does culture play in this regard?

A: From my point of view, while the development and growth of business is of course an important issue for policymakers, it is not a recipe for success to give this task to regulators.

For our part, our statutory mandate is clear and it is balanced. We work in the public interest — to safeguard monetary and financial stability and to serve the interest of consumers and the wider economy.

There is of course an increasing focus on industrial policy and competitiveness in global politics. But given the hard work that has gone into building resilience into our financial system — and given the clear risks the world faces — this is certainly not the time to lower standards and to fall again into the mistakes of the past.

And while, as you say, there are tensions between delivering safety and soundness, on the one hand,

To deliver “state of the art supervision,” our supervisors need to have the right skills, the right mindset, the right tools and the right data to do their jobs.

Delivering proper and effective regulation is very much in the long run interest of the financial sector.

and calls for regulators to facilitate the growth and competitiveness of the financial sector, on the other, for me, delivering proper and effective regulation is very much in the long run interest of the financial sector.

A stable, well-regulated and trusted sector, with well-run firms, is one that is set up well for growth — and one which will be at a competitive advantage in the long-run over sectors that

prioritise short term growth at the expense of longer term stability.

Q: Late last year, the CBI finalized its [Individual Accountability Framework \(IAF\)](#) and it is now engaged in the implementation process. What do you hope to achieve through the IAF? How does it support your other supervisory work regarding culture and behaviour?

A: We see the IAF as an important addition to the wider regulatory framework — one which will help underpin sound governance across the financial sector by setting out clearly what is expected of well-run firms and responsible role holders.

The overarching aim of its introduction is to strengthen and enhance individual accountability in the financial services industry. It also seeks to ensure that there is clarity within firms on the responsibilities and functions of senior executives — providing transparency to supervisors and the public, but also empowering role holders-by making clear what they are responsible for.

While the IAF is an important step in a regulatory framework designed to foster a well-run and stable financial sector, it goes without saying that ensuring and delivering good corporate governance will remain the responsibility of firms themselves.

The IAF will help — both firms and ourselves — to explain and understand how a firm is being run, how it is implementing its business model, and managing its risks.

In that regard the IAF is very much a complement to our existing and wider supervisory work, and will sit alongside our wider framework focused on governance, culture and behaviour.

Over time our strategic hope is that, along with our other efforts, the IAF will help make firms take more ownership and responsibility for running their business and addressing any risks or deficiencies they may have. Our supervision will continue to take a risk-based, proportionate approach, reflecting the context of smaller, less complex, and/or less risky firms.

Q: Others in this report call for greater adoption of AI-powered technologies, with a view to improving supervisory capabilities — “SupTech” tools. The European Central Bank (ECB) has been a leader in this regard. Is SupTech something the CBI is exploring?

A: We take a pretty dynamic approach to SupTech — which is not just about AI but also many other approaches to enhancing supervision through technology. Where we see an opportunity for supervisors, we take a staged approach to building tools that are flexible, involving our supervisors and their needs from the start. For us, using SupTech tools is all about more effective supervision, by helping supervisors to better do their jobs.

While Generative AI is in the headlines, we have found single task Machine Learning to be useful, in particular for tasks such as prospectus

reviewing, automating various market reports and combatting greenwashing. In all of these tools, it is key that we have supervisory judgement and tangible supervisory actions to drive change in firm behaviours where needed.

The case for global cooperation is clear.

We are though, like others, exploring the use of Generative AI. Right now, how valuable Gen AI will be remains to be seen, but we have identified some potentially useful applications and are running trials to determine how useful they may or may not be.

One critical concern we have is the reliability and competence of the underlying technology. A calculator can always produce the same answer given the same inputs; sometimes Gen AI cannot. So while it is a powerful technology, it can be brittle.

As we all get used to this technology, we also need to be mindful of the confidence-calibration gap between what we think it knows and what a Gen AI algorithm actually understands. For me, this points to the importance of supervisors being always in the loop for decision-making — as they would be with all the other analytical tools we use — as well as the importance of ensuring differing types of AI are appropriate to use given a set context, values, and risks.

With a rapidly changing financial sector, the importance of engagement with a wide variety of stakeholders has increased.

Q: Another topic that has received much attention in this year's report is that regarding the need for international collaboration — between global regulators, as well as between the public and private sectors, the technology community, and academia. What are your thoughts and expectations in this connection? What would you encourage and what might the CBI seek to foster?

A: I fully agree on the importance of international collaboration, and indeed my own career has involved extensive international work. Simply looking at the global nature of the financial sector, the case for global cooperation is clear.

This is particularly true in Ireland's case. We have a very large and international financial sector, which has grown significantly in recent years.

This is very much a success story but, for the Central Bank of Ireland, it also entails a growing responsibility to the global system as well as international investors and consumers. This is a responsibility which we embrace. Along with our domestic responsibilities, it is why we put such importance on the proper and effective regulation and supervision of the financial sector — with engagement and international collaboration playing a key part in that.

Your question touched on it there, but what we have also seen in the last few years is that, with a rapidly changing financial sector, the importance of engagement with a wide variety of stakeholders has increased. This is something the Central Bank of Ireland has been focused on in recent years — with enhancing our engagement deemed a strategic necessity.

Such engagement
is crucial to
retaining the trust
placed in us.

Going forward I expect such engagement to only become more important — particularly in the context of an uncertain and changing world, not to mention the increasing digitalisation of finance — with increasingly complex inter-linkages and dependencies outside of the financial system being something that regulators cannot and will not ignore.

We also regularly engage with the public — through regional outreach events and meeting members of the public, as well as our extensive links to academia through our work, including our Research Exchange — a forum for research engagement between our teams and external experts and researchers. Such engagement is crucial to retaining the trust placed in us as a central bank and financial regulator — by building a shared social understanding of the benefits of our work for the public, consumers, and the wider economy.

Sharon Donnery was first appointed Deputy Governor in March 2016 and has been an ex-officio member of the Central's Bank Commission since that date. She has held the Deputy Governor, Financial Regulation role at the Central Bank of Ireland since 1 July 2022 and is a member of the Supervisory Board of the European Central Bank (ECB) and the General Board of the European Systemic Risk Board.

In Focus

Navigating Cultural and Ethical Transformations in the EU Banking Sector

By: WIM MIJS



Wim Mijs



Introduction

The integrity of any business relies heavily on the ethical behaviour of those who operate within it. This is not different in banking. Adjusting to the shifts in culture and ethics within the EU banking sector calls for a holistic strategy aligned with the regulatory expectations and the values upheld by society. While considerable efforts have been made by

financial regulators to instil a balanced ethical culture in the sector, it is undisputed that the industry also has a vital role to play.

It is helpful to examine examples such as the Dutch Bankers' Oath¹ to understand the growing trend within the industry towards self-regulation and independent ethical initiatives. This article uses the Dutch context as a case-study, explores other industry-led initiatives across Europe, and highlights the foreseeable cultural and ethical concerns the industry is expected to navigate.

The foundation of any successful business is rooted in the ethical and cultural behaviour of its employees and leadership teams.

BACKGROUND: THE IMPORTANCE OF ETHICS IN BUSINESS

Ethics in business serve as the cornerstone for establishing a positive corporate culture. The foundation of any successful business is rooted in the ethical and cultural behaviour of its employees and leadership teams. High ethical standards promote a positive public image and, most importantly, also build trust and confidence in society. Companies can effectively mitigate risks and enhance transparency and accountability by integrating ethical practices into everyday business operations. Corporate responsibility tends to be rewarded with more loyal customers and a top-talented workforce. Overall, understanding the importance of ethics in business offers a key context for examining specific industries, including banking.

THE SHIFT IN THE EU BANKING SECTOR

The EU banking sector has experienced a fundamental cultural and ethical transformation. The transition from a closed national banking sector to an open-market liberalised cross-border banking business model marks a significant evolution in the EU financial landscape in the late 90s. Traditionally, banks operated within national boundaries, adhering strictly to local regulations and serving primarily domestic markets. However, with the enactment of liberalising and deregulating policies and the push for globalisation, the banking sector witnessed a paradigm shift towards a more open and competitive business model.

This liberalisation encouraged banks to expand their operations across borders, including outside the continent, enabling them to

offer services to a broader clientele and benefit from diverse market environments. This globalising shift increased competition among banks — by finding

new global competitors — and promoted greater efficiency and innovation in financial products and banking services.

This transformation has fundamentally reshaped banking in the EU, because the business model shift also shifted the sector's culture, which in turn changed the link between banks and society. Increased interest in capital markets, a stronger focus on increasing shareholder value, and more ambitious profit expectations added competition pressure among banks. This was the start of the cultural shift.

Market liberalisation and globalisation exposed banks to varying regulatory standards and social practices and brought significant cultural and ethical challenges to the EU banking sector. Adapting to changes in culture and ethics within the sector requires a comprehensive approach that aligns with both regulatory expectations and societal values. Firstly, banks should proactively engage with new regulatory frameworks emphasising transparency, customer protection, and risk management.

In the last 15 years, EU regulatory bodies have increasingly focused on ethical banking practices, making it essential for financial institutions to stay ahead of compliance requirements. This includes training programs that highlight ethical decision-making and the consequences of non-compliance, tailored to different levels of the organisation. Regular audits and reviews can also ensure that policies are not only in place but are actively enforced and updated in response to new cultural and ethical challenges.

Banks must also cultivate a culture that promotes ethical behaviour and accountability from the top down. Leadership is crucial in setting the tone for an organisation's culture. Executives and managers should embody the ethical standards they wish to instil in their teams, demonstrating integrity in their decision-making processes. Initiatives such

as establishing clear lines of communication for whistleblowing and encouraging a speak-up culture can empower employees to report unethical practices without fear of retaliation. Furthermore, integrating ethical considerations into performance metrics and promotion criteria can reinforce the importance of ethics in achieving business objectives.

LOOKING BACK: THE GLOBAL FINANCIAL CRISIS MOMENTUM

The 2008 global financial crisis was a critical wake-up call for banking regulators worldwide, displaying the dire consequences of deregulation and inadequate ethical standards. Triggered by poor lending practices and a manifest lack of transparency, the crisis led to a global recession, highlighting the need for improved regulatory oversight in the banking sector. These events have led to financial losses and eroded public trust, prompting a reassessment of regulatory frameworks.

Without prompting, the EU banking industry has progressively adopted self-regulatory measures, opening the path to an ethical banking reform. These initiatives, developed independently from regulatory frameworks, are driven by the understanding that ethical banking is essential for long-term success and stability. By embracing these ethical practices, banks aim to restore public trust and secure financial stability.

Ethical banking is essential for long-term success and stability.

THE EXAMPLE OF THE NETHERLANDS AND THE DUTCH BANKERS' OATH

In most European countries, professional oaths are a common practice for doctors, politicians, and lawyers. These oaths are critical to maintaining the integrity and public trust of these professions and are understood as a formal declaration by which individuals commit to upholding the standards and ethics of their profession. This tradition is not only ceremonial; rather, it serves as a moral anchor,

reminding professionals of their obligations and the serious implications of their work. Following the call for action in 2008, professionals of the banking industry in the Netherlands voluntarily started taking such an oath.

The Dutch Bankers' Oath is a solemn pledge mandating banking professionals to uphold integrity, professionalism, and ethical considerations within the industry. It was envisioned as a moral-ethical declaration and a cornerstone to restoring dialogue with society and the public's confidence in the distrusted banking sector. Introduced in 2014-2015 as a recommendation from the updated 2009 Dutch Banking Code, the oath requires all employees working in the Netherlands with an employment contract at a bank licensed in the country — from executives to desk clerks — to affirm their commitment to ethical behaviour.

Despite its voluntary nature, the Dutch Bankers' Oath has been widely adopted by banks in the Netherlands. Just like other professional oaths, it has legal implications: bank employees who violate the oath may be personally accountable and face disciplinary measures, including fines and potential bans from working in the banking industry. Even with some implementation and efficiency obstacles, this industry-led initiative signalled a commitment from bankers to adhere to higher ethical standards and to promote a culture of integrity and transparency.

Undoubtedly, the Dutch Bankers' Oath represents a pioneering approach to embedding ethical considerations into the DNA of banks. A decade after its introduction, the oath is seen as a positive step towards rebuilding public trust in the banking

sector. The Oath has been a powerful symbol and practical tool for reinforcing ethical behaviours across all levels within banks, contributing to creating a new culture.²

Other industry-led initiatives

Taking a different approach from the Netherlands, several European banks have adopted voluntary measures to address ethical concerns — even without a national initiative comprising all the banks of a given country. These measures, taken to address ethical concerns in the European banking industry, range from internal codes of conduct and ethics training programmes to comprehensive governance reforms designed to foster a culture of integrity and transparency.

For example, banks such as Barclays³ and Deutsche Bank⁴ have adopted their own internal codes of conduct that outline the expected standards of behaviour for their employees. These documents typically extend beyond legal compliance to include

commitments to fairness, integrity, and accountability. Other institutions, such as HSBC,⁵ have implemented robust mechanisms that allow for the anonymous reporting of unethical behaviour, designed to protect whistleblowers from

retaliation and to ensure all concerns are seriously addressed, thus promoting an open and transparent organisational culture.

Another initiative worth looking at is the UK's Senior Managers and Certification Regime (SMCR).⁶ It is a regulatory framework that enhances personal accountability for senior managers within financial services firms and aims to improve

Despite its voluntary nature, the Dutch Bankers' Oath has been widely adopted by banks in the Netherlands.

A decade after its introduction, the oath is seen as a positive step towards rebuilding public trust in the banking sector.

the behaviour of all employees. Conceived as a potent instrument of accountability, the SMCR delineates a framework to hold senior executives answerable for conduct within their horizon, thereby instilling a culture of individual responsibility with unmistakable significance.

These different industry-led initiatives, while tailored to meet the specific needs and corporate cultures of individual banks, offer flexible and dynamic responses to ethical challenges. However, they also raise questions regarding their consistency and the enforceability of their measures. Lacking the force of law, these measures' effectiveness heavily depends on senior management's commitment and the genuine engagement of all employees.

Assessing the impact and effectiveness of these industry-led self-regulated initiatives is complex.

While the Dutch Bankers' Oath provides a clear framework and sets explicit consequences for breaches, the voluntary nature of industry-led initiatives can result in varying application and seriousness in enforcement.

While these efforts vary in scope and focus, they all share a common goal: to enhance the integrity and transparency of banking operations and rebuild public trust among clients, regulators, and the broader public. Surveys and interviews with banking professionals across Europe suggest that while many bank employees know of these internal codes of conduct, the depth of their impact is heterogeneous.

Looking ahead, the future of ethical banking may involve a hybrid model, where regulatory frameworks complement industry-led initiatives. This arrangement could combine the flexibility and innovation of voluntary measures with the structural support of regulation, potentially leading to more effective and comprehensive ethical practices.

Looking Ahead: vision for the EU banking sector

The challenges faced by banks during the next decade are not few. Over the next ten years, the EU banking sector will play a pivotal role in supporting the continent's ambitious move towards a carbon-neutral economy. Banks are expected to be key enablers in fostering more competitive and innovative economies throughout Europe by directing financial flows towards sustainable investments and green projects.

This strategic shift is also expected to tackle pressing issues such as demographic shifts, providing targeted financial products and services that reflect the changing needs of Europe's aging population. Furthermore, the sector is asked to bolster the resilience of Europe's financial infrastructure, enhancing its ability to withstand geopolitical

uncertainties, and supporting a degree of strategic autonomy in global financial affairs.

In pursuit of these goals, Europe's financial landscape will likely witness a broader diversification, with non-

banking financial institutions and capital markets assuming more pronounced roles. This evolution is expected to contribute to a more stable, efficient, and integrated financial system characterised by uniform standards across the Single Market. Digital innovation will be embraced, enhancing operational efficiencies and customer experiences, while also addressing associated cybersecurity and privacy risks.

Collaborative efforts between the public and private sectors will be crucial in designing the financial strategies required for the net-zero transition. This partnership will ensure that the banking sector adheres to high standards of integrity and consumer protection and actively contributes to sustainable development goals across the EU.

Looking ahead, the future of ethical banking may involve a hybrid model, where regulatory frameworks complement industry-led initiatives.

How to ensure that we do not crush the dialogue (again)?

The EU banking sector will evolve over the next decade, and so will its culture and ethical values.

Yet, the dialogue between banks and society relies on several cultural and ethical commitments that banks have traditionally taken up. A proactive approach from the sector in addressing these cultural and ethical concerns — including financial inclusion, transparency, and the use of artificial intelligence and machine learning — will not only enhance the reputation of banks but also ensure they deserve society's trust and confidence. We propose to have a closer look at each of these challenges.

1. FINANCIAL INCLUSION

As the sector strengthens its role in supporting Europe's demographic changes, banks must ensure that their services are inclusive and accessible to all segments of society. This commitment extends particularly to the elderly, low-income households, and those living in rural areas, who are often at risk of being marginalised by technological developments. To effectively serve these diverse groups, banks must offer products that specifically address their unique needs.

In addition to developing targeted products, banks must also provide solid support systems to help customers navigate the new technologies and educational programs that teach digital skills and financial literacy. For banks to adapt to the changing demographics in Europe, they must ensure that technological advancements enhance, rather than hinder, accessibility for all members of society.

2. TRANSPARENCY

Non-financial companies in various industries, including the energy sector, confront significant

challenges as they strive to shift towards greener and more sustainable practices. This transition is complex and resource-intensive, requiring substantial financial support to implement green technologies and processes. Banks play a crucial role in this scenario as facilitators, offering the financial resources needed for these companies to achieve their sustainability goals. While banks are essential enablers of the Green Transition, by providing the necessary capital to implement green technologies, they must rigorously assess and verify the environmental impact of the projects they finance.

The Green Transition will not happen without banks. Yet, very ambitious roles carry very complex challenges. With the increasing role of banks channelling investments towards sustainability initiatives, there is a need for increased transparency. As capital flows towards green projects, banks must rigorously assess the sustainability credentials of their investments to avoid greenwashing. Customers, investors, and regulators will demand clear information on how funds are being used, particularly the impact that sustainable investments have on achieving net zero goals.

3. USE OF ARTIFICIAL INTELLIGENCE AND MACHINE LEARNING

Integrating artificial intelligence (AI) and machine learning (ML) into banking operations and decision-making processes must be managed ethically. Their benefits may include improving efficiency, accuracy, and customer service; yet the unintended consequences of AI and ML could negatively impact consumers and the integrity of the entire banking system.

Firstly, ensuring that AI algorithms are designed to avoid perpetuating existing biases or facilitating discrimination is critical. By learning from historical data, AI algorithms risk learning past prejudices or inequalities embedded in such data. To mitigate

this risk, banks must employ techniques that detect and correct biases in training datasets and must continuously monitor the outputs of their algorithms.

Secondly, using AI for critical financial decisions, such as credit scoring or risk assessment, requires a transparent approach. Increased transparency should allow customers to understand the factors leading to a decision. Additionally, it is important for banks to develop ethical guidelines and governance frameworks that oversee the development and integration of AI technologies in their operations.

These guidelines should address issues such as data privacy, security, and the ethical use of AI, ensuring that customers' personal and financial information is protected. By addressing these critical aspects, banks can make the best use of AI and ML, ensuring that these tools are framed — or humanly controlled — by ethical considerations.

The Sea Ahead: ethical challenges and cultural shifts in the EU banking sector

As the EU banking sector navigates the complexities of the modern financial landscape, the role of ethics in banking has never been more critical. Both regulatory and industry-led initiatives play pivotal roles in shaping the landscape of ethical banking. Bank boards are equally important.

The role of ethics in banking has never been more critical.

The Dutch Bankers' Oath and similar industry-led initiatives across Europe represent key efforts to address today's banks' ethical challenges brought by the deregulating and liberalising policies enacted in the 90s. Moving forward, a collaborative approach that leverages the strengths of both models may provide the most effective pathway to restoring and maintaining public trust in the banking sector.

As ethical challenges continue to shape the landscape of the banking sector across the EU, a compelling case emerges for a proactive approach to ethics. Such an initiative should clearly define ethical standards across national borders and reinforce the EU banking sector's commitment to integrity and accountability. Banking was and is an ethical business, and it is crucial that this is not forgotten.

Wim Mijs was appointed Chief Executive of the European Banking Federation in September 2014. Between 2007 and 2014 Wim served as CEO of the Dutch banking association NVB. During this time he transformed the NVB into a modern industry association, positioning it as the key representative of the banking sector in the midst of the financial crisis. Between 2011 and 2015 Wim served as Chairman of the International Banking Federation. From 2012 to 2014 he was Chairman of the Executive Committee of the EBF. And from 2013 to 2015 he was President of the Board of Euribor, now known as the European Money Market Institute.

With thanks to:

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ENDNOTES

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- 4 Deutsche Bank's "Code of Business Conduct and Ethics". Available at: https://country.db.com/japan/documents/Code_of_Business_Conduct_and_ethics.pdf
- 5 HSBC whistleblower policy described here: <https://www.hsbc.com/who-we-are/our-people-and-communities/inclusion/speaking-up>
- 6 SMCR supplanted the Approved Persons Regime (APR), which previously targeted certain senior or approved individuals within regulated companies. Available at: <https://www.bankofengland.co.uk/prudential-regulation/publication/2023/march/review-of-the-senior-managers-and-certification-regime>



European Union

EUROPEAN CENTRAL BANK

Culture, Governance, and Supervision

In a June 2023 speech, Andrea Enria, then Chair of the Supervisory Board of the European Central Bank, argued that last year's bank failures had made clear that supervisors must increase their efforts to ensure that banks have sound internal governance and risk management. "Well-run banks don't fail," Enria insisted.³⁹⁹ **▶ PAGE 277**

"Failures in this area are the common theme underpinning recent events in the United States and Switzerland, and they have also been the core theme of many past crises," Enria said. "In my view, this is the one priority area that both banks and supervisors should be focusing on."

Enria argued that reform efforts would be more effective were they to focus on supervision rather than regulation. "We should abandon the ambition of designing ever-more precise regulations that accurately measure all risks under any circumstances, covering even the most extreme business models and risk configurations," he said. "Instead, we should focus our efforts on empowering supervisory teams, within a strong accountability framework."

Setting an example for others to follow, Enria indicated that the ECB was looking to improve its own culture to assure that it encouraged supervisors to take swift and decisive action when they identify problems in firms. "Developing a supervisory culture that promotes judgment and challenge is crucial here," Enria said. "We need to be unafraid to escalate where we detect deficiencies."

In a blog post later that month, Frank Elderson, a member of the executive board of the ECB and vice-chair of its Supervisory Board, reflected on the failure of Silicon Valley Bank (SVB) and how it had reinforced the importance of effective risk governance.⁴⁰⁰

Elderson referenced the report into the collapse of SVB prepared by US Federal Reserve Vice Chair for Supervision, Michael Barr, which had emphasized failures on the part of SVB's board directors and management to manage their risks adequately. "Effective governance is a key element underpinning several of the Basel Committee on Banking Supervision principles that guide prudential supervisors around the world," Elderson wrote. "In banking supervision, we see all too often that the root cause of various vulnerabilities in banks lies in ineffective management bodies."

Elderson reflected on the ECB's targeted review of management bodies among 20 European banks, conducted earlier in 2023. The review found that many banks lacked a sufficient number of independent non-executive directors on their boards, hindering constructive challenge and independent perspectives. This lack of diversity could lead to enduring weaknesses in oversight and governance.

If these findings are not remediated, Elderson wrote, the ECB supervisory team would look to use all measures in its toolkit to ensure compliance. "Effective management bodies are the bedrock of well-run banks. And well-run banks are the bedrock of a stable banking system," Elderson concluded. "That means safer banks for the people of Europe, which is our mission as European banking supervisor."

In the following months, despite the above arguments presented by Enria and Elderson, some global authorities — including those in the US — sought to respond to the 2023 bank failures by implementing more stringent capital requirements.⁴⁰¹ These efforts have been met by fervent opposition from industry participants and advocates.⁴⁰²

In an interview published in August last year, Andrea Enria argued that an emphasis on capital and liquidity requirements in the wake of the bank failures was misguided. Instead, he encouraged a greater focus on the efficacy of supervision and banks' risk management. "When there are banking crises, the usual reaction is to start thinking about regulatory reforms," he said. "I think that in this case the main lesson is about the effectiveness of supervision and banks' internal controls, rather than regulations."⁴⁰³

While Credit Suisse was in compliance with capital and liquidity requirements before its collapse, these requirements were not sufficient to save the bank from a depositor run, Enria argued. "Credit Suisse had a serious problem with its business model and governance," he said. "This led to the crisis. So, the lessons are about how to make supervision more effective in order to intervene early and effectively, and how to strengthen banks' internal controls."

In a speech in September, Enria doubled down, calling for an end to the debate between industry and regulators on whether we need higher or lower capital requirements. "[B]oth the industry and supervisors need to move on from the capital calibration discussion," he said. "Instead, as the turmoil episodes in March this year showed, supervisors need to focus more on the effectiveness of supervisory action. It is in the banks' own interest to engage with us in this debate."⁴⁰⁴

The focus on capital requirements, and comparing them between countries, displays a clear bias toward capital as the "be-all and end-all of prudential supervision," Enria argued. However, "[c]apital cannot fix a broken business model, nor can it remedy deficient internal governance."

Enria cited a recent paper by Bruce Tuckman, a Professor at NYU Stern School of Business, that outlines three types of supervision:

- Preventive, which involves establishing standardized regulations applicable to all banks or specific subsets of them;
- Detective, which involves supervisors examining individual banks for deficiencies or breaches; and
- Punitive, which involves compelling banks to rectify any issues identified in these assessments.⁴⁰⁵

"The entire discussion on the level of regulatory capital requirements and liquidity buffers is about preventive requirements," Enria asserts. "But we need to focus much more on detective evaluation and corrective action."⁴⁰⁶

Supervisory agencies must also focus on their own internal culture to allow (and compel) supervisors to take decisive punitive action when they identify shortcomings, Enria argued. "This is crucial in areas such as governance and business model sustainability, where too many supervisory findings and measures have gone unaddressed for too long," he said.

Also in September, these arguments were echoed by Kerstin af Jochnick, a Member of the ECB Supervisory Board, who argued that the banking failures were caused by risk management and governance deficiencies. "This common feature of the banking failures which we saw in the United States and Switzerland this spring has also been at the core of several banking crises in the past," Jochnick said. "This is why I believe that, going forward, bankers and supervisors alike should continue to focus on both bank governance and risk management."⁴⁰⁷

Once the public loses confidence in a bank, it is very difficult to restore. As such, good governance and risk management should be seen as the first line of defense against changes in market sentiment, and particularly so where risk governance scandals stem from overt misconduct. This implies a responsibility for bank managers but also one for bank supervisors who must also be able to act quickly in the face of

uncertainty. To fulfill such responsibility, supervisors must be equipped with the powers, and the tools, that permit proactive inquiry.

In a speech delivered that same month, Elderson argued that a bank's culture is the most important driver of employee behavior, risk, and financial performance. As such, culture is of critical supervisory focus for the ECB, Elderson explains. "A healthy culture can spur innovation, nurture customer relationships and foster employee loyalty," Elderson said. "But an imprudent culture can propel institutions towards crises that reverberate through financial history... Culture shapes behaviour, and behaviour, in turn, shapes the destiny of financial institutions."⁴⁰⁸

Banks are not merely physical structures or balance sheets, Elderson asserted, but intricate systems shaped by human interactions and decisions, where culture is the guiding force.

"[Culture] is in the DNA of how a bank functions and how it manages risks," Elderson said. "Behaviour, on the other hand, is the tangible manifestation of this invisible culture." Therefore, culture drives whether risks are well managed and ultimately shapes the fate of a financial institution. Elderson pointed to 2023's bank failures as clear examples of this.

The recognition that culture plays a pivotal role in financial stability has prompted supervisory authorities to adopt innovative approaches to assessing and shaping behavior and culture within the banking sector. De Nederlandsche Bank (DNB), for instance, where Elderson served as Executive Director of Supervision, is well-known for employing organizational psychologists to evaluate behavioral drivers and risk culture in financial institutions.

The ECB is also considering how to integrate culture and behavior into its supervisory approach, which could include scoring risk culture indicators, drawing insights from organizational psychologists, and mandating banks to manage specific corporate

culture risks. The ECB plans to publish a detailed supervisory guide on governance and risk culture by the end of 2024.

"Just as a seasoned sailor navigates turbulent seas with skill, supervisors must be equipped to sense the undercurrents of corporate culture that can propel banks towards prosperity or peril," Elderson concluded.

And, finally, September was also the month that the ECB's Governing Council nominated Claudia Buch, then Vice-President of the Deutsche Bundesbank, to succeed Enria as Chair of the Supervisory Board when his five year term ended on January 1, 2024.⁴⁰⁹ During the following Month, the Council of the European Union finalized Buch's appointment.⁴¹⁰

In December, the ECB made clear that it was planning to put the foregoing sentiments into action. In comments offered to the *Financial Times*, Elizabeth McCaul, a Member of the Supervisory Board, advocated for empowering risk managers to control banker bonuses to improve compliance with risk appetite frameworks. "I think we could do more to strengthen the hand of risk managers," she said.⁴¹¹

McCaul's statement contrasts with calls from industry leaders for Europe to follow the UK in relaxing post-financial crisis bonus restrictions. The EU's rules that limit bonuses to twice base pay were introduced in 2014 to deter excessive short-term risk-taking among top executives. After the UK was freed from ECB requirements, following Brexit, the government removed the bonus cap for UK banks, prompting concerns about an uneven playing field for banks based in the EU. However, according to McCaul, the ECB was "very happy" with how the rules were operating in Europe.

McCaul also emphasized that the ECB would not need to implement new rules to empower risk managers. For example, it could use such existing tools as "peer benchmarking, targeted stock-takes and deep dives,

sharing good practices and ongoing industry dialogue, with appropriate supervisory escalation where key weaknesses are identified.” She made clear that the ECB would use “all available supervisory tools” to drive firms to fix any shortcomings.

In another speech delivered that month, Frank Elderson said that the regulator was taking a more aggressive stance toward Eurozone banks that fail to address risk governance vulnerabilities promptly. The banking turmoil “was a clear reminder of what can happen if issues are detected but not acted upon,” Elderson said.⁴¹²

As an example of such cited in his speech, Elderson noted that the ECB would increase the use of “supervisory escalation,” exemplified in recent warnings issued to 20 banks threatening daily fines — equivalent of up to 5% of their average daily turnover for six months — if they failed to act with sufficient speed. “It is a step that we do not take lightly,” Elderson said. “It is not about forcing banks to do something that is merely nice to have. It is about compelling banks to manage material financial risks adequately and in a timely manner.”

Elderson also outlined several other areas where banks “have been dragging their feet” on fixing weaknesses, such as internal governance, data aggregation and reporting, risk management, and business model sustainability. Firms may face similarly onerous fines if they do not take the initiative to rectify these shortcomings.

In December last year the ECB also published the results of its Supervisory Review and Evaluation Process (SREP) for 2023, providing details on its supervisory activities throughout the year and laying out its priorities for 2024-26. In his introductory statement for the report, Andrea Enria explained that the documents highlighted the regulator’s increased focus on governance and risk management shortcomings in the financial sector.⁴¹³

“As part of this year’s SREP, we focused on persistent, and in some cases long-standing, weaknesses in risk management, governance and internal controls,” Enria wrote. “[B]y quantitative measures...banks are robust. Still, weaknesses continued to emerge from qualitative assessments in areas like risk management and governance.”

In its supervisory engagement, the ECB identified shortcomings in such areas as risk data aggregation and reporting, management body effectiveness, compliance, and risk management. “For many institutions, these areas have shown no progress, or have even deteriorated compared with the SREP findings of the previous year,” Enria lamented. “The March turmoil in US and Swiss banks further underlined the importance of strong governance and robust risk controls even when prudential ratios show little cause for concern.”

These non-financial risk management weaknesses were to inform the ECB’s supervisory activities going forward. In fact, two of its three key supervisory priorities for the next three years are to accelerate the remediation of shortcomings in governance and environmental risk management and to enhance digital transformation and operational resilience. The ECB’s plan to develop supervisory expectations and best practices regarding banks’ governance and risk culture will be a key part of this effort.

In a February 2024 speech, Claudia Buch, now Chair of the Supervisory Board, reiterated that “capital and liquidity ratios are not everything” when it comes to resilience:

Distressed banks often met regulatory requirements until very late. But they performed poorly in terms of governance and risk management, often well before the actual stress events occurred. This is why we pay close attention to banks’ internal governance mechanisms and the long-term sustainability of their business models. Banks

*need strategic steering to adequately assess, control and manage risks, especially in an uncertain environment.*⁴¹⁴

This certainly doesn't mean that capital is less important, Buch argued. Well-capitalized banks can better withstand the implications of bad risk management. However, effective supervision is necessary for identifying and compelling banks to rectify shortcomings in either area.

"This is all supported by the SSM's digital agenda," Buch added. "Digital tools reduce the time spent on routine tasks and provide useful information. Since 2020 we have prioritised our digital agenda and invested in supervisory technologies (SupTech). We now have tools in place that allow fast access to connected data, such as the ownership structures of significant banks, that provide centralised access to all prudential data, and that speed up our fit and proper assessments."

In March, the ECB was awarded the "Digital Transformation Award" by *Central Banking* for its efforts to drive innovation and technology adoption across the Single Supervisory Mechanism (SSM) and beyond.⁴¹⁵

"In this fiercely competitive field, the European Central Bank's efforts to digitise its supervisory arm stood out for the scale of its ambition and the broad scope of tools and governance structures under development," *Central Banking* wrote. "Not only is the [SSM] reshaping its own work, but it is also rolling out innovations across the Eurosystem and supporting efforts outside the boundaries of the eurozone."

In May, it was reported by the *Financial Times* that the ECB had told European banks to accelerate their efforts to withdraw from Russia or risk facing punitive measures from US authorities. The ECB asked the banks to provide detailed plans on their exit strategies as early as June. The letters, which reportedly ranged in severity depending on how advanced each

bank was in the withdrawal process, underlined the increasing pressure from the US for European banks to ensure their activities are not supporting Russia in its war against Ukraine.⁴¹⁶

In a blog post published in May 2023, Claudia Buch announced the ECB's intent to update its Supervisory Review and Evaluation Process (SREP). "The risk environment in which banks operate has evolved substantially in recent years," Buch wrote. "As risks evolve, supervision must evolve too. Supervisors need to understand risks, they need to be forward-looking, they need to communicate clearly with banks, and they need to be intrusive in their actions to ensure that banks remediate their deficiencies."⁴¹⁷

The new SREP, which will build upon ten years of successful European banking supervision, will be more effective and efficient, Buch explained. The ECB's Supervisory Board has set six goals for the new supervisory regime:

- **Focusing risk assessments** — To assess bank-specific risk profiles, supervisors need common tools, methodologies, and procedures;
- **Better integrating supervisory activities** — Supervision needs to deliver a structured, comprehensive, and consistent view of banks' risks, based on different supervisory activities;
- **Using the full supervisory toolkit** — Supervision is not only about identifying risks but also about mitigating them. The reformed SREP will make supervision more effective and intrusive by using the full range of supervisory tools that the law makes available;
- **Enhancing communication** — Supervisory communication to banks needs to be clear and concise. In the future, SREP decisions will be more focused, clearly outline supervisory expectations, and include strong measures when needed;
- **Making methodologies more stable** — Good supervision is based on consistent methodologies like those developed during the

first decade of European banking supervision. The ECB will now work to make those existing methodologies more stable and, where possible, simpler and more transparent; and

- **Making better use of IT systems and analytics** — ECB Banking Supervision has prioritized its digital agenda, and it plans to continue its investment in supervisory technology applications to improve efficiency, access to data, risk analysis, consistency of decision-making, and collaboration.

“The SREP will become shorter and move closer to real-time supervision,” Buch explained. “To fully reap the benefits of these and other measures, ECB Banking Supervision will foster a supervisory culture that focuses on key risks and encourages strong and timely actions.”

SupTech, AI, and Innovation

In recent years, the ECB has emerged as a global leader in the adoption of SupTech and AI to improve its supervisory capabilities. At the Single Resolution Board staff event in June 2023, Elizabeth McCaul delivered a presentation on how the ECB’s “Digitalisation Blueprint” has progressed in driving innovation and facilitating the adoption of SupTech tools.⁴¹⁸

Since 2020, the ECB has sought to drive digital innovation forward throughout the SSM — the legislative and institutional framework that grants the ECB a supervisory role over banks in the EU — by “connecting people, ideas and projects.” As a part of this effort, the ECB developed the Blueprint, which lays out “a clear action plan to build an innovative SupTech portfolio.”

A key focus of this program has been delivering impactful SupTech tools to European banking supervisors. These tools include Virtual Lab — a platform for SSM-wide digital collaboration, code sharing, and cloud computing capabilities — and

Agora — a data lake bringing all prudential data into one location with access for all SSM users. Since these projects launched in 2022, they have been adopted by more than 1,400 and 400 users, respectively.

The ECB has begun to develop an innovation ecosystem across all of European banking supervision, bringing together academics, startups, regulators, and supervisors through global events and conferences. However, without building capability sets, the impact of this work will be limited. As such, the ECB is also providing supervisors with “the capabilities and mindset to fully leverage the potential of SupTech” by partnering with several academic institutions and e-learning providers.

In a speech at the Supervision Innovators Conference in September 2023, McCaul outlined the ambitious “Single Supervisory Mechanism Digital Strategy 2024-2028” aimed at revolutionizing banking supervision in the EU through technology, data, and innovation. “We started working on the first supervisory technology (SupTech) use cases in 2020,” she said. “We assessed, prioritized and started to implement them as part of our Single Supervisory Mechanism (SSM) Digitalisation Blueprint between 2021 and 2023.”⁴¹⁹

McCaul emphasized the need to integrate core IT systems with SupTech to create a seamless and intuitive platform for supervisors. Supervision without information technology has become unthinkable over recent decades. Such an integrated platform would streamline supervisory tasks and allow for a clear view of risks. The ECB also aims to harness advanced analytics, including AI, to enhance the supervisory platform with early warning indicators and real-time insights into potential vulnerabilities.

In a blog post published the following month, Myriam Moufakkir, Chief Services Officer, explained how the ECB is exploring the use of AI to improve its understanding of inflation and bolster its oversight of major banks. Moufakkir wrote that the ECB is

investigating how large language models, akin to ChatGPT, can be employed for various purposes, such as generating summaries and briefings for policy and decision-making, improving the clarity of public statements, and analyzing documents from banks.⁴²⁰

The ECB is proceeding cautiously, addressing data privacy, legal constraints, ethics, transparency, and accountability. But the intention is to “accelerate” its adoption so the bank can be “modern and innovative,” according to Moufakkir.

In a February 2024 article for *Revue Banque*, McCaul highlighted the integration of AI into European banking supervision. “[W]e must adopt a future-proof approach to understanding and using AI,” she wrote. “We should use it to enhance our internal supervisory capabilities and gain greater insights into the risks facing supervised banks as they, in turn, also deploy AI.”⁴²¹

The role of the ECB is to ensure that banks remain safe and sound, not to be prescriptive regarding their business models or the technologies they use, McCaul emphasized. “What we can do, however, is draw on the power of AI to decipher data, understand risks and speed up processes, freeing up more time for human analysis and judgement in an increasingly complex world,” she wrote. “Looking ahead, we will continue investigating the possibilities and challenges of using AI, in cooperation with supervisory authorities across Europe,” McCaul concluded.

In a blog post published the following month, McCaul explained how the regulator is ramping up its supervision of risk data aggregation and risk reporting (RDARR). “Our banking supervisors routinely identify issues, raise any concerns they have and ask banks to take prompt and effective remedial action,” McCaul wrote. “In recent years, many banks have failed to fully address the weaknesses identified in risk data

aggregation and risk reporting. And some banks have not made adequate progress on implementing their remediation plans.”

McCaul emphasized the importance of improving RDARR practices, as “[l]ow-quality information is likely to lead to low-quality risk management decisions.” A bank’s ability to manage its risk-related data is an essential component of its ability to govern risks effectively and make sound decisions, she argued. Supervisors at the ECB are taking note and reviewing escalation options.⁴²²

Collaboration with Other Authorities

In her speech at the Supervision Innovators Conference 2023 referenced above, McCaul explained that in order to drive innovation in supervisory capabilities, the ECB has also undertaken several collaborative projects with international regulators.

“Over recent years we have intensified cooperation in this area with the Monetary Authority of Singapore (MAS) and the US Office of the Comptroller of the Currency (OCC),” she said. “And with our partners at the

Federal Reserve System, the Bank of England and the United Kingdom’s Financial Conduct Authority (FCA), we have identified initial areas for joint SupTech development that will add significant value to our work.”⁴²³

In March 2024, the ECB and the European Banking Authority (EBA) announced that they were establishing a Joint Bank Reporting Committee to improve efficiency and decrease the costs of data reporting. Joining the two institutions on the Committee will be the European Commission and the Single Resolution Board (SRB), as well as other relevant EU bodies, national authorities, and industry representatives. The Committee will work

We have identified initial areas for joint SupTech development that will add significant value to our work.

ELIZABETH MCCAUL

to develop common definitions and standards for the data that banks are required to report for statistical, supervisory, and resolution purposes.⁴²⁴

“A harmonised, proportionate and fit-for-purpose reporting system is a priority for the EBA,” said EBA Chair José Manuel Campa. “I am glad that today we are setting up this committee to ensure a smooth and sound governance underpinning an integrated and efficient reporting process to the benefit of all stakeholders.”

Ireland

INDUSTRY AND REGULATORY BACKGROUND

Auto Finance Probe

As discussed in the UK section of this report, in January 2024, the UK Financial Conduct Authority (FCA) launched a probe into auto lenders’ use of “discretionary commissions” that incentivized finance brokers and dealers to raise interest rates on auto loans until the practice was banned in 2021. “These motor finance firms were historically offering discretionary commission whereby they set a rate and gave the broker an opportunity to determine which rate is given to the customer,” Kate Robinson, Principal at regulatory consultancy Avyse Partners, told the *FT*. “If you’re a customer, you could have been charged a higher rate for the lending in order to increase the broker’s commission.”⁴²⁵ Analysts estimate that the total cost imposed upon the UK auto financing Industry from the investigation could reach £16 billion.⁴²⁶

In February 2024, the Central Bank of Ireland (CBI) stated that it was aware of the investigation, and would begin its own engagement with Irish lenders to ensure they had not engaged in similar misconduct.⁴²⁷

Several of Ireland’s largest banks are already likely to have exposure to the UK investigation. For instance, analysts at Barclays predicted that the Bank of Ireland may face up to €160 million in redress as a result of the FCA’s probe.⁴²⁸ In March, Myles O’Grady, Chief Executive of the Bank of Ireland, warned that the Irish auto financing market may soon face a similar probe from the CBI.⁴²⁹

Fit and Proper

In 2010, the CBI introduced its Fitness & Probity (F&P) regime as a means to rebuild trust and confidence in the financial sector following the global financial crisis. The F&P regime requires that firms ensure that their staff are fit and proper. It also sets out a process by which the CBI must approve candidates for senior management positions in firms, and empowers the CBI to remove employees who do not meet the fitness and probity standards.⁴³⁰

Many jurisdictions globally have since followed suit. For instance, as a part of its Senior Managers and Certification Regime, launched in 2016, the UK FCA administers fitness and propriety tests for employees and senior personnel in financial institutions.⁴³¹ In 2021, the Monetary Authority of Singapore introduced its “Guidelines on Individual Accountability and Conduct,” for which a key outcome was ensuring that all senior managers are “fit and proper” for their role.⁴³² And, more recently, the New York Department of Financial Services introduced final guidance on how banks and other financial institutions in New York State should review the character and fitness of their directors and executives in January 2024.⁴³³ **▶ PAGE 183**

However, the validity of the F&P regime was called into question in February this year when an appeals body issued a highly-critical judgment regarding the CBI’s rejection of a finance executive for board position on an Irish fund. The Irish Financial Appeals Tribunal (Ifsat), an independent body that hears appeals against CBI decisions, said that the CBI’s decision-making process was “flawed” and that

the executive who had been rejected was “denied fair procedures at every stage of the process.” The IFSAT was not, however, able to conclude whether or not the decision to reject the application was the correct one.⁴³⁴

In response to the Tribunal’s decision, the CBI announced that it would commission an independent review of the F&P approval process “to ensure that it remains effective into the future.”⁴³⁵ In March, the CBI announced that it had tapped Andrea Enria, recent past-Chair of the Supervisory Board of the European Central Bank, to conduct the review.⁴³⁶ ► **PAGE 277**

“The review will consider the transparency, efficiency and effectiveness of the central bank’s operation of the fitness and probity regime, considering the purpose and objectives of this regime to support the safety and soundness of firms, threats to consumer and investor protection and the stability of the system overall,” the CBI said. “The focus of the review should be on the processes, systems and structures used by the Central Bank to exercise its functions ... but the reviewer is welcome to make any other observations to improve the overall operation of the regime. The review is to be on the implementation of the framework, rather than the legislative framework itself.” The review will be published in the third quarter of this year.

It remains to be seen what Enria will find. However, the criticism regarding the F&P regime is representative of a global trend of industry resistance to regulation and supervision that is seen to rely on “judgment” not backed by transparent methodologies and metrics. ► **PAGE 187**

CENTRAL BANK OF IRELAND

Individual Accountability

In March 2023, the CBI introduced a three-month consultation on key aspects of its Individual Accountability Framework (IAF), including the

publication of draft regulations and related guidance. This followed the enactment of the Central Bank (Individual Accountability Framework) Bill of 2022 earlier that month.⁴³⁷

The consultation clarified expectations regarding the Senior Executive Accountability Regime (SEAR), which requires firms to set out where decision-making responsibilities sit among senior management. It also established new Conduct Standards, making it mandatory that bank employees act honestly and in the best interest of customers.

Senior leaders will also face additional conduct standards related to how they run the business areas for which they are individually responsible. Lastly, it proposed changes to the current Fitness & Probity (F&P) Regime, clarifying firms’ obligations to certify that individuals in certain positions are fit and proper for their duties.

Central Bank of Ireland Deputy Governor Derville Rowland, stated that the framework would “underpin sound governance across the financial sector” by establishing the practices expected of firms and individual role-holders, while clarifying their personal accountability in this regard. “As regulators, our approach to implementation of the framework will be founded on the principles of proportionality, predictability, and reasonable expectations, underpinned by effective enforcement,” Rowland added.

Following this consultation, in November 2023 the CBI published the final regulations and guidance regarding the IAF. The issued guidance provided clarity regarding the central bank’s expectations in connection with the implementation of: the Senior Executive Accountability Regime, the Conduct Standards, and the Fitness & Probity regime.⁴³⁸

“This piece of regulation is first and foremost about enhancing governance, performance and accountability in financial services,” Rowland wrote in

a related press release. “Today’s publications provide clarity to firms and individuals by setting out clearly the good practices expected of firms and role-holders, and their accountabilities,” Roland asserted. “At its core, financial regulation is about supporting positive outcomes, protecting consumers and investors, and, ultimately, contributing to the economic well-being of the community as a whole. These regulations support this objective.”

Culture Supervision

In its “Regulatory & Supervisory Outlook Report,” published in February 2024, the CBI emphasized driving improved culture at regulated firms as a key priority of its work.⁴³⁹ The Outlook Report described where the CBI will be allocating resources in the coming year, identifying three risk drivers that are shaping its supervisory and regulatory efforts:

- The macroeconomic and geopolitical environment, such as inflation risks;
- The evolution of the marketplace, such as digitalization; and
- Longer-term structural forces, such as climate risks.

Significantly, the CBI called out culture as a ‘horizontal’ factor that impacts all of these areas. ► **PAGE 283**

“Across all the risk themes described above, a consistent risk mitigant is that a regulated entity has a culture and approach that supports the management of its operation in a prudent, proper, forward looking and consumer-centric way,” the CBI wrote. “This requires having the expertise, experience, infrastructure and governance structures in place to run it well.”

IRISH BANKING CULTURE BOARD

In July 2023, the Irish Banking Culture Board (IBCB) published its third-annual éist report, displaying the results of a survey measuring public sentiment towards the five retail banks operating in Ireland. The survey found a substantial increase of 10 points in the public’s trust in the banking sector, though the total levels of trust remain rather low.⁴⁴⁰



FROM OUR 2022 Compendium

Accountability Regimes: Will They Succeed in Changing Behavior and Culture in Banking?

by **Ciaran Walker**

“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.”

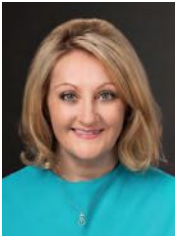


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The survey also found that consumers perceive a difference between their local bank branch, individual banks, and the banking sector as a whole. Consumers are far more likely to trust the bank branches they interact with frequently than the industry at large.

“Gradual progress is being made,” said Marion Kelly, CEO of the IBCB. “The challenge is to accelerate the pace of that progress. While all member banks of the IBCB have been working hard to restore trust, this year’s éist research reflects some understandable negative public sentiment on the departure of two retail banks from the market. Building and maintaining

trust between the banks and their customers, as the market evolves, remains crucial. Both the IBCB and its member banks are committed to that objective.”



FROM OUR 2020 Compendium

Irish Banking Culture Board (IBCB)

by **Marion Kelly, CEO**

“Culture means many things to many people. It was necessary to focus the initial activities of the IBCB on particular aspects of cultural change which would resonate with key stakeholders. For this reason, we decided to ask for, listen to, and act on the views of those two cohorts of stakeholders most impacted by this culture — bank staff and bank customers.”



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Germany

INDUSTRY AND REGULATORY BACKGROUND

Banking Conduct

At the Global Banking Summit in November 2023, Deutsche Bank CEO Christian Sewing argued that banking culture had “completely changed” since the Global Financial Crisis. Dismissing Credit Suisse as an exception, Sewing asserted that “all banks around the world” had changed their culture.⁴⁴¹

“The risk culture and the mindset of the people changed,” Sewing said. “In my view, the clear majority of the CEOs of banks now have a long-term view of stable income streams.” Sewing called for the EU to

follow the UK in lifting the cap on bankers’ bonuses put in place following the Financial Crisis. “Removing the bonus cap, if this is done in most parts of the world, then this is something that we need to consider — always attached to the understanding that the risk culture in banks has clearly changed,” he said.

However, only one month earlier, the Federal Financial Supervisory Authority (BaFin) installed a regulatory monitor at Deutsche Bank amid a spike in customer complaints at its German retail operation, Postbank. Following an IT migration in July 2023, which Deutsche originally claimed was a success, thousands of Postbank customers were locked out of their accounts for weeks. As such, many customers struggled to pay for essentials, and the bank’s customer service center was overwhelmed with complaints.⁴⁴²

“BaFin is fulfilling its legal mandate for collective consumer protection and can intervene on a supervisory basis if the urgently-needed improvements in order processing at Postbank and DSL Bank do not materialise,” the regulatory monitor said.

And in December, the *Financial Times* reported that Deutsche Bank had found thousands of forgotten and unresolved customer complaints regarding Postbank, its German retail bank.⁴⁴³

In February 2024, BaFin threatened to fine Deutsche for failing to resolve longstanding flaws in its anti-money laundering controls. In 2018, BaFin installed a special monitor, distinct from the one discussed previously, to supervise the bank’s transaction monitoring systems. The monitor’s mandate was due to end in spring 2024, but BaFin extended it to October 2024, threatening Deutsche with a fine if it missed the deadline.⁴⁴⁴

Of course, being the largest German bank by a significant margin, Deutsche receives much of the press and attention. However, it is certainly not the

only German bank to face these challenges. In April, BaFin published complaints data for 2023, showing an 87% percent increase over the previous year to 27,000 complaints. Though, notably, BaFin did imply that Deutsche was at least partially responsible for this increase. “A considerable portion of complaints about disruptions in customer service at banks were linked to one financial institution,” said Christian Bock, Head of BaFin’s Consumer Protection Division.⁴⁴⁵

Wirecard’s Continued Fallout

As we discuss throughout this report, over the past several years, there has been heightened scrutiny globally of culture in the accounting sector and the audit quality and professional conduct outcomes that culture promotes. Perhaps one of the most notable examples of this has been the focus on EY following the collapse of German fintech darling Wirecard in 2020.⁴⁴⁶

We have covered the Wirecard story extensively in past reports, and we would encourage you to refer to Starling Insights for more information. However, to provide a little background, Wirecard, a payments processor, was at one time the largest financial technology company in Europe, valued at €24 billion. However, after it was discovered that €1.9 billion in cash on its books was somehow “missing” in June 2020, the firm quickly fell into ruin.⁴⁴⁷

Unsurprisingly, after the collapse, many began to question how Wirecard’s auditor of nearly 10 years, EY Germany, could possibly have missed massive fraud in areas so material to the company’s financial results.⁴⁴⁸

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 November 2021, German newspaper *Handelsblatt* published a

confidential parliamentary report into EY’s audit work for Wirecard. The report found that EY Germany had failed to implement professional guidelines and had taken executive assurances at face value on key issues.⁴⁴⁹



FROM OUR 2021 Compendium

Lessons Learned from Wirecard

by **James H. Freis**
past-CEO, Wirecard

“Wirecard exploited the mystique of being a fintech darling to establish itself as a blue-chip company, rising to 24 billion euro in market capitalization by posing a scalable business model within the growth sector of online and digital payments. Some questionnaires of its income stream were rebuffed as ignorant of innovation, technology, or both, and even some of Wirecard’s largest lenders and proponents later admitted they did not fully understand its business model.”



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In an effort to regain the trust of the public and its regulators, EY reorganized its Germany practice⁴⁵⁰ and announced plans to invest \$2 billion to improve audit quality.⁴⁵¹ However, the auditor was not able to shake off its affiliation with Wirecard quite so easily.

In April 2023, German audit watchdog Apas announced that it was banning EY from taking on new listed clients for two years and fined it €500,000 for its failures in auditing Wirecard. Apas also fined five current and former EY employees between €23,000 and €300,000 each. In the statement, Apas wrote

that it “considered violations of professional duties during the audits of Wirecard and Wirecard Bank from 2016 to 2018 as proven.”⁴⁵²

“We regret that the collusive fraud at Wirecard was not discovered sooner, and we have learned important lessons from this matter,” EY said in response, stating that it had taken significant steps to improve audit quality and risk management.

In December 2023, a group of 13,000 individual and institutional investors filed a lawsuit against EY for its Wirecard audit work, claiming more than €700 million in damages. Klaus Nieding, a lawyer representing the shareholders, said that EY should have discovered that the funds “did not exist in Wirecard’s corresponding accounts” as another auditor “found this out very quickly.”⁴⁵³ Nieding was likely referring to a special audit conducted by KPMG, which concluded in April 2020 that a large portion of Wirecard’s business and account balances could not be verified.⁴⁵⁴

Only a week after the investor lawsuit was filed, Michael Jaffe, Wirecard’s insolvency manager, filed a separate €1.5 billion lawsuit against EY.⁴⁵⁵

In March 2024, EY decided to drop its appeal against Apas’ aforementioned penalties. The auditor said it would “fully comply with the sanctions” in order to “bring a conclusion to [the] proceedings.” EY added that it had “learned important lessons from this particular case,” claiming to have improved its audit quality control and fraud prevention capabilities. The new client ban had been on hold pending the results of the appeal, and would likely take effect from that point.⁴⁵⁶

In April, Apas published a summary of its review into EY’s audit work for Wirecard. Therein, the watchdog criticized the auditors’ “deficient execution” and “insufficient audit reporting” that resulted in “objectively inaccurate audit opinions.” Apas laid blame on the “grave failure” of EY’s

audit quality controls, accusing “several key executives” of committing “multiple violations of professional duties.”⁴⁵⁷

Spain

INDUSTRY MISCONDUCT

In January 2024, the Spanish National Securities Market Commission (CNMV) initiated disciplinary proceedings against Deutsche Bank for the alleged mis-selling of risky derivatives to small and medium-sized businesses. The bank is said to have marketed high-risk foreign exchange derivatives as low-risk currency hedges without adequately disclosing the downsides between October 2018 and March 2021.⁴⁵⁸

Deutsche Bank’s internal investigation revealed instances of bad faith and the exploitation of internal control weaknesses by some employees. The firm had already paid substantial settlements and disciplined staff after several clients faced significant losses from these products. The CNMV said Deutsche’s conduct “may constitute” a “very serious infringement” of Spanish securities law. Potential fines for such infringements can reach 10% of the annual turnover of the local subsidiary. The regulator stressed the bank’s legal obligation to provide balanced, clear, and non-misleading information about complex derivative products.

BANCO DE ESPAÑA

In a blog post published in December 2023, the Banco de España’s Javier Tarancón, Head of Information Analysis and Suptech, and Pilar Puig, Head of IT Risk Inspections, explained how the central bank is working to adopt innovative supervisory technologies (SupTech), including those powered by AI.⁴⁵⁹

“Technological developments, such as artificial intelligence (AI), the phenomenon of the moment, have enormous transformative potential,” they

wrote. “The banking sector is aware of this and seeks to incorporate technological innovations to become more efficient. How can the Banco de España supervise an ever-changing and ever more complex banking sector efficiently? Innovative technology applied to supervision (SupTech) can help.”

In its 2024 strategic plan, the Banco de España committed to promoting innovation as it works to modernize its processes and position itself as a “leading prudential supervision institution.” In order to do so, the central bank will:

- Participate in the European Single Supervisory Mechanism’s (SSM) SupTech initiative;
- Develop its own SupTech tools as it fosters a culture of innovation; and
- Train its staff on the application of data science to supervisory challenges.

“The ongoing work of adapting to new technologies is key to fulfilling our supervisory mission,” Tarancón and Puig concluded. In this direction, the Banco de España has commissioned an external evaluation of its SupTech function, and will publish a report on the findings in the coming months.

In an April 2024 blog, the Banco de España’s Alejandra Bernad explained how the central bank establishes its supervisory priorities. While the EU’s Single Supervisory Mechanism (SSM), of which the Banco de España is a member, establishes the priorities for significant banks across the Eurozone, the Banco de España sets the priorities for all of the remaining Spanish banks.⁴⁶⁰

“The process begins with an assessment of the risks affecting the banking sector,” Bernad wrote. “This analysis is used to identify credit institutions’ vulnerabilities and prioritise the most important ones, and a work plan is then drawn up. Macroeconomic, financial and geopolitical considerations are taken into account, as are market perceptions and the findings of supervisory reviews.” Such macroeconomic and

geopolitical factors that have driven supervisory priorities in recent years include the Covid pandemic, the war in Ukraine, and the US “banking turmoil” in the spring of 2023.

In 2024, this process culminated in a set of priorities for both Significant and Less Significant banks that have several common emphases:

- Remediating shortcomings in governance arrangements;
- Building robust operational resilience frameworks to ensure digital transformations are undertaken safely; and
- Improving the management of credit, liquidity, interest rate, and climate-related risks.

Netherlands

AUDIT CONDUCT

The primary focus of this report is on the financial sector and the culture and conduct challenges faced by firms in that industry. However, over the past several years, conduct scandals among accounting firms have increasingly called our attention to similar culture struggles in the audit sector.

In July 2023, for instance, KPMG Netherlands confirmed reports that at least 500 employees had been found to have cheated during mandatory accounting exams. An internal investigation was launched after an employee reported that others were sharing test answers. KPMG confirmed that sanctions were imposed on an undisclosed number of employees, including several being fired, in response to the cheating.⁴⁶¹

Marc Hogeboom stepped down as head of KPMG’s accounting arm in the country but was to continue as an audit partner. Cheating in exams has been an ongoing issue in the accounting sector, with other major firms like EY and PwC facing significant

finances for similar misconduct in recent years. “I am shocked by the scale of this cheating and the fact that it is playing out across all layers of the organisation,” said Hanzo van Beusekom, Chairman of the Authority for Financial Markets (AFM). “We strongly urge employees within the sector to proactively report abuse.”

In April 2024, the US Public Company Accounting Oversight Board (PCAOB) levied its largest ever fine, \$25 million, on KPMG Netherlands for “egregious” and widespread exam cheating at the firm from 2017-2022. The regulator also banned KPMG Netherlands’ former head of assurance, Marc Hogeboom, from the industry.⁴⁶²

PROFESSIONAL OATH

In April 2024, De Nederlandsche Bank (DNB) published a brochure on how firms and employees in the financial industry can bring the Professional Oath to life in their day-to-day operations.⁴⁶³

In 2015, the Dutch Financial Supervision Act introduced the Professional Oath, which requires that individuals in the financial sector commit to a set of moral and ethical principles when practicing their profession. The Oath was established to strengthen trust in the financial sector, and is backed by a disciplinary regime if employees violate the principles set out therein.

A 2021 survey by the DNB, encompassing banks, insurers, and payment institutions, revealed that firms were not consistently embedding the principles of the Oath into day-to-day operations. The survey explored how well the Oath principles were adopted by operational management, how they factored into disciplinary matters, and how successful firms were at sustaining awareness of these principles. “One of the findings of the survey was that while institutions go to great lengths to invest the oath-taking ceremony with

meaning and lustre, the oath does not seem to feature explicitly in people’s everyday work life once the ceremony is done,” the DNB writes in the brochure.

The brochure was the outgrowth of a seminar organized by the DNB along with the financial sector and other stakeholders to explore ways in which the Oath could be ingrained into everyday life more effectively. The seminar proceedings culminated in a strategy encompassing five key categories: taking the Oath, dialogue, behavior, nudges, and organization. These suggested actions include:

- Translating the Oath into specific behaviors for specific roles;
- Ensuring that the “work context” — what we would call “culture” — compels employees to act in accordance with the Oath; and
- Adapting the Oath to fit the organization.

Switzerland

FALLOUT FROM CREDIT SUISSE

The Failure of Credit Suisse

In our past writings, we have recounted in extensive detail the long stream of conduct, governance, and risk management failures that plagued Credit Suisse in the years leading up to its near-collapse and emergency rescue by UBS in March 2023.⁴⁶⁴ We will not seek to repeat that saga here. We would, however, encourage you to reference our past *Compendium* editions **▶SEE THE COMPENDIUM ON STARLING INSIGHTS** and our 2022 *Deeper Dive*, “The Costs of Misconduct,” for more information. **▶SEE “THE COSTS OF MISCONDUCT” ON STARLING INSIGHTS**

In the wake of Credit Suisse’s demise, it has been widely recognized that the bank was brought down by deficiencies in culture, governance, and risk management. In a *Wall Street Journal* article in November 2023, journalist Margot Patrick traced the

decline of Credit Suisse, analyzing the impact of Urs Rohner's leadership during his tenure as Chairman of the bank from 2011 to 2021.⁴⁶⁵

Following Credit Suisse's liquidity crisis and eventual emergency rescue in spring 2023, much of the blame was placed on external circumstances. "But insiders and investors combing over the wreckage say that Credit Suisse's board, headed by Rohner, was ultimately responsible," Patrick wrote. "It was the bearer of a flawed culture that led the bank into a series of calamities."

Rohner has defended his tenure, however, pointing to the tens of billions in profits Credit Suisse delivered over the decade he was Chair. And the scandals that hit the bank during this time, he argues, were legacy issues that dated before his tenure. Instead, he insists, the bank's downfall was caused by decisions made after he departed in 2021.

Former executives at Credit Suisse say that Rohner and his board did not set the right "tone at the top" regarding risk management and culture. "During his tenure, Credit Suisse's stock lost three-quarters of its value," Patrick recounted. "A series of scandals... culminated in Rohner's final days with one of the biggest sudden losses in banking, a more-than \$5 billion hit from the collapse of family office Archegos Capital Management."

In our 2022 *Compendium*, Brad Karp, Chairman of US law firm Paul, Weiss, Rifkind, Wharton & Garrison, wrote about his experience as lead author of the report the firm was commissioned to prepare after its internal investigation at Credit Suisse in the wake of the Archegos crisis. "[The report] 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," Karp wrote. **►READ MORE FROM BRAD KARP ON STARLING INSIGHTS**

With this context in mind, it was largely unsurprising to most informed onlookers when Credit Suisse failed in March 2023.⁴⁶⁶ However, its merger with UBS left many open questions as to how the newly-combined bank would resolve these long-standing shortcomings.

The Unibank

The forced merger of UBS and Credit Suisse created a bank that is abnormally large compared to the economy of the country in which it sits. Some have worried as to whether the country and its economy would be able to withstand the failure of such a bank, and whether its regulatory regime is equipped to prevent such a failure.⁴⁶⁷

Others have argued that UBS' size could have a chilling effect on competition in the market. In February 2024, it was reported by *Reuters* that Switzerland's Competition Commission (COMCO) had recommended an investigation of UBS' dominance in certain parts of the market in a report to the Swiss Financial Market Supervisory Authority (Finma) in late 2023. However COMCO's recommendation is not binding, and it is not clear at this time as to whether Finma will undertake such a probe.⁴⁶⁸

These worries are exacerbated by additional concerns as to how UBS will grapple with the legacy matters it inherited from Credit Suisse. In June 2023, the *Financial Times* reported that UBS faced hundreds of millions of dollars in fines relating to Credit Suisse's mishandling of Archegos.⁴⁶⁹

This came to bear in July 2023, when the US Federal Reserve Board (FRB) announced a consent order and a \$268.5 million fine against UBS Group AG for misconduct by Credit Suisse, which UBS had officially acquired in June of last year. The sanctions stem from Credit Suisse's dealings with Archegos, and its failure to manage related risks properly despite repeated warnings.⁴⁷⁰

“The Board is requiring Credit Suisse to improve counterparty credit risk management practices and to address additional longstanding deficiencies in other risk management programs at Credit Suisse’s U.S. operations,” the FRB wrote in its announcement. The action was taken in conjunction with actions by Finma and the UK Prudential Regulation Authority. The related fines totalled approximately \$387 million.

UBS has also been tasked with integrating the organizational culture that some have speculated led to Credit Suisse’s risk management failures, and the employees that were involved, into its own organization. “We are worried about ‘cultural contamination,’” said UBS Chairman Colm Kelleher at the bank’s general meeting in May 2023. “We are going to have an incredibly high bar for who we bring in to UBS.”⁴⁷¹

All of this adds up to a very difficult challenge for Sergio Ermotti, who was brought back as CEO of UBS just days after the emergency acquisition, having previously led the bank from 2011 to 2020. The deal could be hugely profitable for UBS, or it could be existentially ruinous.⁴⁷² If it turns out to be the latter, it will be incumbent upon Switzerland’s regulators and supervisors to ensure they are prepared to stop the bank from going the way of Credit Suisse.

Regulatory Reforms

Unsurprisingly, the failure of Credit Suisse and UBS’ subsequent dominance has brought heightened scrutiny of Switzerland’s regulators and supervisors. Many have questioned not only why action was not taken sooner to resolve the deficiencies at Credit Suisse, but also how regulators are planning to plug those holes to prevent an even more devastating failure at UBS.⁴⁷³

A key debate over the past year has been whether Finma is equipped with the statutory mandate necessary to fulfill its role as regulator and supervisor of the financial sector. In September, a panel of eight

financial experts, including academics, bankers and former regulators, appointed by the Swiss government to analyze the collapse of Credit Suisse, issued its report. The panel found that Finma lacked the tools necessary to enforce the country’s rules. While Finma had identified shortcomings at Credit Suisse, the bank was “recalcitrant” toward regulatory scrutiny, according to the report.⁴⁷⁴

The panel called for urgent reforms to expand the regulator’s statutory basis. These include giving Finma the ability to levy fines, as it is currently the only regulator in a leading financial centre that lacks that power. It also proposed that the regulator be allowed to “name-and-shame” firms and individuals who are subject to enforcement proceedings.

Also in September, Finma announced that its CEO, Urban Angehrn, was stepping down after less than two years due to health consequences caused by the “high and permanent stress level” of the job.⁴⁷⁵

In a speech in November, Sergio Ermotti, CEO of UBS, advocated for increased powers for Finma to sanction negligent bankers. “It should be easier for the bank, or the regulator, to go after people who demonstrated great negligence in their duties,” Ermotti said. However, he emphasized that there was no need for a fundamental change to Switzerland’s regulatory framework. Instead, Ermotti endorsed the aforementioned set of reforms proposed by the government-appointed panel.⁴⁷⁶

In December, Finma issued its own report into the collapse of Credit Suisse. The report called for enhanced powers to oversee banks, maintaining that Finma had done all it could within the limits of existing statutory powers to try to prevent the collapse of Credit Suisse.

The bank’s collapse was caused by “inadequate implementation of its strategic focus areas, repeated scandals and management errors,” Finma wrote.⁴⁷⁷ The regulator claimed to have spotted these problems

at the bank and to have moved to stabilize it. “Although its actions had an effect, they were unable to overcome the causes of the loss of confidence, such as shortcomings in strategy implementation and in risk management,” said Thomas Hirschi, Head of Finma’s Crisis Unit and Banks Division. In order to be able to compel banks to remedy such shortcomings in the future, Finma argued that it would need to be able to issue fines and hold executives individually accountable.

In January 2024, Finma appointed Stefan Walter, previously the Director General of Horizontal Line Supervision at the European Central Bank (ECB), as its new chief executive. Finma Chair Marlene Amstad said Walter’s “knowledge in the area of large bank supervision and his links to international supervisory authorities will be a great asset for Finma’s supervision of the systemically important Swiss banks.”⁴⁷⁸

In February, the Financial Stability Board published its “Peer Review of Switzerland,” suggesting many of the same reforms that were recommended by the expert panel and requested by Finma. These included recommending that Switzerland establish a Senior Managers’ Regime, implement a more effective early intervention framework, and add additional resources to Finma.⁴⁷⁹

In April, the Swiss government proposed a wide-ranging package of reforms to the country’s too-big-to-fail regime. Through these changes, the government aims to empower Finma to compel banks to resolve supervisory findings more effectively. The proposals include the introduction of a Senior Managers Regime, bonus clawback provisions, improved information-gathering capabilities, and strengthened legal grounds for management changes. Finma will also receive increased staffing and resources, and the government said that it would explore extending personal penalties for misconduct

to smaller banks. However, the government stopped short of granting Finma the ability to levy fines on banks.⁴⁸⁰

While Finance Minister Karin Keller-Sutter and others had advocated for empowering Finma with fine-imposing capabilities, the government’s proposal for banking reform merely suggests examining the possibility. While fines are a standard tool for other regulators in large financial centers, further study is needed to avoid weakening banks’ willingness to cooperate, according to the government.

It remains to be seen whether or not these reforms will give Finma the tools it needs to prevent another Credit Suisse-style failure. We would encourage you to sign up for Starling Insights for updates on this story throughout the next year. ▶ **SEE STARLING INSIGHTS**

ANTI-MONEY LAUNDERING REFORMS

Switzerland has long held a reputation as a haven for illicit monies and laundered funds. However, Switzerland has been responding to international pressure to demonstrate seriousness with regard to its anti-money laundering obligations. This is especially true as other governments, and the public, demand the consistent application of sanctions targeting Russia following its invasion of Ukraine.⁴⁸¹

In August 2023, Karin Keller-Sutter, Switzerland’s Finance Minister, unveiled a package of reforms aimed at combating money laundering and enhancing transparency as the country seeks to shed its reputation as a hub for the movement and concealment of illicit funds. The reforms would require “beneficial owners” of trusts and companies to be declared as such, both in order to increase transparency and to close legal loopholes. Notably, Switzerland is currently the only European nation lacking a national register of beneficial ownership.⁴⁸²

“A robust system to protect against financial crime is essential to the reputation and lasting success of an internationally significant, secure and forward-looking financial centre,” Keller-Sutter said. The new register of beneficial owners would be accessible by regulators, government, and police, as well as accredited banks and lawyers performing due diligence. Additionally, Swiss lawyers, accountants, and service providers will face stricter relevant obligations themselves, such as conducting due diligence on clients and reporting suspected money laundering cases to authorities.

As of this writing, the new regime has not yet been implemented.

In Focus

Time to Tackle Unfinished Business

By: WAYNE BYRES



Wayne Byres

It's now more than a decade-and-a-half since the 2008 financial crisis. In that time, the scale of the regulatory reform agenda has been impressive: stronger capital and liquidity requirements, tougher requirements for systemically important institutions, the advent of structured macroprudential policy frameworks, and more robust recovery and resolution planning, to name just a few.

Supervisory toolkits have also been enhanced, with more attention on the identification of potential vulnerabilities through advances in stress testing, better data collection, greater attention to operational resilience, and a more systematic approach to assessing organisational governance and culture — with a particular emphasis on risk culture.¹

There's no doubt that the financial system is more resilient because of these efforts. While there can, of course, never be any guarantee that such a crisis could not occur again, many of the fault lines that existed in 2008 — both in the financial system, and in its regulation and supervision — have been substantially addressed.

Prudential supervision is needed to fulfil the goal of being anticipative and preventative.

Unfinished business

Yet, 15 years on, one important issue remains largely unaddressed by the international regulatory and supervisory community: establishing and reinforcing a strong supervisory mindset and culture. It would be a pity if this remained consigned to the “too-hard” basket.

To be clear, this is not a criticism of any individual jurisdiction or agency. As discussed below, there have been a range of domestic initiatives to promote more active and effective supervision. But the financial system is a global one, and weaknesses in supervision can impact well beyond national boundaries. It's time for the relevant international bodies tasked with promoting good supervision to take a closer look at the issue, and to play their part in promoting a stronger supervisory culture more widely.

It has long been understood that strong regulatory foundations are necessary, but not sufficient, to deliver a stable financial system. Prudential supervision is needed to fulfil the goal of being anticipative and preventative — that is, heading off small problems before they become big ones. Importantly, good supervision is more than just checking compliance with regulation: it needs to be sceptical, questioning, forward-looking, and proactive. Indeed, ideally regulation will be framed in a manner that empowers supervisors to act in a timely and effective manner (though far too often it is not).

Because good supervision is forward-looking, it must involve a degree of judgement applied (judiciously and proportionately) in a proactive manner. It's therefore often rightly said that supervision

is more art than science. Good supervision isn't mechanistic — it requires a blend of experience, intuition, foresight, a degree of scepticism, and a healthy dose of courage, to be effective. A supervisor

obviously needs the requisite analytical tools to identify potential vulnerabilities, but identification without action achieves little.

Hence, establishing the right supervisory mindset and culture — especially a bias to action — is critical to effective supervision. That seems fairly well accepted in principle. So the relative lack of attention given to the issue by the relevant international bodies tasked with promoting good supervision (primarily the BCBS, IAIS and FSB) is perhaps somewhat surprising.

Globally, supervisors have rightly recognised governance and culture as important contributors to the financial safety and soundness of regulated firms. More attention has therefore been given to drivers of culture, and particularly to the design of incentives for risk-taking. And yet this attention to culture within firms has not flowed into similar international efforts to strengthen the mindset and culture of financial supervisors.

Ex-post reviews of crises and periods of turmoil since 2008 have inevitably raised questions about whether supervisors did enough, and quickly enough. While hindsight is a wonderful thing, rarely has it been concluded that supervisors didn't have enough information, or sufficient powers, to identify problems. Rather, supervisory inaction, or insufficient action, has often been called out. And yet steps to tackle this issue head-on remain, at best, piecemeal and largely left to domestic supervisors to pursue individually.

Moreover, evidence shows that organisational governance and cultural failings are not just confined to financial firms. If poor culture and governance can produce poor decisions and practices in any sort of firm, why should we not expect these issues to challenge a financial supervisor too?

Yet maybe it's not so surprising this issue remains largely unaddressed by the international supervisory community.

Establishing the right supervisory mindset and culture — especially a bias to action — is critical to effective supervision.

The topic is undoubtedly a hard one. Assessing culture is a complex, and sometimes highly subjective, task. Supervisors are far from having an internationally agreed framework or the necessary skillsets for comprehensively

reviewing culture within banks and other financial institutions, let alone agreeing an approach that could be applied to supervisors themselves.

The post-crisis reforms also had a strong emphasis on the incentives for risk-taking created by the design and quantum of variable remuneration in financial firms. Supervisors typically don't use variable remuneration structures (at least of any meaningful size). A framework for the analysis of the drivers of supervisory culture and mindset would, therefore, need to begin from a substantially different starting point.

Perhaps the most challenging aspect is that, human nature being what it is, it's always easier to judge others than it is to judge oneself. If done well, self-assessments can be uncomfortable. Any internationally coordinated response would thus require the leaders of supervisory agencies to begin by acknowledging that, 'as leaders, we would benefit from help to do better.'

History mightn't repeat, but it sure rhymes

Time and time again the issue of supervisory mindset and culture are prominent features of postmortems conducted in the wake of a financial failure.

More than 20 years ago, contemporaneous inquiries into the failures of two insurance companies (HIH Insurance in Australia and Equitable Life in the UK) identified similar issues. In both cases, it was found that supervisory shortcomings were not the primary cause the failures; the companies were the authors of their own demise. Yet it was noted that supervisors were overly passive in the face of identified issues and should have done more to respond to problems and to alleviate the eventual costs to policyholders and taxpayers.

In the case of HIH, a Royal Commission found that the supervisor's performance was wanting. "It missed warning signs, was slow to act ... In many instances, APRA did not react appropriately."² In the case of Equitable, the Penrose Report found "there was a general failure on the part of [supervisors] to follow up on issues that arose in the course of their regulation of the Society."³ Supervisors "did identify relevant issues," Penrose found, "but consistently these were not followed through and were allowed to evaporate."⁴

Unfortunately, these lessons were not learnt more broadly. As a result, many similar findings emerged from the multitude of reviews and postmortems that followed the 2008 financial crisis. Most had their own variant of the powerful and succinct statement by the US Financial Crisis Inquiry Report: "We do not accept the view that regulators lacked the power to protect the financial system. They had ample power in many arenas and they chose not to use it."⁵

And yet, despite this clear message, the problem continues to reappear.

Most recently, the US Federal Reserve published a review of its supervision and regulation of Silicon Valley Bank (the Barr Report). With echoes of the HIH and Equitable cases 20 years earlier, the

Report concluded "[w]hen supervisors did identify vulnerabilities, they did not take sufficient steps to ensure that Silicon Valley Bank fixed those problems quickly enough."⁶

Attention to culture within firms has not flowed into similar international efforts to strengthen the mindset and culture of financial supervisors.

In discussing what it needed to do better, the Report noted the Fed's first area of focus would be to "improve the speed, force, and agility of its supervisory process ... We need to develop a culture that empowers supervisors to act in the face of uncertainty. In the case of SVB, supervisors delayed

action to gather more evidence even as weaknesses were clear and growing. This meant that supervisors did not force SVB to fix its problems, even as those problems worsened."⁷

It would be brave to suggest this will be the last time that supervisory mindset and culture are deemed to be inadequate to the task at hand. That the issue has emerged in many different jurisdictions, each with different supervisory architecture and powers, suggests that this problem is not a product of any particular supervisory structure, approach or methodology. Yet little seems to have been done by the international community to help address the challenge.

Agency leadership — the missing ingredient?

That's not to say no one has sought to tackle the issue.

The IMF published an important contribution in 2010, when it set out to establish the fundamentals of good supervision. The IMF identified that, to be effective, supervisors must have both the *ability* to act and the *willingness* to act, with the latter acknowledged as the more difficult of the two dimensions to develop.

“Supervisors must be willing and empowered to take timely and effective action, to intrude on decision-making, to question common wisdom, and to take unpopular decisions.”⁸ The paper identified some foundational elements that would support these proclivities, including a clear and unambiguous mandate, operational independence, skilled staff and an appropriate relationship with industry.

The IMF’s paper was followed up by the Financial Stability Board, later that year, with recommendations to improve the intensity and effectiveness of the supervision of systemically important institutions.⁹ As with the earlier IMF paper, the FSB’s emphasis was on getting the right *infrastructure* for active supervision: mandates, powers, resources and analytical capabilities.

In both cases, however, one critical component was overlooked: the role of *organisational leadership* in establishing the right culture for the supervisory agency. Having the right powers and tools is a critical precondition for effective supervision, but without the right mindset — the willingness to act, in the IMF’s terminology — they will not be enough.

The Basel Committee’s *Core Principles for Effective Supervision* have incorporated the IMF’s foundational elements in their assessment criteria. The Principles also emphasize, in many places, the importance of supervisors acting “at an early stage” to bring about “timely corrective action” in relation to supervisory concerns.¹⁰

Yet, despite pointing to the importance of supervisory assessment of the risk culture within banks, the Principles are largely silent on the importance of establishing the right culture (as distinct from the infrastructure of frameworks and policies) within the

supervisor itself. There is no discussion — and hence there will be no subsequent assessment — of the role of supervisory leaders in setting the right ‘tone from the top’ within their organisations. The International Association of Insurance Supervisor’s *Insurance Core Principles* are similar in their inclusions and omissions.

Most recently, the Basel Committee’s *Report on the 2023 banking turmoil* noted that an important

lesson for supervisors was the importance of exercising supervisory judgement, and that supervisors must consider “how they can effectively complement ... standards by exercising judgement — and therefore intervene proactively even when specific rules have not been breached.”¹¹

Despite repeated shortcomings being identified, relatively little has been done over the past couple decades, from an international perspective, to support the strengthening of supervisory mindset and culture towards one of action.

Although the Report (disappointingly) offers some justifications for a lack of supervisory action, it does suggest that “supervisory authorities could also review whether the guidance and processes given to individual supervisory teams appropriately incentivises a willingness to act early, accompanied by a clarity of process on how to do so.” This is perhaps the closest any of the guidance comes to touching on the responsibility of the leadership of supervisory agencies for establishing a culture of action.

Time for action

To be genuinely effective, financial supervisors need to have a bias to action, and the courage to act. Despite repeated shortcomings being identified, relatively little has been done over the past couple decades, from an international perspective, to support the strengthening of supervisory mindset and culture towards one of action. The regulatory framework has been substantially strengthened, and supervisory toolkits have been significantly enhanced. Yet, as noted above, analysis without action achieves little.

Having led a supervisory agency for over 8 years, I know well that establishing and maintaining the right supervisory culture and mindset is no easy task. It's difficult to get right. Supervisory successes — problems averted — are largely unseen. Stakeholder priorities and expectations can shift through the economic cycle. Most of the time, the supervisor will be regularly reminded to avoid excessive regulatory burden, and to not be overly prescriptive and hands-on when it comes to how a financial firm is managed. Yet, when problems in the financial sector occur — as they are wont to do — the supervisor will often be critiqued and told it should have done more. It is the supervisor's lot to grapple with this tricky balancing act.

More support from international bodies to help national supervisors strike this balance this would be a welcome development.

In recent years, there have been many domestic initiatives to strengthen and reinforce supervisory culture with a view to getting this balance right:

- APRA's Enforcement Review¹² sought to create a better integration of routine supervisory activity with formal enforcement action;
- the Expert Group Review of the European Central Bank's Supervisory Review and Evaluation Process¹³ recommended greater use of empowered supervisory judgement, supported by a well-defined supervisory culture and risk tolerance framework; and
- Canada's Office of the Superintendent of Financial Institution's Transformation Program¹⁴ seeks to ensure that the organisation, including its culture, is fit for the future.

But while these and other domestic initiatives are to be commended, they could usefully be supported through complementary international initiatives.

The critical role of agency leaders in establishing the right supervisory mindset and culture — especially one with a bias to action — needs to be explicitly acknowledged.

The first step needed is for the international regulatory and supervisory community to take the issue out of the "too-hard" basket. This could build on the post-crisis work of the IMF and FSB, support and reinforce work already underway in many countries at a domestic level, and help propagate good practice across the wider supervisory community. Even for those jurisdictions that are considered to already have strong and active supervisors, being able to

benchmark themselves more systematically against good practice and developments elsewhere should be seen as a helpful way of preserving that status.

In recognising that more can and should be done, the critical role of agency leaders in establishing the right supervisory mindset and culture — especially one with a bias to action — needs to be explicitly acknowledged. The current guidance on establishing an effective supervisory function focuses primarily on the necessary infrastructure — mandates, legal powers, skillsets, etc — but neglects any mention of the role of leaders in setting the right culture for their organisation. It's akin to saying that, as long as a financial firm has all the right policies and frameworks, it will automatically generate prudent outcomes.

We have learnt that this emphasis on risk governance infrastructure over risk culture is insufficient in financial institutions, and it's no different in supervisory agencies.

This article originally appeared in Starling Insights' "[Physician, Heal Thyself](#)" Deeper Dive.

Wayne Byres served as the Chair of the Australian Prudential Regulation Authority (APRA) from 2014 to 2022. Prior to this, he was Secretary General of the Basel Committee on Banking Supervision. Earlier in his career, he served in several regulatory and supervisory roles at APRA, the Reserve Bank of Australia, and the Bank of England.

ENDNOTES

- 1 The term 'risk culture' lacks a precise definition, but a commonly accepted reference is the Financial Stability Board's *Guidance on Supervisory Interaction with Financial Institutions on Risk Culture* (April 2014), which defines risk culture as an institution's norms, attitudes and behaviours related to risk awareness, risk taking and risk management.
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- 6 *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank* (April 2023), p ii
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In Focus

Strong and Effective Supervision of Governance and Culture

By: CHRIS GOWER



Chris Gower



APRA

Like many in today's financial regulatory community, my formative experience as a regulator came in the Global Financial Crisis and its aftermath. As a corporate lawyer working in the UK, I found myself supporting the Bank of England in its contingency planning for possible bank failures. There wasn't much time for reflection. When you're

working on plans to prevent possible depositor panic and loss of confidence in the banking system, you don't have time to pause and dissect the root causes.

Time to reflect "at leisure" has been in short supply since then, as my career took me into the Bank of England's resolution unit full time and later to build out the resolution function at the Australian Prudential Regulation Authority (APRA). APRA is in the relatively rare position of being both the prudential supervisor and resolution authority. In that context, and as I've transitioned into supervision in recent years, I've had to focus more on how risks

deficiencies in governance and risk culture can be early indicators of potential financial risks.

to viability materialise from end to end. The single most important insight I've gained is the importance of asking 'why' — and that the earlier you ask it, the better.

Why do financial firms fail — and what can supervisors do?

In the wake of last year's global banking turmoil, it was critical for regulators to ask that question of ourselves. The international consensus of various reports into the events of March 2023 was clear: "the first and most important source of financial and operational resilience comes from banks' own risk management practices and governance arrangements" and "poor risk culture" was a key factor.¹

It has long been recognised that deficiencies in governance and risk culture can be early indicators of potential financial risks. However, in a world where complex non-financial risk is growing rapidly, global regulators are increasingly recognising that the key to viability is not only to require more capital and liquidity, but also for supervisors to require good governance and a sound risk culture.

This is not news for anyone involved in Australia's financial sector over the past five years. Since the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry² of 2018/19, APRA has strengthened its supervisory framework to assess governance and risk culture

more explicitly among the banks, insurers and pension funds it regulates.

It has also enhanced its enforcement approach to empower supervisors to require entities to act before financial

soundness is threatened. This has resulted in more use of the full range of our tools — capital overlays,

licence conditions and enforceable undertakings — to require entities to address governance and risk culture weaknesses alongside other improvements.

As European Central Bank Supervisory Board Vice-Chair Frank Elderson said: “While balance sheets are often scrutinised with a hawk’s eye, it is often culture that whispers the first signs of trouble.”³ As the global regulatory community reflects on what makes an effective supervisory response to governance and culture concerns, I wanted to take the opportunity to share the lessons APRA has learned so far in asking “why”, covering four particular elements we have found critical to achieving good outcomes.

1) IDENTIFYING THE RISK — THE IMPORTANCE OF ROOT CAUSE ANALYSIS

Where supervisors do identify potential governance and risk culture issues at a regulated entity, it will be important to assess the materiality of underlying issues and to right size the supervisory response accordingly. APRA’s supervisory risk assessment process considers:

- governance and risk management including risk culture for every entity, alongside more traditional risk types, with more detailed assessment for the largest entities; and
- when multiple problems crop up, whether this can accumulate into an aggregate risk assessment requiring escalation and whether there are deeper underlying concerns.

Where material concerns arise in or one or more areas, supervisors ask themselves and the entity “why?” Are there broader or underlying problems that need to be addressed? At this stage, the entity needs to join the dots across risks — which is where the critical role of root cause analysis comes in.

There are many approaches and models for root cause analysis. Regardless of the methodology we’ve observed the following key ingredients of an effective root cause analysis:

- It goes well beyond the initial reasons that gave rise to concerns, joining the dots across issues, incidents, and breaches to understand “why” these collective issues occurred.
- It goes deeper on “why” — “insufficient investment” or “inadequate oversight” are red flags that reflection has not been deep enough, as they describe symptoms, not root causes.
- It pinpoints the underlying behavioural norms, cultural drivers and leadership mindset which shaped the environment and context for the observed failure of risk management.

Supervisors play an important role setting expectations upfront with the entity (and / or its consultants or advisors) that the root cause analysis will be sufficiently robust to yield these insights. In our experience, this can make the difference between the entity truly understanding what it needs to do, not only to remediate the risks identified but to make itself more resilient in the future.

Remediation plans that neglect leadership and cultural change rarely succeed.

2) BEYOND REMEDIATION — INTEGRATED TRANSFORMATION PLANS

Understanding of the cultural and behavioural root causes is critical to help the entity formulate a plan to address the identified issues. A good root cause analysis will prompt self-reflection from the entity about where gaps exist in its leadership and culture. Plans that focus solely on remediating immediate risks or satisfying the regulator at best only fix problems in the short term and similar issues recur soon enough.

The brutal fact is that many transformations fail, and a common reason is failure to culturally transform.

Remediation plans that focus on frameworks, systems, and processes but neglect leadership and cultural change rarely succeed.

Achieving sustainable transformation again starts with asking “why” — entity leadership needs to set out a compelling vision for how the plan will build a better business. Why are we bothering? Why does it matter? Why will our business be better off because of this change — or worse off if it doesn’t change?

Other key features that APRA has observed in plans that are more likely to succeed include:

- **Aligns with the entity’s strategy** — without articulating how improved governance and risk culture will support the overall strategic plan, entities will struggle to achieve buy-in.
- **Leadership participates in change** — in addition to setting a clear vision and tone from the top, boards and executive teams set out where they themselves will improve.
- **Ownership across all three lines of defence** — too many plans are set up primarily as a Risk-led project. Successful outcomes should result in measurable change across the core business.
- **Multiple levers to address root causes** — workstreams have clarity on problem statements and target states, which collectively add up to comprehensively address the cultural root causes.
- **Focus on sustainability** — workstreams look beyond design and implementation to articulate activities in terms of embedding change and describing how desired outcomes will be measured.
- **Accountability for delivery** — appropriate executives are accountable for the plan and for specific workstreams, using APRA’s accountability regime and linked to performance scorecards.

Independent assurers help supervisors to understand if real change is taking place.

Taking this integrated approach to risk transformation increases the chances that a remediation plan will achieve sustainable change and make the entity better able to respond to other risks in the future.

3) CRITICAL PARTNER — THE ROLE OF INDEPENDENT ASSURERS

Many regulators make use of third parties to monitor and oversee rectification or remediation plans as part of enforcement action. While APRA has long had powers to require the use of independent third parties by entities, relying on them to support risk transformation is a relatively recent practice. Done right, this can augment and complement the role of the supervisor during the delivery phase of the plan.

While the entity is responsible for delivering the plan and driving change and uplift, the independent assurer plays a critical role in helping leadership teams

and program leads by objectively assessing progress towards target states and addressing root causes. Typically, the independent assurer has been involved in the root cause analysis and so has a deep understanding of the “before” state.

Independent assurers also help supervisors to understand if real change is taking place. While entity reporting and attestation is important, independent assurers can test whether changes are operating as intended in practice. Ensuring their scope of work covers assurance not only of design effectiveness, but also operating effectiveness is therefore critical to ensuring change is sustainably embedded.

Independent assurers can then provide early feedback to entities on whether the activities under the plan are achieving the desired outcomes. Ongoing trilateral engagement with supervisors also allows for transparent and open communication on what is working well and what is not — and why. This can

help entities to proactively course correct where they are not hitting the mark and to avoid costly revision later.

4) SUSTAINABLE OUTCOMES — WHAT GOOD LOOKS LIKE

Supervisors will reach decision points whether to remove coercive tools and assess the entity risk as reduced. This is based on attestation from the entity, the independent assurance provided, and their own supervisory assessment from ongoing entity engagement, applying a “transformation lens”. At first glance, it seems counter-intuitive to say that a key sign of a successful uplift program is that it carries on.

However, in APRA’s experience the most important indicator of whether change is embedded is evidence of a self-sustaining culture of continuous improvement. This doesn’t mean nothing will ever go wrong again — far from it — but it does mean that, when risk issues do occur, they are less material and result in an appropriate response and reflection from the entity, which continues the uplift as part of “BAU”.

Asking themselves “why” on the smaller things helps entities identify early warning-signs or blind-spots. Entities that exhibit this capability and willingness to proactively identify and address risks themselves — whether financial or non-financial — and continuously improve their risk governance and culture, without waiting for the regulator to tell them to do it, are better equipped to be resilient whatever emerges.

Culture and mindset are key ingredients to this. A successful transformation moves the dial from a reactive and complacent culture to a mindset of “chronic unease”⁴ that values constructive challenge and continuous improvement.

A sound governance and risk culture are essential foundations for a more resilient system.

Why does this matter?

These four elements are APRA’s learnings so far about what makes an effective supervisory response when considering action to address deficiencies in governance and risk culture. As more and better international practice emerges, we look forward to continuing to contribute to and learn from the dialogue. Building a culture and mindset of continuous improvement and asking “why” is a shared endeavour for regulators and industry alike.

My experience has shown me that entities that reflect in quieter times on where — and why — they might have gaps or deficiencies will be better placed to weather troubled times. As threats to the financial

system continue to evolve, and operational or reputational risk events in individual entities have the potential to migrate ever faster into financial losses, a sound governance and risk culture are essential foundations for a more resilient system.

Chris Gower is the Executive Director for the Cross-industry Insights Division of APRA. The division is responsible for risk analysis, insight and response, with the aim of identifying risks as they emerge and ensuring regulated entities respond appropriately. Chris joined APRA in 2013 and has held various senior roles across APRA’s different functions. He has a deep understanding of prudential regulation, end-to-end supervision, enforcement and resolution activities. Prior to joining APRA, Chris worked at the Bank of England for a number of years following the global financial crisis, and prior to that as a lawyer in London. Chris has degrees in law from the University of Manchester and University of Cambridge.

ENDNOTES

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- 2 Royal Commission into Misconduct in the Banking, Superannuation and Financial Industry, "Final Report," Feb. 4, 2019. [LINK ▶](#)
- 3 Frank Elderson, "Treading Softly Yet Boldly: How Culture Drives Risk in Banks and What Supervisors Can Do About It," Speech at the 10th Conference on the Banking Union, Frankfurt am Main, Sept. 19, 2023. [LINK ▶](#)
- 4 Australian Prudential Regulation Authority, "Prudential Inquiry into the Commonwealth Bank of Australia (CBA) Final Report," Apr. 2018. [LINK ▶](#)



In Focus

Culture, Conduct & Putting Customers at the Centre: The Hayne Royal Commission 5-Years On

By: ANNA BLIGH



Anna Bligh



February 2024 marks five years since the final report of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry was handed down.

Today, the Australian banking sector looks very different from the one that faced the excoriating experience of the Commission's six rounds of

hearings, during which the conduct and culture of the financial services sector were laid bare.

For those executives who took the stand during the public hearings to answer probing questions, scars are etched on memories and important lessons have been learned.

Post-Hayne Reforms

The regulatory change that has occurred over the last five years has been vast and it has been driven from three sources: the recommendations from the Royal Commission itself; additional regulatory reform the Government has since embarked on in light of community and stakeholder concerns; and the Australian Banking Association's (ABA) complete re-write of the industry's self-regulatory Banking Code of Practice.

The Royal Commission recommended major reforms to conduct, culture and the sale of financial products. In response, the Government has legislated a raft of new laws, implementing such reforms as: "Design and Distribution Obligations" requiring banks to undertake target market assessments for all credit products; new "Product Intervention Powers" giving the Australian Securities Investments Commission (ASIC) the ability to halt the sale of products they deem harmful; and the banning of unsolicited offers of credit and credit increases. Additionally, the Financial Accountability Regime (FAR) was legislated, empowering regulators to hold accountable persons to higher standards for conduct within their organization.

The ABA's Banking Code of Practice has seen significant enhancements, including better protections for vulnerable customers and small businesses, improved practices when assisting farmers with distressed loans and banning informal overdrafts on basic bank accounts.

The collective impact of these regulations is such that Australian consumers are now well protected when accessing financial products and services. The very low level of arrears, currently at 1.3% across our ABA member banks, is testament to the fact that banks are enabling a more prudent environment for customers.

There is no question that banks today are more responsive to customers over profits. Australian banks had the opportunity to demonstrate this

during the early days of the COVID-19 pandemic when they allowed customers to defer payments of their loans for six months or longer. This was unprecedented in Australian banking.

Five years on, the clear and present theme of appropriate conduct in the Australian banking sector is front and centre for the executives and Boards responsible for these organisations. The Australian Prudential Regulation Authority (APRA) has continuously elevated conduct risk and risk culture as key elements of operational risk management. At various times in the period between 2018 and 2021, the five biggest banks collectively were required to hold AUD\$3.5 billion in capital overlays because of conduct or risk culture-related matters.

Further, APRA has emphasized holding senior executives and boards of banks to account, requiring substantial remuneration penalties be applied in cases of misconduct. Banks have also been ordered to revise their remuneration frameworks to embed cultures that pay heed to risk. The FAR, which came into effect in the banking sector in March 2024, is an expanded version of the Banking Executive Accountability Regime (BEAR), enacted in 2019. The FAR further embeds accountability and oversight responsibilities and requires the implementation of greater internal controls to prevent misconduct and to ensure responsible business practices. Under the FAR, individual executives, and the scope of their accountability, are specifically named and reported to APRA and ASIC.

Both the Corporations Act (Cth) and the National Consumer Credit Protection (NCCP) Act set out obligations for financial services companies and their licencees to act 'efficiently, honestly and fairly.' Although the Royal Commission didn't

recommend any specific changes to the NCCP, the obligations have taken on new meaning in its aftermath. There is no starker evidence of this than the mammoth remediation tasks banks have undertaken, repaying over \$6 billion to rectify past wrong-doings and mistakes, such as collecting 'fees for no service' in their financial advice businesses.

The concept of 'fairness' is further reinforced by the Australian Financial Complaints Authority (AFCA), which requires banks to operate in a way that is accessible, independent, fair, accountable, efficient and effective when considering complaints by consumers. Although AFCA's fairness remit is broad and non-prescriptive, it does refer to fair dealing, fair treatment, fair service and fair remediation. Those principles set out how financial firms are expected

to engage with customers experiencing vulnerability, the timeliness and fairness of claims and the ethical and professional values that underpin the delivery of financial services.

There is no question that banks today are more responsive to customers over profits.

A new cultural theme has also emerged described as 'should we, not can we,' derived from APRA's cultural review into the Commonwealth Bank of Australia. This review determined compliance functions in banks had a focus on whether they could undertake a particular activity within regulatory frameworks and not whether doing so was in the best interests of customers. 'Should we, not can we' has changed the way decisions are made in banks, enabling a more proactive stance with customers at the centre.

In summary, over the past five years, banks have implemented myriad new regulatory obligations and have grappled with higher expectations in their cultural obligations.

Simplification

Another important theme of the Royal Commission was the virtue of simplification. Excessive legal complexity was identified as the basis for many of the problems the Commission found, and Commissioner Hayne called for 'simplification' so that the 'law's intent is met.'

The philosophy behind this conclusion is that simpler laws that do not overlap are easier to understand and, therefore, easier to comply with. An opportunity to seize this revised approach lies in the recommendations from the Australian Law Reform Commission's (ALRC) final report, "Confronting Complexity: Reforming Corporations and Financial Services Legislation," issued earlier this year.

Since 2001, the Corporations Act has almost doubled in length to more than 4000 pages and over 800,000 words. The ALRC described the Act as 'longer than the novels War and Peace by Leo Tolstoy and the Lord of the Rings by Tolkien'. The relevant laws were referred to in the report as 'torturous' like 'porridge' and 'treacle'.

The ALRC has thus made 58 recommendations to simplify the law, including a revamped legislative framework for the financial services sector. These reforms aim to reduce costs for service providers and consumers, improve productivity by reducing complexity and provide more clarity around compliance requirements and enforcement.

The key recommendations are centred around re-designing financial services legislation to make it easier and less costly to find, navigate and understand and to make it easier to tell when something is a 'financial product' or 'financial service' by proposing a

Simpler laws are easier to understand and, therefore, easier to comply with.

The five-year anniversary of the Royal Commission is an opportunity to consider the current environment and whether Australia has struck the right balance.

single, simplified definition of both terms. The ABA is of the view that prioritising these reforms could lead to improved customer outcomes in the long term.

In summary, five years on from the Royal Commission, we have an opportunity to consider whether the right balance has been struck between enhanced consumer protections and the appropriate risk appetite to continue to support growth in the Australian economy.

Proportional Regulation

The ongoing domestic debate surrounding regulation and credit availability underscores the complexity of financial systems and the need for careful consideration of various factors to maintain a healthy balance between stability and growth. With 1175 pages of new laws and regulations since the Royal Commission, it is incumbent upon the banking sector and its regulators to make sure the focus is on regulation that really improves customer outcomes and demonstrates a recognition that there is not one average customer profile.

This is particularly pertinent for mid-tier lenders, who are disproportionately impacted by regulatory burden.

The ABA's view is that one of the ways to strike the right balance is to establish a proportional regulatory agenda as a means of easing the burden on mid-tier banks and facilitating competition in the market.

This can be achieved by APRA setting out proportionate regulation in its work program, particularly in stress testing and regulatory reporting, giving the mid-tier banks a better chance of competing with the larger players in the sector. Across the ditch, the New Zealand Reserve Bank (RBNZ) has acknowledged the diversity in the banking populations

it supervises and, in March this year, announced a proportionate approach to regulation. The RBNZ clearly recognises that the mid-tier banks are a category that requires its own set of regulatory rules rather than combining them with the Domestically Significant banks of the economy.

The ABA is strongly encouraged by the Albanese Government's attention on easing the burden on mid-tier banks and, in particular, the recent announcement from the Government to establish a regulatory grid. Based on the current model in the United Kingdom, the grid provides financial services organisations with an opportunity to better plan their regulatory program and to prioritise the regulatory requirements that deliver the most valuable customer outcomes and protections. In implementing the Regulatory Grid, the ABA urges the government to ensure that proportionality is incorporated into the decision-making processes of the agencies and Government departments contributing to it.

The five-year anniversary of the Royal Commission is an opportunity to consider the current environment and whether Australia has struck the right balance. Customer protections are a critical component of a well-regulated banking sector. But the burning question on the minds of

the leaders in the banking sector is: "Have we got the balance right between conservative lending practices and taking enough risk to drive growth in the Australian economy?" And, "Are the people who should be getting credit getting it or are they being pushed into the unregulated space where credit costs more?"

If a consequence of the Royal Commission is a sense of purpose across Government and regulators to simplify regulation in the interests of improved customer outcomes and to adopt a proportional regulation agenda, that will be a worthy objective and a venture worth embarking on as we seek to get the balance right.

Anna Bligh has served as the Chief Executive Officer of the Australian Banking Association since 2017. While working to strengthen bank culture and rebuild trust following the Hayne Royal Commission, Anna also drove the industry's response to COVID-19. She was the Premier of Queensland from 2007 — 2012, and was awarded the Companion of the Order of Australia in 2017 for services to the Parliament of Queensland, and as an advocate for education, the role of women in public life, and services to the not-for-profit sector.

Australia

INDUSTRY AND REGULATORY BACKGROUND

Continued Consequences of the Hayne Commission

In previous editions of this 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.⁴⁸³

In a speech in late May 2023, Kenneth Hayne criticized what he saw as ongoing conflicts of interest and a lack of ethical culture in the country’s financial sector and in corporate Australia more generally. He warned that boards and executives have more to learn from the key findings of his Commission.⁴⁸⁴

Scandals in several industries since the Hayne Commission have sparked concerns about conflicts of interest and continuing professional misconduct issues similar to those uncovered in the financial services sector during the Commission’s inquiry. “If there are persistent ways where breaches of the law are identified, it can say a lot about leadership, culture and governance within the relevant entities,” Hayne said.

In order to reduce instances of misconduct, Hayne called for simpler standards that prioritize obeying the law, fairness, and acting in customers’ best interests. By focusing on these fundamental principles, companies can align their

conduct with societal expectations and build consumer trust, he argued. And when firms violate these standards, regulators need to go further in punishing breaches of corporate law. A failure to do so quickly or strongly, Hayne warned, means that “so-called bad apples will multiply.”

A few days later, at the International Congress of Actuaries in Sydney, Hayne laid out four key matters organizations should consider to help them avoid the repeated scandals that have damaged trust in financial services:

- conduct and reward;
- asymmetries of power and information;
- conflicts between duty and interest; and
- how entities are held to regulatory account.⁴⁸⁵

The fundamental norms regarding these matters are “widely accepted, well established, easily understood,” Hayne argued. “Of course, all of them will find some reflection in the law,” he added, “but expressed in the form in which I have, they may provide a more useful framework for judgment than simply saying that an enterprise must obey the law.”

In a December 2023 *Banking Day* article, journalist John Kavanagh expressed concerns about the lack of progress made regarding the management of misconduct risks in Australia’s banking sector. “What has changed since Hayne is that the misconduct is less likely to be the result of venal management, and more the result of system errors that can’t be fixed easily,” Kavanagh wrote. “But intractable system failures are just as big a concern as profiteering because the impact on customers is the same.”⁴⁸⁶

Intractable system failures are just as big a concern as profiteering because the impact on customers is the same.

JOHN KAVANAGH

Kavanagh pointed to several examples from the past year. In one such case, the Australian Securities & Investments Commission (ASIC) published a review which found that many Indigenous consumers were

using high-fee accounts despite being eligible for lower-cost options. While banks were aware of “high numbers” of customers eligible for low-fee accounts, they did not have adequate processes for notifying and transferring them.

In another, the Banking Code Compliance Committee (BCCC) reported in June that six Australian banks had continued to charge the accounts of deceased customers for services despite being notified of their deaths. “Several years ago now, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry showed that banks had a lot of work to do,” said Prue Monument, CEO of the BCCC. “It is reasonable for the community to have expected more progress and seen improvements sooner.”

As reported by the *Australian Financial Review* in February 2024, John Lonsdale, Chair of the Australian Prudential Regulation Authority (APRA), said that improving risk culture and remuneration practices in Australia’s financial sector remains a “work in progress.”⁴⁸⁷ February marked five years since Kenneth Hayne issued the final report of the landmark Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry.

“There’s been some important changes since Hayne, and with some of it you can see the effects,” Lonsdale said. “But there’s a pool of it, I think, that is yet to play through: and we’re watching.” APRA intends to step up its supervision of governance and culture matters in 2024, to include heightened focus on remuneration and use of profit-based performance incentives.

In related comments to the *AFR*, Anna Bligh, CEO of the Australian Banking Association, said that the job of improving culture in the financial sector is never complete. “Sunlight is the best disinfectant during times of crisis and change,” Bligh said. “The excoriating experience of the royal commission is etched deeply in the minds of people in the banking sector.” **▶PAGE 329**

Audit Industry Issues

Over the past year, there have been several high-profile scandals in the audit sector globally. However, none have captured quite as much attention as that which has plagued PwC in Australia.

As discussed in our “Renal Failure” *Deeper Dive* published in March 2023, at the beginning of 2023 Australia’s Tax Practitioners Board (TPB) deregistered the former head of international tax for PwC Australia, Peter Collins, for dishonesty and sharing confidential government briefings with the firm’s partners and clients.⁴⁸⁸ **▶SEE “RENAL FAILURE” ON STARLING INSIGHTS**

“Internal communications within PwC indicated an awareness amongst the internal PwC recipients, including PwC taxation partners, that the confidential knowledge gained from the consultations with Treasury would be leveraged to market PwC to a new client base,” it said. Australian Federal Treasurer Jim Chalmers said that he was “absolutely furious” about the incident — calling it “a shocking [and] appalling breach of trust.”

In February, Michael O’Neill, CEO Secretary of the TPB, told Australia’s Parliament that between 20 and 30 PwC partners and staff had been involved in the scheme, representing a clear conflict of interest issue, though the extent to which each of those people were involved in the matter remained unclear. “The monetising of this matter is more than just Mr Peter John Collins, who suffered a personal response from the Tax Practitioner Board,” Labor Senator Deborah O’Neill said. “He didn’t monetise this by himself. He did it with other people in PwC.”⁴⁸⁹

In response, PwC promised to reform its internal controls and announced that some partners and employees would undergo additional training to reemphasize confidentiality obligations. Despite the scandal, the Tax Office continued to use PwC’s services at the time as the firm remained listed as an official supplier to the federal government.⁴⁹⁰

“I think there should be much stronger penalties in terms of PwC’s future contracts,” said Senator Barbara Pocock, who demanded a wholesale review of the federal government’s over-reliance on consultants. “It is a serious issue and a serious breach,” she added. “The question for me is about the prevailing cultural norms within PwC.”

Amid this scandal, and several others in recent years, the Australian Senate launched an inquiry into conflicts of interest in consulting in March 2023. The inquiry aimed to gain more information regarding the professional conduct of audit and consulting firms that engage in lucrative government contracts.

“The Australian public are spending billions and they deserve to know that their money is being well-spent and delivering value,” said Senator Pocock, who was a driving force behind the inquiry’s creation. “Recent examples demonstrate serious problems in terms of transparency, integrity and outcomes.”⁴⁹¹

In response to requests from the senate inquiry, PwC, Deloitte, and KPMG reported on instances of misconduct in their businesses. PwC revealed 119 separation arrangements in the past five years, mostly related to underperformance, but two involved incidents of sexual harassment and six were related to bullying. Deloitte reported 28 disciplinary cases for the misuse of confidential information and 38 substantiated claims of sexual harassment in the past two years. And KPMG stated that 22 people had been fired in the past two years for breaches of its code of conduct, including one for sexual harassment.⁴⁹²

The CEOs of those firms, as well as EY, were called before the inquiry in July. In his testimony, David Larocca, CEO of EY Oceania, criticized rival consulting firm PwC over its tax leaks scandal, stating that such “deeply disturbing and disappointing conduct” has rightly brought “intense scrutiny” to the entire sector.⁴⁹³ The leaks were “very serious and damaging to public trust,” Larocca said. “Therefore, our entire

industry must accept the critical importance of integrity, confidentiality, and ethics in our actions and behaviours,” he continued.

Larocca emphasized that EY operates differently from PwC, asserting that they do not breach confidentiality, frustrate regulators with blanket legal professional privilege claims, or condone such behavior. But EY has, of course, suffered its own cultural problems in recent years. In his testimony, Larocca discussed the suicide of an EY staffer, for instance, which prompted the firm to commission an external review of its culture led by former sex discrimination commissioner Elizabeth Broderick. ► **PAGE 153**

The Broderick review, which was published shortly after Larocca’s testimony and was based upon a survey of over 4000 employees, revealed serious workplace issues, including overwork, bullying, harassment, and a lack of safety and inclusion for women and minority groups. The report exposed rampant overwork, with almost half of the staff experiencing health issues stemming from long work hours: some 11% reported regularly working over 61 hours per week; and some 40% of staff had considered quitting because of the hours demanded.⁴⁹⁴

EY personnel also reported widespread bullying (experienced by 15% of staff over the past five years), sexual harassment (10%), and racism (8%). Some employees felt that reporting such behaviors was discouraged or futile, especially when perpetrated by those in leadership positions. “[P]articipants spoke of these behaviours occurring from the top down,” the report read, “where instances of bullying by Partners and more senior staff was accepted, particularly in circumstances where it is perceived as leading to higher rates of productivity within the team.”

The review team made 27 recommendations to improve the workplace, including more accurate project scoping and costing to reduce excessive

hours, increasing accountability for staff retention, and revising key performance metrics to emphasize diversity and inclusion.

Returning to PwC, in July, Macquarie, an Australia-based global asset manager and investment bank, announced that it would consider PwC's culture and reputation issues as it reviewed its audit relationship with the firm that began in 1993. Macquarie's Chairman, Glenn Stevens, assured shareholders that the review would be "a comprehensive review that will take into account the culture and [any] reputational matters."⁴⁹⁵ It is unclear what came of this review, as PwC was still listed as Macquarie's auditor in its annual report published in May 2024.⁴⁹⁶

After the tax leaks were disclosed, several other organizations, including the Reserve Bank, AustralianSuper, and the Australian Retirement Trust, reconsidered using PwC for new work. And Lendlease, a multinational construction and real estate company, removed the firm from an audit contract panel.

In August 2023, it was reported by the *Australian Financial Review* that the Australian government had drastically reduced its spending on external advisory. In the 2022-2023 financial year, top consulting firms — KPMG, PwC, EY, Deloitte, and Accenture — secured contracts worth approximately \$1.2 billion (all figures AUD unless otherwise indicated) with federal government departments, a notable decline from nearly \$1.7 billion the previous year.⁴⁹⁷ KPMG won the largest share of government work, with \$328 million in new contracts, followed by Deloitte's \$226 million. Notably, PwC's involvement in government work had plummeted to near zero.

The following month, PwC published an independent review which unveiled a deeply flawed corporate culture that tolerated bad behavior and prioritized the pursuit of profit "growth at all costs." The review, conducted by former telecommunications CEO Ziggy Switkowski, also found a lack of governance that allowed misconduct to persist unchecked for years,

ultimately leading to the firm's tax leaks scandal.⁴⁹⁸ "The report highlights that we've had failure of leadership, by individuals and by the firm," said Kevin Burrowes, who was appointed CEO of PwC Australia following the ouster of his predecessor.

Switkowski's report made 23 recommendations for reform, including adding independent members to the governance board, granting the board power to dismiss the CEO, and overhauling weak risk management systems. The report also repeatedly emphasized that the chief executive role had become too powerful and effectively unaccountable. "Culturally, the generally accepted view is that the CEO 'runs the show,'" Switkowski wrote. "During a long period of commercial success, this has translated to a reluctance of partners to challenge the CEO, even at senior leadership levels."

Additionally, the review revealed a troubling "good news" culture within the top partnership, where bad news was not communicated, leading to blind spots. It also called out a lack of transparency regarding sensitive complaints and legal matters, with limited information shared with the board of partners.

PwC Australia accepted all the report's recommendations and, notably, committed to publishing audited financial statements from 2025, a first among Big Four accounting firms. However, critics, including Labor Senator Deborah O'Neill and Greens Senator Barbara Pocock, believed PwC was aware of misconduct for too long without taking adequate action and called for further independent investigation of the firm.

In a separate scandal in November 2023, the Australian Taxation Office (ATO) filed an application in Federal Court to pursue penalties against a former EY partner over an alleged tax exploitation scheme. The ATO said it was taking the action under "promoter penalty" laws, which allow it to penalize individuals who promote tax exploitation. "Promoter

penalty laws are in place to deter and disrupt the promotion and implementation of aggressive tax avoidance and evasion schemes," the ATO said.⁴⁹⁹

"The promotion of tax exploitation schemes undermines the integrity of the tax and super system and challenges community trust and confidence. These schemes create an uneven playing field for everyone, including businesses and advisers," the Office added.

In a December 2023 interview with the *Australian Financial Review*, Senator Deborah O'Neill warned that the audit, accounting, and consulting sectors should not expect a quick reprieve from ongoing scrutiny heading into 2024. "The scale of misconduct in this industry, which is now part of the public record, requires extensive and ongoing attention in order to reform," she said.⁵⁰⁰

During a joint parliamentary inquiry, former competition watchdog Graeme Samuel recommended that auditors should be banned from providing consulting services to audit clients. He also suggested the resumption of "naming and shaming" firms with poor audit quality and bringing partnerships under federal corporate law for better executive oversight. The joint inquiry, which received 73 submissions and held four days of public hearings, was set to deliver its recommendations in the middle of this year.

In February 2024, PwC International faced substantial criticism for refusing to release a report regarding the tax leaks scandal at its Australia office which, it claims, absolves its international partners of involvement in the scheme. Prepared by law firm Linklaters, PwC used the report to argue that the incident was isolated to Australia. The report, however, found that six international partners should have raised questions about whether they had received confidential details from a colleague and yet failed to do so.⁵⁰¹

Australian authorities have requested access to the report. "If we don't see the report, it ain't going to be pretty," said Senator Richard Colbeck, who chairs a parliamentary inquiry into the scandal. "We are deadly serious about this." Nevertheless, PwC International has persisted in refusing to share it. Nor had it been provided to PwC Australia's leadership before CEO Kevin Burrowes appeared before Parliament earlier in February.

"I've formally requested the Linklaters report again from PwC International Limited and that request was refused on the basis that the information contained in that report is privileged and confidential to PwC International Limited," Burrowes told the inquiry. However, later in February, Burrowes defended the decision not to release the report, arguing that Australian authorities had all the evidence they needed to investigate any international partners involved.⁵⁰²

In March 2024, the Australian Senate inquiry into consulting firms published its interim report, denouncing PwC International's refusal to release a report into overseas aspects of its tax leaks scandal, and labeling it part of an ongoing cover-up

that "worsens the crime."⁵⁰³ The Senate's interim report demanded transparency from PwC, arguing that its Australian arm had failed to demonstrate genuine reform following the scandal. It also criticized both PwC International's use of legal privilege to withhold crucial information and PwC Australia's former leadership for seeking to evade responsibility.

The scale of misconduct in this industry, which is now part of the public record, requires extensive and ongoing attention.

DEBORAH O'NEILL

According to Senator Deborah O'Neill, the interim report highlighted "the immense failures of leadership, professionalism and ethics which enabled the tax leaks scandal to occur in the first place, and the gross failures of professional accountability which saw it go unacknowledged and unpunished for so long." Senator

Barbara Pocock condemned PwC Australia's initial response and accused it of attempting to mislead the public and hinder investigations.

"We have taken considerable steps to transform our firm and rebuild trust, making significant progress on our comprehensive transformation program and implementation of our Commitments to Change," PwC offered in response to these concerns. However, criticism has persisted regarding PwC International's perceived control over the Australian arm. "PwC Australia is nothing more than a puppet on a string that stretches all the way back to head office in London," said Senator Pocock. The Senate report concluded that the firm's refusal to provide appropriate transparency had undermined PwC's ability to enact reform and restore trust.

In April, the US Public Company Accounting Oversight Board (PCAOB) fined PwC Australia USD \$600 thousand for failing to disclose the investigation by Australia's TPB for over a year. The PCAOB found that the firm's "siloes nature" and lack of transparency in leadership had caused the delayed reporting.⁵⁰⁴

This fine posed additional risks to PwC's global operations, and its efforts to quarantine the scandal in its Australian arm. "Failure to disclose required information is not acceptable, and the PCAOB will hold firms accountable," said PCAOB Chair Erica Williams. The PCAOB's fine marked the first time an overseas regulator had taken action related to the matter. Under the order, PwC Australia would be required to undertake remedial measures to establish and revise policies and procedures for compliance and reporting requirements.

The firm, expressing regret for governance and cultural shortcomings under past leadership, acknowledged the late filing and cooperated with the PCAOB. "This disciplinary order stems from the same issue and we acknowledge this late filing and apologise for our initial failure to report this incident," a spokesman for the firm said. "The firm

has cooperated with the PCAOB during this process and has taken a number of steps to improve our policies and procedures related to the reporting requirements," they added.

These scandals, and others, have prompted many calls for reform of the audit sector and its systems for maintaining audit quality and good professional conduct.

In November, it was reported that the Australian government was set to introduce legislation to impose stringent fines of up to \$780 million on companies found undermining tax laws. The legislation would also remove confidentiality rules hindering information sharing between the TPB and the ATO. "This bill will crack down on tax practitioner misconduct and rebuild public confidence in the systems and structures that keep our tax system and capital markets strong," said Assistant Treasurer Stephen Jones.⁵⁰⁵

The overhaul extends tax promoter fines — which typically target individuals who promote tax evasion — to large multinational firms, increasing the maximum penalty from \$7.8 million to \$780 million. Additionally, ATO officials gain greater discretion to apply promoter penalty laws, and whistleblowers receive enhanced protection.

The TPB would also obtain new powers to disclose information about investigations publicly, with an extended two-year timeframe for complex inquiries. Additionally, the legislation enables officials to share protected information with professional disciplinary bodies if ethical standards are suspected to have been breached. "The PwC scandal exposed severe shortcomings in Australia's regulatory frameworks, and that undermines community confidence in our tax system," Jones said.

In December, the Australian Government announced that it would be providing an additional \$22.2 million, and another \$1.1 million per year for the next few

years, to several government agencies to lift oversight standards and increase powers following the PwC scandal. The bolstered agencies include Treasury, Finance, the attorney-general, and the ATO. “The government is focused on addressing shortcomings in governance and regulation related to these services that were highlighted by the misconduct in the PricewaterhouseCoopers matter,” the Government wrote in its Mid-Year Economic and Fiscal Outlook.⁵⁰⁶

The industry has also undertaken efforts to drive culture change. In February this year, the Chartered Accountants Australia & New Zealand (CA ANZ), a professional body with regulatory powers, announced that it would require members to pledge annually to behave with integrity and competence in an effort to restore trust to the sector.⁵⁰⁷ In a publication sent to its members, the organization outlined recommendations for rebuilding this trust in the accounting industry. These cover actions that CA ANZ, the Accounting Professional and Ethical Standards Board (APESB), and the government can take to raise ethical and behavioral standards.

The APESB creates and administers a Code of Ethics to which accountants in Australia and New Zealand must adhere. In its recommendations, CA ANZ urged the APESB to include in the code a requirement that members report wrongdoing by peers. For its own part, CA ANZ committed to expanding its mandatory ethical training to six hours every three years and creating new training for non-accounting employees at audit firms.

In May 2024, Australia’s Treasury proposed limiting the number of partners in Big Four accountancies and forcing the firms to incorporate their consulting businesses, as reported by the *Australian Financial Review*. The Treasury expressed doubts as to whether the accounting firms are capable of governing themselves and argued that the existing model of self-regulation through industry bodies was not fit for purpose.⁵⁰⁸

According to Assistant Treasurer Stephen Jones, the tax leaks scandal exposed severe shortcomings in the regulatory regime for consultants. The paper laid out 17 issues for feedback focused on six key areas of reform: governance; professional standards, regulations, and laws; transparency, public information, and reporting; enforcement and setting standards; protection of whistleblowers; and competition and resilience of the audit sector.

The Big Four firms, for their part, seem supportive of consolidating the fragmented framework by which they are currently regulated and supervised. However, they are likely to be less welcoming of any reforms focused on limiting their size and changing their partnership structure.

Financial Sector Conduct

In this section, we will discuss some of the scandals faced by the financial sector over the past year as a result of such culture shortcomings and highlight what some stakeholders are doing to drive change.

As with other jurisdictions discussed in this report, Australia’s financial sector has continued to face scrutiny for its management of culture and conduct risks over the past year. In 2023, the Australian Financial Complaints Authority received more than 100,000 customer complaints about financial services firms for the first time ever, increasing 23% from 2022. From these complaints, consumers were issued \$304 million in compensation and refunds, up 38%.

“We believe many financial firms could be doing a better job of handling complaints within their own internal complaints processes, so only the most complex cases reach AFCA — which is the role we are meant to play,” said AFCA Chief Executive and Chief Ombudsman David Locke.⁵⁰⁹

Financial sector culture has also had a deleterious effect on the mental health of the employees working within it. In September 2023, a survey by Allianz Australia found that 80% of workers' compensation claims were related to psychological costs.⁵¹⁰

Enforcement Actions

In September 2023, the Federal Court ordered National Australia Bank (NAB) to pay a \$2.1 million fine for "unconscionable conduct," as it continued to charge periodic payments even though the bank knew it was overcharging customers.

"An unconscionable conduct ruling, penalty and resulting remediation program demonstrates the consequences that come from not resolving an issue in a timely way," said ASIC Deputy Chair Sarah Court. "If systems have let customers down, we expect all financial institutions, especially our banks, to act quickly to reduce consumer harm."⁵¹¹

In September 2023, ASIC announced that it was suing Westpac for failing to respond to customers' hardship notices within the time required by law. ASIC alleged that, between 2015 and 2022, a problem with Westpac's online hardship notice process resulted in 229 customers not receiving a response to their notice within the required 21 days.⁵¹²

"ASIC has taken this action to highlight the importance of lenders responding to hardship notices within the required timeframe to reduce harm to their customers," said ASIC's Sarah Court. "Westpac's failures to respond to these notices compounded their customers' difficult financial circumstances."

In January 2024, in an entirely separate case, the Federal Court declared that Westpac had engaged in "unconscionable conduct" regarding a trade executed in October 2016. The misconduct occurred when the bank pre-hedged ahead of a \$12 billion interest rate swap transaction — the largest ever in

Australia — that it was undertaking with a consortium of superannuation funds AustralianSuper and IFM Investors.⁵¹³

"This is a significant outcome which assists to clarify expectations regarding pre-hedging, particularly around disclosure and consent where the pre-hedging can have a detrimental impact on the counterparty to the transaction," said Sarah Court, Deputy Chair of ASIC. "Appropriate conduct for pre-hedging is an issue of global significance. In this case, Westpac's behaviour was unconscionable and exposed its client to significant risk. Westpac's conduct was also in stark contrast with several other banks."

That same month, a Federal Court ordered Members Equity Bank Limited (ME Bank) to pay a fine of \$820 thousand after pleading guilty to criminal charges. The bank was accused of making false and misleading representations and failing to provide required written notices regarding home loans. Between May 25 and September 3, 2018, ME Bank sent 589 to home loan customers informing them of incorrect minimum payment amounts. And, between December 2016 and February 2018, ME Bank failed to send letters to inform them of a change in their interest rate and minimum payment. The prosecution followed an investigation and referral from ASIC.⁵¹⁴

"This misconduct arose from ME Bank failing to send accurate home loan information to its customers," said Tim Mullaly, ASIC Executive Director for Enforcement & Compliance. "Banks are expected to properly notify and update customers who are entitled under the law to receive accurate information about changes to their loans. Where banks fail to meet these requirements, they can face criminal convictions."

Insurance

In November 2023, APRA took customer-owned insurer RAC Insurance to task in a governance review that criticized the firm for "significant weaknesses" in board-level decision-making, outsourcing controls,

and conflict management. The regulator mandated that RAC set aside an additional \$20 million in reserve capital, limiting their available funds for operational purposes.⁵¹⁵

While the insurer has stated that it is committed to fulfilling its compliance and regulatory responsibilities, it has not disclosed the specifics of the issues raised. “Board independence and effectiveness are central elements of strong governance and were found to be lacking in our review,” APRA Executive Board Member Suzanne Smith said. “The increased capital requirements reflect the heightened prudential risks and should also act as an incentive for [the insurer] to quickly and effectively implement the planned remedial work,” she added.

Efforts for Reform

In a report published in October 2023, the Australian Institute of Company Directors (AICD) provided a guide for boards to prevent sexual harassment within the workplace. Rooted in the Australian Human Rights Commission’s Positive Duty Guidelines, the report underscores the imperative role of leadership in fostering an environment of respect, safety, and equality.⁵¹⁶

It is not enough to simply state that the company has a “zero-tolerance policy” toward sexual harassment, the AICD argued. “[S]exual harassment policies and practices have not led to significant improvements in incidence rates and culture, even when intentions are good and resources are allocated,” the report read. “The sexual harassment ‘generic policy, compulsory training, standard grievance procedure’ approach has sometimes led to a tick-a-box approach, delegated to a human resources unit.”

Instead, the report laid out seven key principles for directors as they seek to prevent sexual harassment in their organization:

- Leadership — recruit the right leaders and hold them accountable;
- Culture — foster an environment where employees feel safe to speak up;
- Knowledge — develop, implement, and communicate a meaningful sexual harassment policy;
- Risk Management — involve employees to develop controls to minimize sexual harassment risks;
- Support — prioritize support for employees experiencing or witnessing violations;
- Reporting and Response — set expectations that management report to the board regularly on these issues; and
- Monitoring, Evaluation, and Transparency — encourage management to develop appropriate metrics and collect related data across the organization.

In a November 2023 report, Fidelity International identified workplace misconduct as a financial risk with systemic implications. The report coined the term ‘culture-based financial risks’ to define how culture can pose risks for investors and impact shareholder value.⁵¹⁷

Therein, Fidelity proposed a framework to understand how harmful behaviors can create three levels of risk for investors: operational, societal gap, and systems-level. “[C]ompany-level incidences (operational) can lead to negative perceptions of a sector (societal gap), which in turn impact the sector’s social license to operate (systems-level),” the report read. “They can then lead to long-term and material impacts on economic productivity. The interconnected and additive nature of these risks can then form a vicious cycle for communities and economies.”

“The approach to managing culture-based financial risks needs to shift beyond human resource departments to the enterprise risk level, with greater visibility and accountability from chief executive

officers and boards,” said Daniela Jaramillo, co-author of the report and Head of Sustainable Investing in Australia for Fidelity International. ►PAGE 81



FROM OUR 2022 Compendium

Strengthening Supervisory Assessments of Risk Culture

by **Wayne Byres,**
past-Chair, Australian Prudential Regulation Authority

“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.”



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The report implored companies to improve their management of misconduct, and to enhance disclosures of such information so investors can utilize it in decision-making and corporate engagement. “Disclosures on issues related to corporate culture are often subjective and difficult to compare,” Jaramillo explained. “They also rely on companies having strong ‘speak up’ cultures for employee responses to be accurate. Therefore, the paper encourages third-party independent assessments of workplace culture, in addition to board and C-suite level oversight of culture, and potential linking of these issues to remuneration.”

Fidelity also recommended that stakeholders collaborate on developing best practices regarding workplace misconduct and culture, modeled on the Taskforce on Climate-related Financial Disclosures (TCFD).

In February 2024, Wayne Byres, recent past-Chair of APRA, joined the board of Macquarie Bank. Byres was brought into Macquarie for his deep international connections, as he previously served as Secretary General of the Basel Committee on Banking Supervision. ►PAGE 317 This was expected to help the bank to better ensure compliance with the many regulatory regimes in which it operates, and to ameliorate long-standing regulatory issues with APRA.⁵¹⁸

Macquarie has been under pressure from its regulators to improve its governance and culture over the past several years. For example, the bank is still working to resolve shortcomings in its compliance with capital requirements that led APRA to impose a \$500 million capital add-on in 2019. “For one of the country’s largest financial institutions to have committed breaches of this nature is disappointing and unacceptable,” APRA’s John Lonsdale said at the time.

Individual Accountability

In our past reports, we have discussed in some detail Australia’s Financial Accountability Regime (FAR), the impending successor to its 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.⁵¹⁹ For more on the history of the FAR, please reference the 2023 edition of our report.

In March 2023, the Australian government introduced the Financial Accountability Regime Bill 2023, the third iteration of legislation intended to establish the FAR. The new bill would require that financial firms withhold 40% of their directors' and top executives' bonuses for four years, then to be disbursed only if satisfactory conduct standards are met.

The FAR would not, however, include the provision allowing regulators to fine executives up to \$1.1 million, which was present in an earlier draft of the bill. This removal came following lobbying from banks, which argued that the fines could make it difficult to recruit senior executives, and further asserted that the rules might make banks excessively risk-averse.⁵²⁰

Critics, such as Treasury Spokesman Nick McKim of the Greens Party, accused the banking sector of donating its way out of million-dollar fines. "Labor is trying to create a financial accountability regime that does not hold bankers accountable," McKim said.⁵²¹ However, the Bill soon passed the House of Representatives, and moved on to the Senate, where it was delayed for several months.⁵²²

In July 2023, Australia's financial regulators — APRA and ASIC — issued a consultative draft of the FAR to enhance responsibility and accountability within the financial services industry.⁵²³ Jointly administered by both regulatory agencies, the FAR would replace the existing BEAR. The new Regime would apply to banks, insurance companies, superannuation trustees, and non-operating holding companies. It aims to strengthen risk and governance cultures in these institutions by imposing a framework of accountability on their directors and senior executives.

As with other individual accountability regimes globally, under the FAR, institutions will be required to formalize and document the distinct responsibilities allocated to specific senior officials, referred to as "accountable persons." The regulators sought feedback from the industry on the proposed rules,

including detail on the reporting of key functions of accountable persons and guidelines for transitioning away from BEAR.

According to law firm Clyde & Co, the FAR is "easy to understand in theory but difficult to implement." The FAR expands upon the previous BEAR and applies to insurers, banks, and superannuation funds. FAR requires regulated entities to identify directors and senior executives, outline their responsibilities in "accountability statements," and comply with broader obligations related to integrity, skill, and cooperation with regulatory bodies. "If they don't, they can be personally liable, as can the organisation," the law firm explained.⁵²⁴

To prepare for FAR compliance, Clyde & Co suggested that firms establish new "reasonable steps" for each executive, emphasizing the importance of good corporate governance and clear reporting structures. "[E]mployees need to know where responsibility lies and who to report to in any given scenario," the law firm wrote. FAR aims to attribute liability to specific individuals, regardless of direct responsibility for any failures. "Ignorance or 'decision by committee' is no defence under FAR," Clyde & Co warned. "It is specifically designed to attribute liability to one person, irrespective of whether they are directly responsible for the failure or not."

In September 2023, the Australian Senate passed the Financial Accountability Regime Bill 2023. The FAR then awaited Royal Assent, after which banks would have 6 months to transition their framework to the new regime. Insurance companies were to be given 18 months following Royal Assent to come into compliance, as they were not previously covered under the BEAR.⁵²⁵

The FAR gained royal assent shortly thereafter, with the implementation dates set as March 15, 2024 for banks and March 15, 2025 for insurers and superannuation funds.⁵²⁶

A key aspect of the final FAR is the requirement for executives to take “reasonable steps” to prevent risk management failures. In a blog post around the time of its passing, consultancy Rhizome explained how companies can begin establishing a framework that ensures such reasonable steps are taken, looking to other global accountability regimes as indications of what might be expected. Culture will be an essential driver of success or lack thereof, Rhizome asserted.⁵²⁷

“Culture will be a critical through line in FAR implementation — in many cases poor outcomes won’t come from single decisions — they will be the result of a series of decisions about what strategy to pursue, what is funded, what is deprioritised, what is not done,” Rhizome wrote. “How decisions are made and how well frameworks are implemented will be impacted by the culture that exists or is formed with respect to accountability and risk.”

APRA and ASIC issued a letter in February acknowledging that a slowdown in finalizing the rules governing the FAR may delay banks’ implementation.⁵²⁸ Despite being passed by Parliament in September 2023, the specifics of the regime are laid out in “ministerial rules,” which must be signed off on by the country’s Financial Services Minister, Stephen Jones.

A spokesperson for Jones said that the government and regulators were still “actioning” the input it received in the consultation on the ministerial rules in 2022. “The Financial Accountability Regime will improve the governance culture within the financial sector and the government is committed to its implementation,” they said. “The government is committed to genuine consultation so that regulation is proportionate.”⁵²⁹

The Financial Accountability Regime will improve the governance culture within the financial sector and the government is committed to its implementation.

Directors’ duties and the high standards that they demand set the tone for corporate Australia.

SARAH COURT

ASIC and APRA wrote that banks should use the guidance that was available at the time to submit applications to register accountable persons “as promptly as possible,” and no later than June 30 this year.⁵³⁰

In early March, the regulators unveiled final rules and guidance to facilitate the implementation of the FAR — just in time for bank implementation to begin on March 15.⁵³¹

The released package included:

- Rules outlining information for inclusion in the FAR register of accountable persons;
- Transitional rules detailing data requirements for authorized deposit-taking institutions (ADIs) transitioning from BEAR to FAR;
- Descriptions of ADI key functions to aid in function allocation; and
- Reporting form instructions to facilitate data submission to APRA and ASIC.

In an accompanying letter, the regulators addressed issues raised during consultation, such as data collection for the FAR register and the definition and application of key functions. This release supplemented the FAR information package issued in October 2023.

Separately from the FAR, ASIC has committed to holding directors accountable for predatory lending. “The conduct of directors has long been of interest to ASIC,” wrote Sarah Court, Deputy Chair of ASIC, in a February 2024 article. “Directors’ duties and the high standards that they demand set the tone for corporate Australia. When these obligations are not met there can be significant harm to consumers and investors. The most egregious governance failures can lead to corporate collapse.”⁵³²

Accountability for Regulators

Throughout this report, we discuss a growing trend: regulators are facing increased scrutiny from legislators, politicians, and the public for their culture and the outcomes it supports. Australia is one of the most prominent examples of such, and has been for several years.

Before we review the developments from the past year, it is perhaps helpful to provide some background.

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 a Financial Regulatory Assessment Authority (FRAA) in early 2020.⁵³³ In May 2021, the Financial Regulator Assessment Authority Bill 2021 was introduced to Parliament, and passed a little over a month later.⁵³⁴ In September of 2022, the FRAA released a report on its inaugural review of ASIC. The review found ASIC was “generally effective and capable,” but noted that there was opportunity for improvement at the regulatory agency.⁵³⁵

Specifically, the report made four recommendations for ASIC to become more effective:

- reform culture to facilitate the adoption of data and technology solutions;
- improve stakeholder engagement;
- develop metrics for measuring its own effectiveness; and
- enhance its breadth of abilities to better be able to regulate the financial industry of the future.

That is, the regulator is being held to account for many of the very issues it has emphasized in its oversight of the firms under its remit.

In November 2022, the FRAA launched its first review of APRA, which would be a “targeted assessment of the effectiveness and capability of APRA’s supervision and resolution functions, focusing on superannuation.”⁵³⁶

That same month, the Australian Senate voted to launch a two-year inquiry into ASIC and its handling of complaints from the public and whistleblowers. The inquiry is examining ASIC’s necessary capabilities in investigating misconduct, and the effective utilization of its \$800 million budget. The review was partly prompted by John Adams, an economist who analyzed the regulator’s annual reports over ten years, revealing a sharp increase in the number of whistleblower complaints upon which ASIC took no action.⁵³⁷

A Senate committee would also investigate ASIC’s process for dealing with disputes between businesses and customers, the effectiveness of its actions in deterring misconduct, and how it allocates its budget to enforcement and investigations. The inquiry is expected to conclude its investigations in mid-2024 “It is time for a much closer look at ASIC’s law enforcement record and capability,” said Senator Andrew Bragg, who had pushed for the inquiry. “ASIC must get better at its one job of law enforcement or the integrity of our financial system is at risk.”

In July 2023, the FRAA published its inaugural review of APRA, focusing on the agency’s supervision and resolution work in the superannuation sector.⁵³⁸ The FRAA found that, while APRA’s supervisory function was effective, its resolution function was less well-developed — findings which aligned with APRA’s own self-assessment. The FRAA outlined five recommendations for APRA to improve its effectiveness and capability in these functions:

- increase efforts to identify and understand emerging risks;
- prioritize recruiting and training to improve staff capability;

- continue investment in data and technology;
- be more transparent around supervisory expectations and activities; and
- improve awareness of recovery and resolution planning requirements.

“APRA welcomes the FRAA’s review of APRA’s superannuation capabilities,” said APRA Chair John Lonsdale. “The recommendations provide helpful guidance and reinforcement for a more effective APRA into the future. APRA will continue to build on its strong foundation of safeguarding the financial wellbeing of the Australian community by further strengthening prudential frameworks and improving capability to drive better industry practices in superannuation for the benefit of members.”⁵³⁹

While the FRAA was intended to undertake such reviews every two years when it was established, the 2023-24 budget announced the Government’s intention to reduce the frequency to every five years.⁵⁴⁰

In November, Treasurer Jim Chalmers announced that the government would set a statement of expectations for ASIC to focus on oversight, competitiveness in financial services, and climate change. In response, ASIC CEO Joe Longo welcomed the new expectations, but cautioned the Government to ensure that the country’s regulators were “properly resourced” to fulfill them.⁵⁴¹

In February 2024, Senator Andrew Bragg criticized the current regulatory framework for the financial sector in Australia. In particular, he pointed to failures in the country’s twin peaks model of two independent regulators focused on market conduct and supervision, represented by the ASIC, and financial system stability, through APRA.⁵⁴²

In an address to the Financial Services Council (FSC), Bragg argued that both ASIC and APRA were failing in their mandates. He argued that ASIC fails to address

corporate misconduct effectively and that APRA is insufficient in its enforcement of the best financial interests duty (BFID) in superannuation funds.



**FROM OUR
2022 Compendium**

The Crypto Challenge

by **Andrew Bragg,
Australian Senator**

“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.”



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Bragg, who has led an inquiry into ASIC since October 2022, highlighted instances where ASIC allegedly failed to act on reports of corporate misconduct. Failures of oversight at companies like Nuix and Dixon Advisory ultimately lead to significant losses for investors, Bragg recalled. With respect to APRA’s supervision of super fund practices, Bragg expressed concerns that the regulator favored older members over younger ones.

In response to these issues, Bragg proposed a Financial System Inquiry (FSI) to address structural problems in the regulatory framework. He declared that the twin peaks model has outlived its usefulness and called for a recalibration of the regulatory system. Bragg outlined several areas for examination during the FSI to include payments, taxation, housing

affordability, superannuation's influence on the economy, deregulation opportunities, and a review of the overall regulatory architecture.

Bragg, who contributed to Starling's 2022 *Compendium*, emphasized the need for bold reforms to ensure Australia's competitiveness in the financial services sector and maintain its status as a regional hub. He argued that the proposed FSI, coming nearly a decade after the last one, is necessary to address the deficiencies in the current regulatory enforcement and to capitalize on opportunities for improvement.

In his April 2024 comments to a Senate inquiry, Doug Niven, former Chief Accountant at the Australian Securities and Investments Commission (ASIC) for over 25 years, criticized the regulator's oversight of major audit firms.⁵⁴³

Niven questioned ASIC's decision to eliminate its annual audit quality report card on major auditors like Deloitte, PwC, KPMG, and EY. "Rightly or wrongly, reduced audit file reviews could be perceived by some to be a response to inappropriate criticism by some auditors of findings and the transparency on those findings," Niven said.

ASIC's shift to a "data-led, risk-based approach" resulted in fewer audit reviews, with the regulator conducting only 15 in 2022-23 compared to 45 in the previous two years. Niven found this reduction "concerning," especially after international counterparts increased their reviews. "A problem does not cease to exist just because evidence of the extent of the problem is less apparent," he argued.

Niven argued that establishing a new, independent regulator would ensure that funds were allocated more appropriately and would attract more professionals to auditing and oversight roles. Niven also expressed worries that ASIC's new audit oversight model risks eroding confidence in audits.

"Consistent with my concern with the reduced level of ASIC's proactive audit file reviews, it is of concern that ASIC has reduced numbers of suitably qualified and experienced financial reporting and audit staff," he said.

In its own response to the Senate inquiry, ASIC argued that its previous approach to audit quality oversight was ineffective and "at risk" of enabling regulatory capture. "It was unlikely to identify actionable misconduct and was at risk of being influenced by discussions with audit firms themselves," a spokesperson said. "And because we are reviewing audits where changes have been made or where we have concerns about material misstatement, [it] is more likely than the old approach to result in ASIC action," they added.⁵⁴⁴

In May, the *Australian Financial Review* reported that staff at ASIC had displayed critically low levels of satisfaction and motivation in a 2023 culture survey. The report, which was made public through a Senate inquiry, showed that ASIC achieved "average" or "desirable" on just two of 12 outcomes. The *AFR* had previously sought the results of the survey after a whistleblower report described them as "dire." However, ASIC pushed back, arguing that releasing the results would have a "significant adverse effect on the management of ASIC staff members."⁵⁴⁵

The survey found that the levels of stress and job insecurity among ASIC employees were unacceptably high. At the same time, positive measures, including intention to stay and role clarity, ranked well below what would be considered "desirable." Notably, staff rated organizational-level quality at just five out of 100. "The results are particularly damning given ASIC... [has] pushed for powers to regulate company culture," the *AFR* wrote. However, the efforts of well-intentioned leaders do not inevitably lead to culture change.

International Collaboration

In October 2023, ASIC signed onto the International Association of Insurance Supervisors's (IAIS) Multilateral Memorandum of Understanding, an agreement with more than 80 members accounting for more than 75% of the global insurance sector. Under the agreement, ASIC will increase its collaboration with the other insurance supervisors, supporting its efforts to protect consumers in Australia.⁵⁴⁶

"As we have experienced over the past years of social and economic challenges, there are enormous benefits to the global insurance sector when supervisors are able to cooperate quickly and effectively across jurisdictions," said Vicky Saporta, Executive Committee Chair at the IAIS.

AUSTRALIA PRUDENTIAL REGULATION AUTHORITY

Operational Resilience

In July 2023, APRA announced the final Prudential Standard CPS 230 Operational Risk Management, which is slated to become effective on July 1, 2025. CPS 230 was developed following an industry consultation that commenced in July 2022 with the primary goal of improving the management of operational risks in the financial sector.⁵⁴⁷

Although the Australian financial services market has remained relatively isolated from the recent financial crises, it has faced a number of high-profile cyber incidents. CPS 230 aims to enhance the resilience of regulated financial entities, enabling them to withstand disruptions, whether they are related to cyber threats or other operational risks. To enhance operational risk management, CPS 230 extends previous regulations to cover 4th party providers (vendors' vendors).

Under these guidelines, APRA-regulated entities must set out to manage operational risks and maintain appropriate standards for conduct and compliance. The responsibility now lies with board members of organizations to effectively mitigate potential operational risk. Each regulated entity must define its risk appetite and tolerance levels and formulate plans to ensure they operate within these predefined limits. Notably, these requirements also apply to reputational risks arising from damage to public trust and confidence in a firm.

In a speech the next month, Therese McCarthy Hockey, an APRA Executive Board Member, explained that the regulator would look to punish deficiencies in operational resilience and governance in the transition to CPS 230.⁵⁴⁸

In this transition, APRA expects boards to focus on three key actions:

- putting the right governance arrangements in place;
- identifying critical operations and material service providers; and
- beginning to develop a new organizational mindset.

Throughout the process, governance will be a critical aspect of APRA's engagement with entities. The regulator will look to ensure the governance of the change management process is robust, as this will be essential to implementing the new standard successfully.

"APRA has delivered a longer than usual implementation period for our new standard on operational resilience given the scale of the change — now it's up to banks, insurers and super trustees to deliver on the new requirements," she concluded. "Should they fail to do so, don't be surprised to see APRA apply a little heat of its own."



FROM OUR 2021 Compendium

APRA's Evolving Approach To Transforming Risk Culture in Australia

by **Mark Roe,**
past-Head of Risk Culture,
Australian Prudential
Regulation Authority

"As supervising risk culture requires different skill-sets and approaches compared to traditional areas of prudential regulatory focus, APRA has established a specialist Risk Culture team which has enabled APRA to enhance its focus on risk culture through a broad range of activities. These activities include: the development of a risk culture framework, the roll-out of a risk culture benchmarking survey, the completion of a number of deep dive reviews of entities, and the up-skilling of supervisors in how to assess an entity's risk culture."



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In a speech delivered in November 2023, APRA Chair John Lonsdale discussed the regulator's emphasis on operational resilience and how it is looking to data to supervise the industry more effectively. Lonsdale outlined APRA's work to enhance operational resilience standards by promoting better governance, risk culture, remuneration, and accountability in regulated entities.

This, he said, "includes our work to increase the focus of boards and senior managers on non-financial measures such as community outcomes, and sharpened accountability to prevent poor outcomes."⁵⁴⁹ Lonsdale also discussed the importance of addressing system-wide risks and implementing cross-industry stress testing to safeguard financial

stability and highlighted the critical role of data in effective prudential supervision, emphasizing the need for accuracy at the individual, industry, and economy-wide levels.

APRA has been actively enhancing its data collection and analysis capabilities to support risk-based supervision, gain deeper insights, and increase transparency. Notably, APRA established a new Technology and Data division in 2023, signaling a commitment to improving data-related processes and capabilities within the organization.

"In a more complex, interconnected financial system where products, companies and services transcend traditional boundaries, clear, constructive and forward-looking engagement between regulators and industry is required," Lonsdale concluded. "So too are strong ties between the regulatory community... By working together appropriately, APRA, ASIC, the Reserve Bank of Australia, AUSTRAC and other agencies can better protect the community, balance the regulatory burden for entities and ensure there is still room for competition and innovation to flourish."

New Zealand

INDUSTRY AND REGULATORY BACKGROUND

In 2018, joint reviews conducted by the Financial Markets Authority (FMA) and Reserve Bank of New Zealand identified a significant gap in financial services regulation. They found that banks and insurers failed to establish sufficient systems to monitor the risks of poor conduct or customer outcomes.⁵⁵⁰

In late June 2022, New Zealand's Parliament passed the Financial Markets (Conduct of Institutions) Amendment Bill. The legislation, also referred to as the "CoFI" bill, introduced a new regime that will require financial institutions to comply with a "fair

conduct principle.” A firm’s license to do business will depend on how the FMA assesses its conduct toward consumers in the context of these CoFI-established requirements.

“This will enhance the culture of core financial services in New Zealand, with a focus on putting conduct and the fair treatment of customers at the heart of every business,” FMA Chief Executive Officer Samantha Barrass said. “Firms will be held to account by the FMA for the way they sell products and look after their customers.”

That December, the FMA issued guidance materials and information sheets on the CoFI regime.⁵⁵¹ Among those was a licensing guide aimed at clarifying the license application process. The documents also contained guidance on establishing, implementing, and maintaining Fair Conduct Programs (FCPs) designed to ensure compliance with the regime’s fair conduct principle.

However, the fate of the CoFI regime came into question in the summer of 2023, when the leader of New Zealand’s Conservative National Party, Christopher Luxon, pledged to repeal the bill if elected in the 2023 general election.⁵⁵²

In a blog post published in August 2023, Mark Jephson, a Partner at financial services consultancy Mosaic, discussed the consequences of a potential repeal of the CoFI bill. “[T]his begs the question, do principles ever really die even after repealing principle-based regulatory constructs such as CoFI?” he asked.

CoFI’s purpose is to help ensure that the societal principle of treating people fairly is not overlooked in the pursuit of shareholder profits. Preparations for CoFI have aided financial service providers, Jephson argued, fostering positive changes like enhanced care for vulnerable customers and a focus on product suitability and lifecycle service.

Even if CoFI were to be repealed, this work need not go to waste. “Financial institutions will need to remember that any wind back or repeal of CoFI does not mean the perfectly reasonable principle of treating your customers fairly does not apply,” Jephson asserted.

Regardless of CoFI’s outcome, financial institutions must continue proactive measures instead of adopting a “wait and see” stance. Society will hold firms that fail to adhere to these principles to account, and regulators will issue sanctions and fines where transgressions occur. “Surely those financial institutions genuinely guided by the principle of treating your customers fairly will be the winners,” Jephson concluded.

When the National Party won power in October,⁵⁵³ it seemed as though the CoFI would be short lived.⁵⁵⁴ However, following the election, the Government backtracked on its commitment to repeal the legislation. In January 2024, Commerce and Consumer Affairs Minister Andrew Bayly announced that the government would retain the CoFI, but would “streamline” it.

“CoFI serves an important purpose to support good financial outcomes for consumers, but it needs streamlining so financial institutions have certainty and flexibility to get on with the business of delivering for their customers,” Bayly said.⁵⁵⁵

In particular, the Government would ensure that firm management and boards would have the freedom to develop their FCP as they see fit. This means that it is up to the financial institution to identify key areas of risk and tailor them appropriately,” Bayly said. “However, it is my expectation that the FMA will provide clear guidance as to the minimum requirements to ensure the FCPs are sufficiently developed.”

FINANCIAL MARKETS AUTHORITY

In a speech delivered in August 2023, Clare Bolingford, the FMA's Executive Director of Regulatory Delivery, explained why the regulator is increasingly looking to adopt outcomes-focused regulation, the CoFI regime being one such.⁵⁵⁶



FROM OUR 2021 Compendium

Addressing the Blind Spots

by **Clare Bolingford**
Director of Banking &
Insurance, Financial
Markets Authority

"The focus of bank leaders should be on identifying and acting on behaviours that produce poor customer outcomes over time — and the implementation of this approach is ultimately an exercise in change management. Unfortunately we have seen firms spending a lot of time and money developing voluminous compliance manuals and processes that fail to deliver much value for their business or their customers."



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"A focus on outcomes is just a way of saying we're focused on results — on ends, not means," Bolingford said. "And while it might seem like heresy coming from a career regulator, rules, and compliance with rules, are not an end in themselves."

Of course, rules are one means by which regulators can achieve good results for markets, consumers, and societies, she explained, but they are not the only way. "Regulation in financial services is done best when it is resilient to economic cycles and external shocks," Bolingford said. "Therefore, it's important for the

design and delivery of legislation to start from high level principles, only introducing detailed prescription where it is necessary for consistency in practices." This allows for a regime that is more flexible and adaptable to "continually evolving risks, innovation and opportunities" that emerge over time.

In a response to Starling Insights' 2024 *Compendium* survey, the FMA explained that it is also planning to redesign its supervisory framework in the coming year. "This is a strategic initiative at the FMA that will strengthen supervisory culture and effectiveness," the FMA wrote. "Part of this is embedding our approach to outcomes focussed regulation, and how we assess regulatory risks to foresee future harm and plan forward looking supervision activity."

Singapore

INDUSTRY AND REGULATORY BACKGROUND

Financial Sector Conduct Concerns

Much like other jurisdictions discussed in this report, Singapore has witnessed conduct problems in the financial industry over the past years. Below, we discuss how the courts and regulators have sought to hold the firms and individuals involved in these situations to account.

Wirecard's Continued Fallout

In June 2023, two former finance executives at Wirecard, James Wardhana and Chai Ai Lim, were sentenced to prison in Singapore, marking the first criminal convictions related to the collapse of the fraudulent German payments company. Wardhana was sentenced to 21 months in prison, while Lim was sentenced to 10 months.⁵⁵⁷

The two convicted executives admitted to having been active participants in the embezzlement conspiracy, working with their superior, Edo Kurniawan, currently a fugitive subject to an Interpol “red notice.” Kurniawan led Wirecard’s accounting in the Asia-Pacific region and disappeared ten days after the *Financial Times* published reports on suspected accounting irregularities.

The upcoming trial of James Henry O’Sullivan, a UK citizen allegedly central to the Wirecard fraud, will also take place in Singapore. O’Sullivan faces charges of abetting the falsification of documents that purposefully misled Wirecard’s auditors. If convicted, he faces up to ten years in prison. Jan Marsalek, former chief operating officer of Wirecard, remains at large, with reports suggesting he may be in Moscow. The trials and investigations surrounding Wirecard’s collapse are expected to continue for several years.

Also in June 2023, the Monetary Authority of Singapore (MAS) imposed fines totaling SGD \$3.8 million⁵⁵⁸ on Citibank, DBS Bank, OCBC, and Swiss Life for breaches of MAS’ anti-money laundering (AML) and countering the financing of terrorism (CFT) requirements. The penalties were imposed following MAS’ examinations of the AML/CFT controls of banks that had dealings with persons linked to in the Wirecard fraud scandal. “Although the breaches were serious, MAS did not find wilful misconduct by any staff of these FIs [financial institutions],” MAS wrote in a related statement.⁵⁵⁹

Operational Resilience Lapses

In April 2023, MAS directed DBS Bank to engage an independent third-party to conduct a comprehensive review of its digital banking service. This followed a series of service interruptions that DBS Bank had suffered. DBS Bank had developed a roadmap to address the shortcomings and improve system resilience. MAS reviewed DBS Bank’s remediation plan and was satisfied with its scope and planned measures.

On 1 November 2023, MAS directed DBS Bank to suspend all non-essential changes to the bank’s IT systems for a six-month period. DBS Bank was also not allowed to acquire new business ventures during this time or reduce the size of its branch and ATM networks in Singapore. The move was intended for the bank to keep a sharp focus on executing its remediation plan.



FROM OUR 2021 Compendium

Culture and Conduct Supervision — a Journey

by **Ho Hern Shin**
Deputy Managing Director,
Monetary Authority of
Singapore

“A sound organisational culture strengthens alignment of attitudes and behaviours within an organisation to positive corporate values. It ensures consistency and quality in how financial institutions execute their policies and processes, and how they make decisions on a daily basis at all levels within the organisation.”



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The direction was taken due to continued disruptions of DBS Bank’s services including one in October 2023 which had a wide impact. “DBS must put in place immediate measures to ensure service reliability while it continues to invest in the longer-term efforts to bolster its operational resilience,” Ho Hern Shin, Deputy Managing Director of Financial Supervision at MAS, said. “We have imposed this six-month pause on the bank to give it the space to take the actions needed to maintain customer trust.”⁵⁶⁰

In line with MAS' expectations, DBS Bank held senior management accountable for the lapses, and the board also enhanced its governance approach to oversee implementation of the roadmap.

It was expected to take up to 24 months from 1 November 2023 for DBS Bank to fully implement the planned changes. In the event of service disruptions, MAS expects the bank to recover from the disruptions quickly, and communicate with its customers in a clear and timely manner.

Other Conduct Matters

In September 2023, MAS published its enforcement report for the period of January 2022 to June 2023. Therein, MAS disclosed that it had imposed SGD \$12.96 million in civil penalties related to market abuse cases, a higher amount compared to any previous 18-month period. It had also levied SGD \$7.1 million in penalties for AML/CFT breaches.

"MAS has taken strong enforcement actions and deepened relationships with our partners to uphold the integrity and reputation of Singapore as a trusted financial centre," said Peggy Pao, Executive Director of Enforcement at MAS. "Even as the novelty and complexity of our cases increase, we will continue to administer an effective and fair enforcement regime in order to deter misconduct, protect consumers and maintain investor confidence."⁵⁶¹

Also in September, several of Singapore's banks — including DBS Bank, OCBC, Citigroup, and Deutsche — became embroiled⁵⁶² in the investigation into a SGD \$3 billion money laundering scheme.⁵⁶³

In August 2023, 10 individuals from China, Cyprus, Turkey, and Vanuatu were apprehended in coordinated raids involving 400 law enforcement officers as a part of the investigation into a money laundering ring. They were suspected of having laundered proceeds from overseas criminal activities, including scams, online gambling, and document

forgery. In that raid, and in other activities since, authorities seized assets like luxury homes, cars, designer handbags, cash, and gold bars, collectively valued at over SGD \$3 billion.⁵⁶⁴

Prosecutors said they were seeking documents related to the banking activities of the alleged persons, from at least 10 financial institutions.

This investigation raised concerns about Singapore's reputation as a clean and transparent financial hub, with some critics accusing the government of being too open to foreign money and overseas entities. "If we provide a warm welcome to very dirty businesses . . . then we can't expect to escape without a stain on our 'squeaky clean' reputation," said Kenneth Jeyaretnam, Secretary-General of the opposition Reform party.⁵⁶⁵

According to Josephine Teo, Singapore's Minister for Communications and Information & Second Minister for Home Affairs, the investigation into the money-laundering ring dates back to 2021. Intelligence and information from suspicious transaction reports (STRs) filed by FIs in Singapore had alerted the police to suspicious activities attempted through the financial system. Red flag indicators picked up by FIs that prompted them to file STRs include suspicious fund flows, dubious documentation of source of wealth or funds, and inconsistencies or evasiveness in information provided to the FIs.⁵⁶⁶

MAS' examinations of the relevant banks are ongoing. The regulator made clear that it would take "firm action" against financial institutions found to have breached anti-money laundering requirements and inadequate controls against money laundering/terrorism financing risks.⁵⁶⁷

In a separate development, in late December 2023, MAS imposed a SGD \$3.9 million civil penalty on Credit Suisse for its failure to prevent or detect misconduct by relationship managers (RMs) in its Singapore branch. The RMs had provided inaccurate

or incomplete post-trade disclosures to clients, resulting in clients being charged spreads which were above bilaterally agreed rates.⁵⁶⁸

The enforcement action followed MAS' review of pricing and disclosure practices in the private banking industry. MAS found that Credit Suisse had failed to put in place adequate controls, such as post-trade monitoring, to prevent or detect the RMs' misconduct.

MAS emphasized the importance of financial institutions implementing robust governance frameworks and processes. "We will continue to engage the banks to improve their controls in this area and will not hesitate to take firm enforcement action against financial institutions found to have breached our laws," said Ho Hern Shin, Deputy Managing Director of Financial Supervision at MAS.

MAS's strict supervisory and regulatory regime has driven up the compliance costs for firms in Singapore. A study published in October found that financial institutions in Singapore had spent \$7.8 billion to fight crime and meet regulatory expectations over the prior year. This represented a substantial increase from previous years.⁵⁶⁹

Individual Accountability

In September 2023, MAS issued a lifetime prohibition order against Ng Chong Hwa, also known as Roger Ng, a former Managing Director for Goldman Sachs in Singapore. The prohibition order followed his conviction in the United States for conspiring to launder embezzled funds from 1Malaysia Development Bhd (1MDB), and for violating the US' Foreign Corrupt Practices Act.⁵⁷⁰

"Mr Ng's severe misconduct has given MAS reason to believe that it would be contrary to public interest to allow him to carry on business as a representative," MAS wrote.

Between 2009 and 2014, Ng was found to have conspired with others, including ex-Goldman banker Tim Leissner, to launder billions of dollars misappropriated from 1MDB, including funds raised through three bond offering transactions underwritten by Goldman Sachs. Under the prohibition order, Ng is permanently barred from performing any regulated activities under the Securities and Futures Act (SFA) and providing any financial advisory services under the Financial Advisers Act (FAA). Additionally, he cannot hold management roles, act as a director, or become a substantial shareholder in capital market or financial advisory firms.

MONETARY AUTHORITY OF SINGAPORE

In September 2023, MAS announced that Managing Director Ravi Menon would retire in January 2024.

Menon had been MAS' Managing Director since 2011, during which time MAS emerged as a global leader in the regulatory and supervisory communities, driving new practices and promoting innovation in the oversight of the culture and conduct risks on which this report focuses. We at Starling deeply appreciate his example of leadership in this regard.⁵⁷¹

Chia Der Jiun, previously Singapore's Permanent Secretary of Development at the Ministry of Manpower and a former Deputy Managing Director at MAS, was appointed to succeed Menon. Chia had previously spent 18 years at MAS, where he played a leadership role across MAS' major functions, including monetary policy implementation, reserve management, banking supervision, prudential policy, and macroeconomic surveillance.

Governance Reforms

In November 2023, Menon announced that MAS would consider the addition of a new provision to the Singapore Code of Corporate Governance to promote good corporate culture.

Speaking at the Securities Investors Association Singapore (SIAS) Corporate Governance Week conference, Menon referenced the Hong Kong Stock Exchange's (HKEX) decision to implement such a requirement following a review of corporate governance in 2021.⁵⁷²

The HKEX now requires boards to clearly establish that their purpose, values, and strategy align with organizational culture, and that all directors promote the desired culture through the example of their own behavior. "MAS will work with the Singapore Exchange and the Corporate Governance Advisory Committee⁵⁷³ to assess if there is merit in introducing a similar provision," Menon said.

Supervision and Investigations

The Singapore Parliament passed the Financial Institutions (Miscellaneous Amendments) Bill 2024 (FIMA Bill) in March 2024. "This will further strengthen Singapore's position as a safe and trusted international financial centre," said Alvin Tan, Minister of State for Culture, Community and Youth, and Trade and Industry, who also serves as a Board Member of MAS. "As our financial industry grows in size and complexity, MAS must continually review and enhance its regulatory powers to ensure that it can effectively supervise financial institutions, as well as investigate and punish serious misconduct in our financial sector."⁵⁷⁴

The FIMA Bill proposed to harmonise and enhance MAS' investigative powers and to enable MAS to regulate FIs in the capital markets sector more effectively.

The amendments to MAS' investigative powers across six Acts⁵⁷⁵ would strengthen MAS' evidence-gathering powers and facilitate greater inter-agency coordination by enhancing its powers to (i) compel individuals to attend interviews and record written statements, (ii) enter premises without a warrant and without prior notice where there are reasonable

grounds for suspecting that the premises are or have been occupied by a person under investigation, (iii) obtain a court warrant to seize evidence where there has been non-compliance with a production order or when evidence may be destroyed or tampered with, and (iv) transfer evidence between MAS and other agencies.

The FIMA Bill would also enhance MAS' supervisory powers in the capital markets. Amendments are to be made in three Acts⁵⁷⁶ which include:

- Issuing directives⁵⁷⁷ to holders of capital markets services licences over their conduct of unregulated businesses, addressing potential risks from dealing in products that are not regulated by MAS, such as digital payment token derivatives that are traded on overseas exchanges; and
- Requiring regulatory approval for the appointment of key persons, for locally incorporated recognised market operators and recognised clearing houses, and approved trustees.

Innovation

In August 2023, MAS announced the renewal of its Financial Sector Technology and Innovation Scheme (FSTI 3.0) with a commitment of up to SGD \$150 million over a period of three years. FSTI 3.0 aims to accelerate and strengthen innovation within the Singapore's financial sector by supporting projects involving the use of cutting-edge technologies or with a regional nexus.⁵⁷⁸

"Since 2015, the Financial Sector Development Fund (FSDF) has awarded \$340 million as part of the FSTI program to drive the adoption of technology and innovation in the financial sector," said Ravi Menon. "With FSTI 3.0, we look forward to continued collaboration with the industry to advance purposeful financial innovation."

The program introduced three new tracks: an enhanced Centre of Excellence track where the scope of grant funding will be expanded to include corporate venture capital entities, an Innovation Acceleration track to conduct open calls for the use of innovative technologies in industry use cases, and an ESG FinTech track to spur adoption of ESG FinTech solutions.

The FSTI 3.0 would also continue to support advanced capability development and adoption in key areas such as Artificial Intelligence and Data Analytics (AIDA) and Regulatory Technologies (RegTech). The initiative is a part of MAS' efforts to foster a thriving financial tech ecosystem.



FROM OUR 2022 Compendium Counting What Counts

by **Marcus Lim**
Assistant Managing Director,
Monetary Authority of
Singapore

"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 [artificial intelligence and data analytics] front perhaps provides us with some digital breadcrumbs on our journey towards a deeper understanding of this important field."



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In a written response to a parliamentary question raised in October 2023, MAS Chairman Lawrence Wong explained how the regulator utilizes artificial intelligence and machine learning in its supervision of the financial industry. MAS has been a pioneer in the trialing and adoption of supervisory technologies (SupTech) that enable it to make sense of risk signals within the "voluminous" data it collects. "This has allowed us to automate certain tasks that used to require manual processing, as well as better identify outliers or suspicious networks for closer scrutiny," Wong wrote.⁵⁷⁹

Wong identified several such use cases. For example, MAS uses machine learning to identify financial advisory representatives that present a greater risk of bad behavior. "FIs with a greater number of representatives presenting higher risks of engaging in mis-selling will be prioritised for deeper supervisory engagement," Wong explained. MAS intends to explore other possible use cases for AI/ML and other advanced technologies to "responsibly and securely" enhance financial supervision.

India

RESERVE BANK OF INDIA

In a June 2023 speech, Shaktikanta Das, Governor of the Reserve Bank of India (CBI), emphasized governance and culture as concerns central to the central bank's regulatory and supervisory activities. "A robust governance structure is the first and the most important requirement for ensuring stability of a bank as well as sustainable financial performance," Das argued.⁵⁸⁰

In pursuit of good governance, boards must ensure that they are providing clear and consistent direction on banks' values, policies, and strategic objectives. "Setting the correct tone at the top is a primary step in building a conducive corporate and risk culture

as well as ethical behaviour among the rank and file,” Das asserted. “It is the responsibility of the Board to ensure that the processes and systems in the bank facilitate effective decision-making and good governance, which should also percolate down within the Bank.”

And these are not “abstract concepts,” Das emphasized. Rather, they are essential to building and maintaining trust in banks and the banking system itself. “The importance of public trust in the banking system, as exemplified in the recent bank failures in the United States, also needs to be appreciated,” Das said. “In this kind of milieu, it is upon the Banks and their Boards to assiduously build a sound corporate culture and value system within the organisation.”

In a speech in June 2023, Mahesh Kumar Jain, then a Deputy Governor of the RBI, called for supervisors to adopt a risk-based, forward-looking approach to their work, achieved through the use of new analytical tools, such as artificial intelligence and machine learning.⁵⁸¹

The financial sector is more technologically advanced than ever, and the rate of innovation is only increasing. As such, both banks and bank supervisors must build the capabilities necessary to manage the risks associated with these technologies, while at the same time developing greater ability to take advantage of the promise that new technologies offer. In recent years, the RBI has undertaken various efforts to improve its own supervisory capabilities, and to create a more agile supervisory framework that emphasizes identifying and addressing the root causes of vulnerabilities.

In this direction, the RBI has employed various new analytical tools, including key risk indicators and stress testing. It is also working to apply artificial intelligence and machine learning to its supervisory data, in order to gain deeper insights into the operations of supervised entities. “These initiatives

reflect the Reserve Bank’s commitment towards harnessing the power of technology and data-driven approaches to strengthen its supervision,” Jain said.

Jain laid out nine areas on which supervisors should focus in order to become more effective going forward. These include:

- Governance, lapses in which are invariably found among the root causes of supervisory concerns;
- Culture, which influences whether and how compliance priorities permeate throughout an organization; and
- Data analytics, which enable supervisors to identify risks, make data-driven decisions, and take timely actions to safeguard financial stability.

“By staying abreast of technological advancements, monitoring the evolving risk landscape, keeping pace with regulatory developments, building necessary capacities and skills and adopting [the] latest analytical tools, supervisors can more effectively fulfil their role in maintaining financial stability, protecting consumers, and fostering a resilient banking sector,” Jain concluded. “Learning from past experiences and collaborating across jurisdictions can help better navigate the challenges ahead.”

In August 2023, the RBI awarded McKinsey and Accenture a nearly \$11 million contract to develop supervisory technology (SupTech) capabilities utilizing artificial intelligence and machine learning (AI/ML). The consultants will be responsible for analyzing the data that the RBI already collects, as well as any supplementary data sources that may be available, with a view to uncovering a means of generating improved supervisory inputs.⁵⁸²

Given the RBI’s emphasis on governance and culture, it is perhaps reasonable to assume that some of these new SupTech capabilities will focus on assessing these non-financial risk matters.

China & Hong Kong SAR

INDUSTRY AND REGULATORY BACKGROUND

Audit Oversight

In recent years, the audit sector has faced much the same scrutiny regarding culture and conduct challenges as that which we have chronicled in the financial industry over the past six editions of this report. This scrutiny was further elevated throughout 2023, and looks set to continue for the foreseeable future. Last spring, we published a *Deeper Dive* — “Renal Failure” — discussing these topics in more detail. ▶SEE “RENAL FAILURE” ON STARLING INSIGHTS

In July 2023, Hong Kong’s Accounting and Financial Reporting Council (AFRC) accused small and medium auditing firms of an “unacceptable attitude” that “compromises audit quality” and threatens the city’s status as a global financial center.⁵⁸³

The AFRC’s harsh assessment of the industry came even as the city offered itself as a neutral ground in the years-long auditing dispute between the United States and China. “There is huge room for improvement for these accounting firms,” Janey Lai, Head of Inspection at the AFRC, said.

In response to the criticism, Edmund Wong, a lawmaker for the sector who also runs a small accounting firm in Hong Kong, said smaller players are hampered by difficulties in recruiting the best talent. “The medium and small accounting firms also want to be auditors of big deals but they may not find it easy to get the talent needed for the more complex jobs,” Wong said, asking the government to train more talent to make work more efficient.

China’s Ministry of Finance (MOF) has also agreed to expedite the transfer of documents required for audit investigations to Hong Kong’s accounting regulator.

The MOF and the AFRC have been working on cross-border cooperation in investigating alleged audit failures, including cases involving Hong Kong-based accounting firms handling the accounts of mainland-based companies. The MOF’s commitment to timely document transfer is expected to facilitate smoother cooperation between the regulators.

The increased scrutiny on auditors is evidenced by the number of complaints handled and investigations undertaken by the AFRC. In January 2024, the AFRC received 169 complaints regarding audit irregularities and conducted 207 investigations. These numbers are several multiples higher than they were in 2019, when the regulator counted 56 complaints and 46 investigations.⁵⁸⁴

This followed reforms in 2019 that transformed the regulator from only handling investigations to having a full regulatory mandate over listed companies’ auditors. The AFRC was also given a larger budget, and has grown its headcount from 25 to 145.

The Collapse of Evergrande

As many of our readers will likely remember, Chinese property development giant Evergrande hit the papers globally in late 2021 amid concerns about its ability to make payments on its more than \$300 billion in debts. At the time, there was much hand-wringing regarding what such a default would mean for global property markets and economies more generally.⁵⁸⁵

Evergrande did eventually default on its debts in December 2021, leaving many open questions regarding what would come next. Investors were unsure as to whether the company would restructure, be sold to another firm, or be bailed out by the Chinese government.⁵⁸⁶ They did not receive an answer to this question until January of this year, when Hong Kong bankruptcy Judge Linda Chan ordered the property developer to go into

liquidation. In her judgment, Chan cited what she saw as Evergrande's inability to provide a concrete restructuring plan over the 1.5 years of proceedings.⁵⁸⁷

This story certainly has far-reaching implications, many of which are outside the scope of this report. However, as with many of the corporate collapses we have discussed over the past several years, much of the conversation surrounding Evergrande has focused on why its auditors had not flagged its financial weaknesses sooner.

In 2021, Hong Kong's audit regulator, then called the Financial Reporting Council (FRC), announced that it had initiated an investigation into PwC's audit work for Evergrande. It argued at the time that PwC had signed off on Evergrande's financial statements with no reference to "going concern material uncertainties."⁵⁸⁸ The FRC expressed similar concerns in late 2022, though it is unclear what action was taken, if any.⁵⁸⁹

In January 2023, PwC resigned as auditor of Evergrande over disagreements relating to the audit of the property developer's 2021 accounts. In its resignation letter, PwC said that it had not received information on certain material matters, including cash-flow projections and the value of properties under development and held for sale.⁵⁹⁰

In February 2024, and the *Australian Financial Review* reported that the liquidators of Evergrande were preparing to sue PwC for alleged negligence in its audit work for the firm. PwC served as Evergrande's auditor from the firm's listing in 2009 until 2023. In that time, it signed off on Evergrande's books even as the developer became heavily leveraged to fuel its growth. According to people with knowledge of the situation, liquidator Alvarez & Marsal was "taking steps to protect [their ability to bring] legal claims against auditors."⁵⁹¹

In March, the China Securities Regulatory Commission (CSRC) accused Evergrande of inflating its revenues by \$78 billion between 2019 and 2020, which would make it the biggest case of fraud ever in China. The CSRC fined Hengda Real Estate, Evergrande's main Chinese unit, \$580 million for the overstatement. It also fined Xu Jiayin, Founder and Chairman of the Evergrande Group \$6.5 million and barred him from the securities markets for life.⁵⁹²

This only escalated the scrutiny on PwC and its audit work for Evergrande. A few days later, *Bloomberg* reported that Chinese authorities were investigating PwC's role in the \$78 billion fraud. "There are serious questions about PwC's role in the Evergrande fraud, specifically what it knew about the improper revenue recognition," Nigel Stevenson, an analyst at accounting research firm GMT Research Ltd. in Hong Kong, told *Bloomberg*.⁵⁹³

In April, a letter circulated on Chinese social media which claimed to be written by several of the firm's former partners. The letter alleged that a partner had raised concerns about Evergrande and suggested that it be dropped as a client, but that a senior executive had intervened.⁵⁹⁴ It also accused PwC of failing to establish a system of audit quality control and ignoring the professional and audit quality standards with which it was required to comply. PwC disputed the letter, claiming that it contained "inaccurate statements and false allegations concerning PwC and certain of our partners."⁵⁹⁵

However, the letter was enough to spur Hong Kong's AFRC to open a fresh probe into PwC and its audit work for Evergrande a few days later. "Given the gravity of these allegations and the necessity to safeguard the interests of the investing public, the broader public interest in the auditing of listed entities, and to maintain public confidence in the integrity of the accounting profession, the AFRC is obliged to initiate an investigation," the regulator wrote in its statement. "The AFRC will not hesitate to

take stringent enforcement actions against any firms and individuals if they are found to have committed any misconduct or violated the Accounting and Financial Reporting Council Ordinance.”⁵⁹⁶

It is unclear at the time of this writing how these investigations will conclude. However, it was reported by the *Financial Times* in May that PwC partners fear they may face one of the largest fines ever levied upon a Big Four auditor. “The current partners are braced for impact,” a former PwC partner told the *FT*.⁵⁹⁷

Banking Conduct

Returning to the financial sector, China and Hong Kong have faced similar culture, governance, and risk management challenges in their financial sector as many of the other jurisdictions discussed in this report. This has come out through both the traditional financial sector and through the non-traditional, “shadow bank” sector, and we will discuss examples of each here.

Traditional Banking

In May, the *Financial Times* reported that a Société Générale trader based out of Hong Kong was fired in 2023 for taking unauthorized risky bets. The trader, Kavish Kataria, worked on a Société Générale’s derivatives trading desk called Delta One. The bank confirmed in late April that two employees had left in 2023 after a “one-off trading incident.” According to people familiar with the matter, Kataria had traded within his authorized limits but had dealt in Indian Indices that were outside of his mandate. The intraday trades did not lead to any losses, but had gone undetected and could have been very costly in a market downturn.⁵⁹⁸

However, in a LinkedIn post, Kataria argued that he had done nothing improper. He maintained that he had not hidden the trades, which were booked automatically in the bank’s trading system. “If the risk management team and their risk system would

have identified the trades on day one and would have informed me that the trades are not in your mandate I wouldn’t have traded that strategy,” he asserted.

“Instead of taking the responsibility of the lapse in their risk system and not identifying the trades at the right time they fired me and terminated my contract,” Kataria wrote. He claimed that his trading activities had netted the bank \$50 million for the bank, but his bonuses and salary had been withheld.

Shadow Banking

The Brookings Institution defines a “shadow bank” as a firm that “perform similar functions and assume similar risks to banks,” but exists outside of the formal banking sector. As such, they lack the same safety nets, insurance, and regulatory scrutiny that reduces excessive risk-taking among traditional banks. While these institutions do make financial services more affordable and accessible, the lack of oversight creates substantial risks for both consumers and financial stability.⁵⁹⁹

In January 2024, Chinese shadow bank Zhongzhi filed for bankruptcy after having declared a shortfall of up to \$36.4 billion two months earlier. Zhongzhi’s statement reportedly said that it was “obviously” unable to repay its debts. The firm’s assets under management had shrunk to \$28 billion from a peak of \$140 billion, while it still owed \$64.4 billion.⁶⁰⁰

The decline was largely due to Zhongzhi’s ties to the real estate market, which has struggled for many of the reasons discussed in our retelling of Evergrande’s downfall. “The persistent decline in the real estate market, coupled with stringent policies and increased financial anti-corruption measures, has hindered timely asset collection,” Zhao Jian, Head of the Atlantis Financial Research Institute in Beijing, told *Bloomberg*. “Redeeming these assets has become exceedingly challenging.”

The challenges facing China's shadow banks are not limited to poor risk management. Also in January, Italian police had uncovered a \$1.9 billion tax fraud carried out by 85 individuals. The proceeds were laundered through a network of shadow banks, which are not bound by the same anti-money laundering obligations as traditional banks.⁶⁰¹

Regulatory Reforms

Recognizing the risks posed by these shadow banks, and those posed by poor conduct in the traditional financial sector, leaders in China have undertaken a wholesale transformation of the regulatory and supervisory framework.

In March 2023, China announced a sweeping set of regulatory reforms to reorganize the system by which the country's financial sector is regulated and supervised. One such reform included creating the Central Financial Commission (CFC), a watchdog run by the Chinese Communist Party (CCP). The CFC would be responsible for top-level design, development, and supervision of the financial system.⁶⁰²

At that same time, China announced its intent to establish a new supervisory and oversight body, called the National Financial Regulatory Administration (NFRA). The new regulatory body would oversee all financial sectors save the securities industry, taking over some of the responsibilities of the Peoples Bank of China (PBOC).⁶⁰³

In May 2023, China officially opened the NFRA, under the leadership of Li Yunze, former Vice-Governor of the Sichuan province. At the opening ceremony, Li said that the regulatory agency would strive to close "gaps" and "blindspots" to prevent the manifestation of systemic risks.⁶⁰⁴

In October, the *Financial Times* reported that the CCP was close to establishing the CFC, as nearly 100 officials had been recruited to staff the new super-

regulator at the time. The commission, staffed with party members from various financial watchdogs, aims to address regulatory gaps, particularly in areas like shadow banking and peer-to-peer lending. "Party oversight of China's financial system . . . will become far more centralised and controlling, in line with the ways in which the party itself and economic governance have changed already," George Magnus, an associate at Oxford University's China Centre, told the *FT*.⁶⁰⁵

The CFC held its first meeting in November, headed by Premier Li Qiang. In that meeting, the CFC made clear that stronger supervision of "risks" was a key priority as China continues its efforts to become a "major financial power."⁶⁰⁶

HONG KONG MONETARY AUTHORITY

In September 2023, the Hong Kong Monetary Authority published a report sharing real-life use cases of Regulatory Technology (RegTech) to make anti-money laundering and counter-financing of terrorism (AML/CFT) efforts more efficient. Four broad areas of Regtech implementation and real-life use cases were featured:

- Real-time Fraud Monitoring;
- Machine Learning for Transaction Monitoring Alerts Handling;
- Natural Language Processing for Media Monitoring; and
- Analytics with a "Single View of the Customer."⁶⁰⁷

"I am pleased to see that most banks' AML functions are already well past the early stage of Regtech adoption, and some have reached an advanced stage," said Arthur Yuen, Deputy Chief Executive of the HKMA. "I am confident that these capabilities, when implemented more widely, will help banks monitor and respond to fraud and financial crime risks, and thus contributing further to an effective response across Hong Kong's AML eco-system."



Hong Kong
Monetary
Authority

FROM OUR
2020 Compendium

Culture, Regtech
& Suptech from
a Supervisor’s
Perspective

by The Hong Kong
Monetary Authority

“The HKMA’s reform effort seeks to develop and promote sound banking culture that supports prudent risk management and contributes towards incentivising proper staff behaviour, that will lead to positive customer outcomes and high ethical standards in the banking industry.”



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Japan

INDUSTRY AND REGULATORY
BACKGROUND

Digitalization

In past reports, we have discussed Japan’s efforts to undertake a wholesale digital transformation, amid concerns that the country was still overly-reliant on analog, manual, and in-person processes.⁶⁰⁸ However, in a March 2024 keynote speech, Kazuo Ueda, Governor of the Bank of Japan (BOJ), warned that the current pace of innovation and digitalization poses risks to financial stability.⁶⁰⁹

“Crypto assets, tokenisation, artificial intelligence (AI), and other new technologies may bring opportunities, but they could also pose risks to the financial system,” Ueda said. “A critical challenge

for financial authorities lies in harnessing the advantages of the digitalization of finance while effectively managing risks to ensure the stability of the financial system.”

Diversity & Inclusion

In July 2023, Japan’s Financial Services Agency (FSA) expressed concerns about “gender-washing” practices, following a survey of 100 regional banks it published the previous month. The survey revealed that among regional banks, on average, only 13.7% of managers were women, compared to 20.8% at the country’s three largest banks. However, many of the captured roles were, in reality, quite junior and did not oversee many employees. With these titles removed, only 8.1 percent of managerial roles were held by women.⁶¹⁰



FROM OUR
2021 Compendium

An Interview with
Kathy Matsui, Past-Vice
Chair and Chief Japan
Strategist at
Goldman Sachs

“Two decades on from the launch of our 1999 report, Womenomics: Buy the Female Economy, we have seen female labor participation in Japan surge by more than 70%, to exceed US and European levels. But while Japan has made substantial progress in boosting the quantity of working women, with a record-high female labor participation rate, it still has a long way to go when it comes to quality of opportunity, since there is still a dearth of female leaders in the country.”



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“Regional banks are typically viewed as old, traditional Japanese firms with a seniority-based and male-dominated system,” said Tatsufumi Shibata, Deputy Director-General at the FSA’s Policy and Markets Bureau, calling for a “transformation” of corporate culture.

The broad definition of management roles under Japanese regulations, allowing companies to categorize female employees as managers based on equivalent responsibilities rather than official titles, has resulted in inflated figures for female representation in senior positions. Notably, companies are not required to provide any detail on what the equivalent responsibilities are. Regional banks have reported varying percentages of female managers, ranging from 1.5% to 51.9%, highlighting the disparity and the need for clearer definitions.

The scrutiny on regional banks’ disclosures arose a year after the Japanese government made it mandatory for listed companies to report diversity indicators, including gender pay gaps and the percentage of female managers. Prime Minister Fumio Kishida has set a target for women to occupy 30% of executive positions at top-listed companies by 2030. However, since Kishida came into power, Japan has fallen in the World Economic Forum’s gender equality ranking.



In Focus

The Importance of Culture in an Organization: Are We Learning Yet?

By: BRYAN STIREWALT



Bryan Stirewalt

I write this having just returned from the 23rd International Conference of Banking Supervisors, marking the 50th Anniversary of the Basel Committee on Banking Supervision (BCBS). I am proud to have served for nearly 10-years as the Basel Consultative Group Co-Chair, representing non-member countries.

The men and women around the BCBS table are truly dedicated to their mission, and beyond reproach in terms of integrity, professionalism, and expertise. I can say the same in my interactions with the Financial Stability Board (FSB), the International Association of Insurance Supervisors (IAIS), and the International Organization of Securities Commissioners (IOSCO). The people who make up these bodies are mission-driven public servants who often go largely unrecognized in the important work they do.

Although the BCBS was set up to have a relatively limited life,¹ it is safe to say that the role of the Basel Committee — and indeed all of the standard setters mentioned above — has never been more

important. The future of finance brings many non-traditional risks to the table, requiring shifts in thinking, deeper collaboration, and significant efforts in capacity-building for all financial sector supervisors around the globe.

Supervisors must now consider risks of climate change, digital finance, tokenization, artificial intelligence, cyber resilience, sanctions regimes, and the increasing role that outsourcing critical functions plays on financial institutions. These risks are not simple outgrowths of traditional finance but represent fundamental changes in the way financial products and services are designed and delivered.

Supervisors are now competing for resources not only within the financial industry, but also amidst the growing technology wave — and technology risks — facing all companies. Supervisors must therefore discover new avenues by which to obtain, retain, and maintain their most critical resource — people. In this connection, we have been learning — and re-learning — the importance of organizational culture.

Once more, with feeling

This latter point is not new. Consider this, from a 1988 report² by the Office of the Comptroller of the Currency (OCC): “Management-driven weaknesses played a significant role in the decline of 90 percent of the failed and problem banks the OCC evaluated.” This report further states that “directors’ or management’s overly aggressive behavior resulted in imprudent lending practices and excessive loan growth that forced the banks to rely on volatile liabilities and to maintain inadequate liquid assets.”

Sound familiar? While management was identified by the OCC as the primary cause of that era’s bank failures, the challenge was — and continues to be — when and how to address this management issue.

Often management is downgraded to “poor” by bank examiners only after the symptoms of bad management have manifested in weak financial results. My experience is that the same management teams were many times rated as perfectly adequate when financial results were better. That is, poor management was evidenced by poor results and not before. Assessments of management should serve as a leading indicator of expected results, not a trailing indicator of obvious problems.

More than 20 years later, a publication³ from the International Monetary Fund (IMF) taught us that lessons from the global financial crisis, and findings from country assessment of compliance standards, clearly suggested the following elements as qualities of a good supervisor: intrusive, skeptical, proactive, comprehensive, adaptive, and conclusive. Also sound familiar?

Returning to current debates, 13-years after the IMF report above, a recent FINMA report⁴ on the collapse of Credit Suisse re-established the fact that no amount of capital or liquidity saves a bank — even a G-SIB — from weak management and poor corporate culture. Both the FINMA report just mentioned, and the Federal Reserve Vice Chair for Supervision’s review⁵ of the supervisory lapses at Silicon Valley Bank, emphasize the role that variable remuneration and culture played in the collapse of those institutions.

It is far too easy for many to conclude that additional capital and liquidity are the answer to culture issues. But increased capital should not permit for a tradeoff that allows bad culture to prosper.

Assessments of management should serve as a leading indicator of expected results, not a trailing indicator of obvious problems.

Core principles

These reports referenced above, and many other such reports from regulators around the globe, highlight the importance of culture in the financial industry. Yet few financial sector supervisors have gone so far as to try and implement measures that address the importance of culture.

Core Principle #1 in the recently released “Basel Core Principles”⁶ asserts: “The primary objective of banking supervision is to promote the safety and soundness of banks and the banking system.”

But in addition to being pressured on budgets, supervisors are constantly hearing about new

broader responsibilities: create an environment for growth and innovation, reduce regulatory burden, encourage competition, force customers to deal with climate change, etc.

Core Principle #1 goes further to state that, “If the banking supervisor is assigned broader responsibilities, these are subordinate to the primary objective [safety and soundness] and do not conflict with it.” This deserves some reflection at a time when supervisors must also contemplate how best to cultivate and maintain a proper culture that withstands changes in leadership, staff, and political priorities.

The Basel Core Principles touch on the issues of organizational structures and supervisory cultures only indirectly, with mention of supervisor independence, legal protections for supervisors performing their role in good faith, adequate resources for remuneration and training, etc. This is not a criticism of the Core Principles — developing a global standard for supervisory culture is nearly impossible. But it does point to the fact that the international regulatory community has yet to establish precisely *how* we are to create and embed

supervisory cultures that are appropriately intrusive, skeptical, proactive, comprehensive, adaptive, and conclusive. Doing so is a major challenge in today's political environment.

The changing nature of financial services confront supervisors with broader risks profiles that often fall well outside the traditional regulatory perimeter, as well as with long-term challenges, like climate risk, which increasingly place supervisors amidst the tidal-tensions of broader political agendas.

In the wake of successive bank failures in 2023, for instance, I would dare to say that the shelf-life of the recent outcry for supervisors to be more intrusive with their examinations and more forceful with their remedial actions — including removal of board members and management — might soon reach its sell-by date, displaced again by a political priority emphasizing economic growth and reduced regulatory burden.

Basel Core Principle #11 makes specific mention that supervisors must act at an early stage to address unsafe and unsound practices or activities that could pose risks to banks or to the banking system, and insists that they enjoy a range of supervisory tools to bring about timely corrective actions. Yet here we must be mindful that enforcement powers — including those that deal with management of a regulated institutions — are both gained and lost with decisions that fall on either side of a constantly shifting line that marks out perceptions of “reasonableness” and “burden.”

In 2018, Andrew Bailey, then Chief Executive of the UK's Financial Conduct Authority, noted that: “As supervisors, our objective is to prevent misconduct, not just clear up the messes when they happen. No supervisor can guarantee good conduct at all times,”

We do expect to act to pre-empt and anticipate poor conduct, and society has a right to expect this.

ANDREW BAILEY

he added, “much though we wish it, but we do expect to act to pre-empt and anticipate poor conduct, and society has a right to expect this.”⁷

This is an issue for international standard setters to take up. The role of civil servants is often to stand directly on the line between growth and financial stability, occasionally pouring a bit of water on fires grown out of control.

Means and Mandates

How should supervisors work to create and maintain a proper culture?

Virtually every publication on culture asserts that the “tone from the top” is critical in any organization.

Messaging starts with the board of directors and senior leadership. However, more important than what is being “said” at the top is what is being “heard” and experienced in the middle.

Front-line supervisors are the ones who translate the tone from the top and communicate supervisory culture outward to the regulated community. And this is precisely where the message gets obfuscated.

Which is more important, economic growth or financial stability? Is requiring compliance with rules equally as important as fostering innovation? Are conduct risks just as important as prudential risks? Do I feel safe in speaking out when I see something that is not congruent with the tone from the top?

The answers to questions like these shape the true culture of an organization, and the answers may vary from department to department. Fortunately, supervisors can learn from the same messages that they are communicating to the industry.⁸ Practicing what you preach is a good path to follow.

Culture is best promoted through an environment of open, two-way communication that allows for and even encourages challenge. Highlighting and celebrating successes — and the people involved — are just as important as learning from mistakes. I have found that town halls and frequent one-on-one meetings that take place outside of normal reporting lines are effective in fostering this communication process.

It is important that leadership of the supervisory agency promote and continuously assess culture of the supervisory organization itself. That assessment is achieved by listening to the middle of the organization (the front line of supervision) as well as checking in with the regulated community to learn what they are hearing from the supervisor. Well-sent messages may nevertheless be poorly received. And poorly-sent messages may be uncomfortably common. The supervisor is unwise to make assumptions here.

Confidential, 360-reviews are often the most effective method of eliciting feedback from across an organization. Learnings might not always be pleasant or even welcome, but they must be heard. If the experienced culture of the organization is not consistent with the tone from the top, action is needed. That necessary action may not involve seeking to alter culture, but it may well involve altering message delivery so it is properly heard, understood, and acted upon.

Staff must be made to feel empowered with proper-capacity building to deal with current and emerging risks and provided with tools to supervise effectively. This includes how best to evaluate management and business models, and how to take prompt and effective remedial measures when issues are uncovered. Staff must also feel supported in decisions they take — a particularly important point when confronting recalcitrant boards and management teams. And, of course, staff must also

understand they will be held accountable when their actions, internally or externally, are contrary to expected behaviors.

In my experience, the best way to start understanding culture issues across an industry is through a thematic or horizontal review. Studying culture one institution at a time leads to inconsistencies and time varying conclusions, which do not necessarily lead to effective and efficient identification of good or bad practices. The Australian Prudential Regulatory Authority (APRA) has provided a good example of this practice for the banking industry.⁹

Setting Standards

I believe this is also a lesson to be learned by financial sector standard setters. Bringing supervisors together in the name of collaboration to discuss the strengths and weaknesses of their own cultures, and to explore how best to replicate good practices around the world, would be a welcome endeavor. The Basel Committee is a shining example of effective regulatory collaboration. This deserves to be matched by an emphasis on collaboration with regard to supervision and effective supervisory cultures.

In closing, I will quote Pablo Hernandez de Cos, Governor of the Central Bank of Spain and, until June this year, Chairman of the Basel Committee.¹⁰ Speaking about the future of banking supervisors at the recent International Conference of Banking Supervisors meeting, he offered this:

They will have to be able to navigate the waters collaboratively and cast a wide net. They will need to have not only specialist or technical knowledge about banking regulation, but also a wide range of emerging trends, and to be able to connect the dots and anticipate cross-cutting issues. They will need to think creatively

in a world of greater uncertainty without losing sight of the fundamentals of supervision and its core tenets.

I could not agree more. The balancing act has never been more difficult, nor more important. Culture, on both sides of the fence, is critically important, and we must work together to get the job done right.

Bryan Stirewalt is a former Chief Executive of the Dubai Financial Services Authority (DFSA), having worked at the agency for 14 years. Prior to his role at the DFSA, following a 10-year career with the US Office of the Comptroller of the Currency, Bryan worked with international development organizations in improving financial sector supervision and regulation practices in Poland, Ukraine, Kazakhstan, and Cyprus. Bryan now leads the MENA Financial Services Regulatory at EY.

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- 10 [Building on 50 years of global cooperation \(bis.org\)](#)



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INDUSTRY AND REGULATORY BACKGROUND

Anti-Money Laundering Efforts

The United Arab Emirates (UAE) has long struggled to rehabilitate its reputation as a safe place for criminals and other bad actors to store illicit funds. This has become especially important in recent years, as global scrutiny on anti-money laundering practices has increased in the wake of Russia’s invasion of Ukraine and the unprecedented sanctions regime that was put in place in response.⁶¹¹

In March 2022, the Financial Action Task Force (FATF) announced that it had added the UAE to its “grey list” of jurisdictions with weak anti-money laundering and countering the financing of terrorism (AML/CFT) regimes — subjecting the jurisdiction to increased monitoring. “Robust actions and ongoing measures taken by the UAE government and private sector are in place to secure the stability and integrity of the country’s financial system,” the UAE government offered in response.⁶¹²

And, in March 2023, officials from the US, EU and UK pushed the UAE to step up its efforts to enforce sanctions against Russia. “Part of the message for the private sector — in any of these countries — is that they’re playing roulette,” said James O’Brien, head of the US office of sanctions co-ordination. “Anyone who’s trading in these goods, they now are subject to sanctions because some of the goods they ship are showing up on the battlefield.”⁶¹³

In October 2023, the FATF said that the UAE had made “substantial” improvements to its AML regimes and was on its way to being removed from the grey list.⁶¹⁴ According to Bryan Stirewalt, past-CEO of the Dubai Financial Services Authority (DFSA), being placed on the grey list was “extremely challenging but it forced out a lot of reforms.” **▶ PAGE 365** Some

of these reforms included bolstering its Executive Office of Anti-Money Laundering and Counter Terror Financing, extraditing individuals accused of committing financial crime, introducing an online system to report suspicious activity, and enhancing its national registry of companies.⁶¹⁵

These efforts paid off in February 2024, when the UAE was removed from the FATF’s grey list. “The FATF welcomes the UAE’s significant progress in improving its AML/CFT regime,” FATF wrote in the announcement. “The UAE strengthened the effectiveness of its AML/CFT regime to meet the commitments in its action plan regarding the strategic deficiencies that the FATF identified in February 2022.”⁶¹⁶

DUBAI FINANCIAL SERVICES AUTHORITY

The DFSA supervises various financial institutions within the Dubai International Financial Centre (DIFC), the special economic zone for financial services in Dubai, including entities from the banking, insurance, and wealth management sectors. In May 2024, the DFSA published its 2023 annual report, providing an update on its regulatory and supervisory activities over the previous year.⁶¹⁷

Therein, the DFSA explained that, alongside traditional financial risks, non-financial risks are a key aspect of its prudential supervisory activities. “We also vigilantly monitored key non-financial risks like financial crime and cybersecurity, alongside governance and internal control adequacy,” the DFSA wrote. “Looking ahead, we expect to continue monitoring these areas, along with other emerging risks, such as climate-related financial risks.”

In our 2023 *Compendium*, Ian Johnston, Chief Executive of the DFSA, analyzed whether or not conduct risk can be called the “new” prudential risk. “Until events of the past couple of months, I would have said ‘no,’” Johnston wrote in the report, which

was released in June 2023. “But perhaps the Credit Suisse matter shows that a string of misconduct episodes might sufficiently affect the reputation of an institution that confidence could be eroded. And we know where that can lead.”



**FROM OUR
2023 Compendium**

Is Conduct Risk the New Prudential Risk?

by **Ian Johnston**
Chief Executive, DFSA

“In recent years, the quantum of fines meted out in the financial services sector has grown significantly and firms are increasingly having to factor the consequences of potential misconduct into their financial risks. Might the extent of such fines, disgorgements and, potentially, litigation damages pose a threat to the safety and soundness of firms?”



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As such, and given the DFSA’s long-held emphasis on culture, it is reasonable to expect that the risks associated with culture and employee conduct factor into its non-financial prudential risk supervision.

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.⁶¹⁸



FROM OUR ARCHIVES:

Conduct Regulation in a Developing Country

By **Katherine Gibson**,
Deputy Commissioner, FSCA

“Banking conduct regulation, and particularly appropriate governance practices and culture outcomes, remains a key focus area of the FSCA and a crucial success indicator of the newly adopted Twin Peaks regulatory framework. While the law reform process is underway, subordinate regulation is being introduced by the FSCA that applies the new approach to conduct regulation and supervision on a wider range of financial institutions.”



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The final “new banking conduct standard,” which was published in July 2020, came into full effect in July 2021.⁶¹⁹ The core of the new conduct standard for banks is a set of ‘Treating Customers Fairly’ outcomes. These include various requirements for product design, governance, and advertisements. In a

statement supporting the conduct standard for banks, the FSCA stated that it would monitor compliance with the standard using proactive supervision, covering emerging risks within the institutions and systemic risks in the sector.⁶²⁰

In July 2022, the FSCA published its regulation plan for the following three years (2022-2025). The regulator intends to focus on three key areas of work:

- Regulatory framework developments focused on conduct;
- Regulatory framework developments focused on the financial markets (integrity and efficiency); and
- Regulatory framework developments focused on a broad scope of cross-cutting sector developments and themes.⁶²¹

In the plan, the FSCA indicated that it would work with the country's Prudential Authority (PA) — housed in the Reserve Bank — to develop a joint standard for culture and governance. "Culture and governance remain a critical priority area for both the FSCA and PA and the Authorities are currently in the process of developing a high-level Joint Standard relating to Culture and Governance which is envisaged to be published for public consultation during the course of 2023," the report reads.

In a response to Starling Insights' 2024 *Compendium* survey, the FSCA explained that this joint standard was going through a targeted industry consultation as of May 2024, which would be followed by a formal public consultation.

In its response, the FSCA also emphasized the value of Supervisory Technology (SupTech) and Regulatory Technology (RegTech) for non-financial risk management and supervision. "These technologies offer the ability to provide more predictive and proactive risk management capabilities," the FSCA wrote. "Traditional risk management in culture,

conduct and governance has been more reactive, relying on retrospective and periodic analysis. However, these tools allow regulators and firms to continuously monitor and assess their operations, culture, and conduct, allowing them to detect emerging risks earlier and take preventative actions."

Ghana

BANK OF GHANA

The Bank of Ghana has long emphasized the critical role of trust in the banking industry and highlighted the potential threat to stability and integrity posed by misconduct. In a November 2023 speech at the Chartered Institute of Bankers' 27th National Banking and Ethics Conference, Governor Ernest Addison stressed the importance of high standards of professionalism and ethics in the financial sector to maintain public trust and stimulate economic growth.⁶²²

"Indeed, the importance of ethical behaviour in banking and financial markets has never been as relevant as it is today because of the moral and economic efficiency issues involved," he said. Given the importance of banks to economic growth, Addison implored banks to uphold their moral obligations for the sake of depositors, shareholders, and overall financial integrity.

"The critical issues to focus on regarding the chosen theme include the ethical frameworks that guide banks policies and procedures, and the values that shape the actions of bankers," he stated. While the Bank of Ghana monitors ethical conduct among regulated institutions, it has also implemented its own internal Ethics and Compliance Programme to instill an ethical culture among its staff. In so doing, the central bank seeks to model the same approach to managing culture and behavior it expects of the firms it oversees.

Addison advocated for the aggressive pursuit of ethical business practices by all industry players, emphasizing the importance of a values-driven culture within banks. “When the culture within the banking sector is values-based and values-driven, stakeholders, including depositors, would likely align their values to that of the bank,” he said.

In Focus

What's the Culture Like?

By: NEIL ESHO¹

Introduction



Neil Esho



When you ask someone what the culture of an organisation is like, you typically get a fairly short and clear message: “the place really promotes excellence”; “the CEO dominates the place”; “the institution is focused on its mission and really delivers”; “they always push the envelope on risk-taking”; “it’s a (not) great place to work, the staff are (not) really valued”.

Somehow, we all seem to be able to reach such overarching generalisations of “the way things are done”, either at our own or other institutions, but we probably don’t think too much about we come to such conclusions.

There is broad agreement that culture is an important driver of institutional performance. However, for the most part, our assessments are implicit. There is no explicit or quantitative measurement. The question therefore arises as to whether we need to be more systematic and consistent in our assessments of culture (both of our own and other organisations).

Perhaps it is time to be more explicit in articulating the factors driving supervisory culture and effectiveness.

If a more systematic / structured / quantitative approach is needed, what tools are available to supervisory agencies to embed their own desired supervisory culture into their agency and effect the required changes at regulated institutions? Wayne Byres noted recently that these questions often get put in the too hard basket. ►PAGE 317 (I must confess to doing this myself) Perhaps it is time to be more explicit in articulating the factors driving supervisory culture and effectiveness?

In the remainder of this note, I offer some views on this topic, while noting this is an active area of the Basel Committee’s work program in response to the 2023 banking turmoil.

1. The importance of risk culture

Risk culture is a subset of an organisation’s overall culture, but with a specific focus on values, beliefs, knowledge, attitudes, and understanding about risk. The overall culture of an organisation influences its risk culture by shaping how employees perceive and respond to risk. Risk culture, which is an important component of effective governance, has long been recognised as a key driver of effective risk management at the level of regulated financial institutions and in supervisory authorities. Throughout its 50 years history the Basel Committee has put great emphasis on this concept — most notably through the recently updated Core Principles for effective banking supervision.²

The long list of failures in bank risk management, and related failures of supervision, have been pointed to by many.³ Without recalling the disappointingly long list of failures, it is clear that they are persistent through time (pre- and post-GFC); occur in a wide range of countries; span

a wide variety of institutional structures under which regulation and supervision are organised; and they have occurred under capital and liquidity standards with significant variation in strength and complexity.

The failure of bank risk management and effective supervisory intervention were of course most recently highlighted during the March 2023 banking turmoil. As noted in the Committee's report on the 2023 banking turmoil, the first and most important source of financial and operational resilience comes from banks' own risk management practices and governance arrangements. The banking turmoil highlighted:

- fundamental shortcomings in basic risk management of traditional banking risks (such as interest rate risk and liquidity risk; and various forms of concentration risk);
- a failure to appreciate how the build-up of various individual risks were interrelated and could compound one another;
- inadequate and unsustainable business models, including an excessive focus on growth and short-term profitability (fuelled by remuneration policies), at the expense of appropriate risk management;
- a poor risk culture, as well as ineffective senior management and board oversight; and
- a failure to adequately respond to supervisory feedback and recommendations.

The banking turmoil also highlighted the importance of strong and effective supervision across various dimensions, including:

- the ability and willingness of supervisors not just to actively identify weaknesses in banks but also to take and enforce prompt actions;

- the need to ensure supervisory teams have the appropriate quantity and quality of resources; and
- the need to continuously monitor exogenous and structural changes to the banking system and to adapt supervisory approaches to overseeing risks, especially for banks that are rapidly growing in size or adopting novel business models. ▶PAGE 101

Governance, risk management and risk culture play an important role in all of these areas, whether they apply to banks or supervisory practices.

2. Embedding the “desired” supervisory risk culture

Thinking about how best to achieve sound supervisory outcomes has received increasing attention from a number of supervisory agencies in recent years. Good supervisory outcomes are largely influenced by risk culture, particularly factors such as willingness to act, persistence, and intelligent risk-taking. These intangible qualities are pivotal in enhancing supervisors' ability to promote safety and soundness of banks and the banking system.

Understanding the factors that drive risk culture should facilitate introducing more explicit and deliberate measures to move towards the risk culture we want to promote.

Building on the foundation of the Committee's work on governance and the Core Principles for effective banking supervision, individual agencies have taken significant steps to tackle the issue of supervisory risk culture.⁴ The topic is also a core element of the Basel Committee's ongoing work on improving supervisory

effectiveness. Without pre-judging the outcome of that work, in this section I briefly discuss some on the factors driving supervisory risk culture. Understanding the factors that drive risk culture should facilitate

introducing more explicit and deliberate measures to move towards the risk culture we want to promote, whatever that may be.

Drawing on the relevant Basel Committee⁵ and FSB⁶ guidance to banks is a good place to start when thinking about the factors driving supervisory risk culture. This points to the following six factors: (i) tone from the top; (ii) accountability; (iii) effective communication and challenge; (iv) incentives; (v) data and analytical tools (including technology); and (vi) the external environment.

(i) TONE FROM THE TOP

Governance and risk culture always start from the top of the organisation — in this respect, supervisory agencies are no different to regulated firms. “It is the overarching responsibility of the board and senior management to set the tone at the top, including by clearly articulating the underlying values that support the desired risk culture and behaviours; recognising, promoting and rewarding behaviour that reflects the stated risk culture and its core values; and systematically monitoring and assessing the actual culture”.⁷

In the context of supervisory agencies, this means that the actions and support shown by senior management are vital in establishing a tone from the top that empowers supervisors to take prompt and decisive actions.⁸ This should include articulating supervisory risk tolerance, acknowledging that intervention is expected as part of the supervisory process, and supporting supervisors in taking risks and making judgement calls around the timing, force and nature of interventions.

(ii) ACCOUNTABILITY

“Accountability speaks to the prompt identification, management, and escalation of emerging and unexpected risk issues, and having a clear

understanding of the consequences for not doing so.”⁹ While the risk issues for supervisors are different to those faced by regulated firms, accountability is central to embedding any desired risk culture.

For supervisory agencies, this requires clear accountability and escalation channels, as well as effective internal governance and communication processes.¹⁰ Embedded in these processes are decisions around the degree to which supervisory decisions are automated or allow some discretion. Ideally there should be clear supervisory processes that embed within them an element of discretion, facilitate timeliness by not being too rigid or complex, and which have the right checks and balances along the way.

(iii) EFFECTIVE COMMUNICATION AND CHALLENGE

A sound risk culture encourages open dialogue at all levels of an organisation and welcomes challenge.¹¹ This is applicable to both regulated firms and supervisory authorities. The key messages that drive the behaviours leaders are trying to instil in an organisation should be kept simple, repeated often, and lived throughout the organisation. It is important to avoid high-level platitudes that no one really believes.

Building in mechanisms for challenging decisions is critical for identifying potential risks and taking actions. This can be facilitated through a range of mechanisms, such as having diverse teams involved in the process (with a mixture of technical specialists and those directly responsible for supervision); staff rotation; quality assurance; benchmarking; and investment in the continuous development of the skills and capabilities of supervisory staff. But above all, effective challenge will not occur if staff feel that their views are disregarded, or worse still, held against them.

Incentive structures may be both financial and non-financial in nature.

(iv) INCENTIVES

Incentive structures within supervisory authorities, which may be both financial and non-financial in nature, have a direct impact on individual behaviours and ultimately on risk culture. As noted in the Committee's 2015 "Corporate Governance Principles for Banks", remuneration plays a key role in the governance and incentive structure through which the board and senior management encourage good performance, appropriate risk-taking behaviour and strengthen the institution's risk culture.¹²

While remuneration, particularly variable remuneration, plays a far smaller role in motivating a sound risk culture in supervisory authorities, it is nevertheless important. Supervisors, like any employees, want to feel valued, whether that be through remuneration, promotion, professional development, appraisal or the satisfaction from doing a job that is interesting, challenging, broad and rewarding. It is critical that the incentives provided to supervisors align with an organisation's desired risk culture. And, by the way, increases in supervisory salaries would also be helpful. We all agree that supervision is a critical job for all our societies and economies, but somehow expect excellence to come cheap.

(v) DATA AND ANALYTICAL TOOLS

A strong supervisory risk culture needs to be built on high quality data and rigorous internal analysis. While supervisors bear the ultimate responsibility for implementing supervisory decisions directly with the bank, it is crucial that they are backed by specialist units that provide support in terms of risk analysis and early risk detection. This empowers supervisors and supports confidence in the individual supervisor and the supervisory authority.¹³

Without confidence in the supporting analytics, taking difficult decisions under uncertainty will be even more challenging. Technology may be able to help and should be promoted, but I don't expect it will be a panacea. In recent years, where failures of supervision have occurred, they have been more related to a lack of supervisory intervention rather than an inability to diagnose the problem.

(vi) EXTERNAL ENVIRONMENT

In regulated firms "risk culture, as well as corporate culture, evolves over time in relation to the events that affect the institution's history (such as mergers and acquisitions) and to the external context within which the institution operates."¹⁴ The external environment is also critical for risk culture at supervisory authorities. While operational independence, accountability and governance of the supervisor should be prescribed in legislation and publicly disclosed,¹⁵ regulators and supervisors are encountering unwarranted external criticism and pressure to curtail supervisory powers.

Such circumstances are not conducive to improving supervisory culture. It is important to recognise that simply asserting the negative aspects of all regulations and advocating for the curtailment

There are lots of grey areas in risk management and supervision — where you choose to land within the grey area is often driven by risk culture.

of regulatory bodies will not lead to an automatic improvement in the effectiveness of supervision and the development of a robust risk culture. A more balanced view on the role of supervisors is needed that acknowledges the fundamental purpose of supervision, which is to safeguard and promote the safety and stability of the banking system.

3. Conclusions

There are lots of grey areas in risk management and supervision — where you choose to land within the grey area is often driven by risk culture. Working

towards a better understanding of the factors that drive risk culture will allow us to move from an implicit understanding of it to something more explicit. A more explicit and analytical approach will provide a stronger basis to justify and build consensus around the changes necessary to improve risk culture and help achieve the desired supervisory outcomes. In the same vein, those responsible for the governance of supervisory authorities should uphold the same standards for their authority's risk culture as they anticipate from the firms under their supervision.

The initiatives launched by the Basel Committee in response to the banking turmoil, most prominently

the international work on supervisory judgment and effectiveness, is focused on strengthening supervisory practices and fostering an appropriate supervisory culture.

Neil Esho is Secretary General of the Basel Committee on Banking Supervision. Prior to this, he served as the Deputy Secretary General, having joined the Basel Committee Secretariat in April 2006. Before the Basel Committee, he was Head of Research at the Australian Prudential Regulation Authority.

ENDNOTES

- 1 I am grateful to Markus Grimpe, Stefan Hohl, Joanne Marsden, Ben Gully and David Bailey for helpful comments in preparing this note. The views, opinions, errors and omissions are my own.
- 2 Basel Committee on Banking Supervision (2024), [Core Principles for effective banking supervision](#).
- 3 For example, see: Basel Committee on Banking Supervision (2023), [Report on the 2023 banking turmoil](#); Byres (2024); Adrian, T., Moretti, M., Carvalho, A., Hee, K.C., Seal, K., Melo, F, and Surti, J. (2023), [Good supervision: Lessons from the Field](#), Working Paper, International Monetary Fund.
- 4 See Byres, W. (2024)
- 5 See: Basel Committee on Banking Supervision (2015a), [Corporate governance principles for banks](#); Basel Committee on Banking Supervision (2015b), [Report on the impact and accountability of banking supervision \(bis.org\)](#); Basel Committee on Banking Supervision (2018), [Frameworks for early supervisory intervention](#); Basel Committee on Banking Supervision (2024).
- 6 Financial Stability Board (2014), [Guidance on supervisory interaction with financial institutions on risk culture: A framework for assessing risk culture](#).
- 7 Financial Stability Board (2014). Similar messages are reiterated in Basel Committee on Banking Supervision (2015) and most recently in Basel Committee on Banking Supervision (2024).
- 8 Basel Committee on Banking Supervision (2018).
- 9 Financial Stability Board (2014).
- 10 Basel Committee on Banking Supervision (2024).
- 11 Basel Committee on Banking Supervision (2015a).
- 12 For an analysis of the role of governance and executive pay on bank risk taking, see: International Monetary Fund, Global Financial Stability Report (2014), Chapter 3, Risk taking by banks: The role of governance and executive pay.
- 13 Basel Committee on Banking Supervision (2018), [Frameworks for early supervisory intervention](#).
- 14 Financial Stability Board (2014).
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In Focus

The SupTech Imperative

By: CECILIA SKINGSLEY



Cecilia Skingsley



Innovation in SupTech, or technology applied to banking supervision, is essential to safeguard our financial system. At the Bank for International Settlements Innovation Hub, our view is that all of us — central banks, supervisors, regulators and the private sector — have a role to play in ensuring that digital-enabled markets are complemented by digital-

enabled oversight. So how do we do this?

At the Innovation Hub, we believe that there are two elements through which we can assist financial authorities to keep pace with and benefit from, advancements in technology. These are providing insights into the global SupTech landscape and driving collaborative experimentation through public-private partnerships.

We know that, as the range and complexity of supervisory demands increase, the need for SupTech is becoming more acute. Supervisory authorities are wrestling with updating often manual processes, being required to ingest and analyse ever larger ranges of data, both structured (such as balance sheets) and unstructured (such as news and social media), as well as responding to advancements that are fundamentally changing the markets they oversee.

As the range and complexity of supervisory demands increase, the need for SupTech is becoming more acute.

Within this context, the Innovation Hub has undertaken a comprehensive programme of research to examine the experience of both users and providers of SupTech. We surveyed authorities across the globe to better understand their approaches to, and levels of, SupTech adoption. It is perhaps not surprising and somewhat reassuring that almost all of the countries surveyed have ongoing SupTech initiatives.

Current SupTech solutions being deployed include dashboards to monitor capital, liquidity, credit and market risk; Natural Language Processing to monitor and analyse social media, news, financial statements, etc; and tools to automate supervisory tasks such as licensing. Many more solutions are in development, including in emerging areas such as Environmental, Social and Governance reporting and crypto asset monitoring.

While the breadth of this activity is encouraging, our research has highlighted that the majority of these tools are at an early stage of maturity, focusing largely on digitalisation and automation of existing workflows. These tools are not yet being widely adopted inside institutions, as many in-house solutions remain at proof of concept or prototype stage.

Despite obvious appetite and dedicated resource, questions remain about the extra level and type of support required to take these prototypes and proof of concepts on a path to production. It is our belief that the private sector can play a crucial role in this regard.

Trials and tribulations

Recent research with the global SupTech vendor community has allowed us to understand the range of solutions they are offering, to whom and their experience of interacting with central banks and regulators.

The survey shows that the vendor community is optimistic about the future direction of the SupTech market. But it also highlighted some specific challenges that the private sector has in working with the public sector. Vendors often find it challenging to engage with financial authorities, mentioning the lack of visibility of authorities' needs, complex procurement processes and organisational siloes. The end result being that it is hard to match our problems with their solutions.

This friction in a market dynamic is not uncommon. The public sector may not always be the easiest of customers. Public entities can be complex organisms with a multitude of specialisations and different priorities. Their objectives are often more vague than in the private sector. Most importantly, the public sector needs specific processes to ensure fair and systematic decision-making and to be transparent about how public money is spent. Transparency and fairness are required by law.

All this also means that the public sector is not the most profitable one for entrepreneurs to target. This dynamic is more likely to keep smaller firms out of the game. Large and established vendors are more able to cope with increased uncertainty and higher costs often associated with working the public sector. But it is often in the smaller start-up community where true innovation and cutting-edge thinking happens first.

►SEE MIKE ROGERS ON STARLING INSIGHTS

So, it is up to the public sector to collectively think of ways to bridge the gap between its processes and peculiarities and the private sector dynamics. It needs to be able to be more transparent, even knowing that its work is complex, challenging and sometimes very sensitive.

Public-private partnership

In this context, the Innovation Hub aims to make a difference in bringing the public and private sectors closer together to accelerate SupTech experimentation and adoption. Our projects provide a bridge between the cutting edge of novel technologies being developed in the tech world, and the challenges faced by authorities.

We are building proofs of concept and prototypes aimed at monitoring stablecoins; working to better understand the economic significance of DeFi and crypto assets; monitoring electronic markets; building a regulatory reporting and data analytics platform;

using large language models to enable climate risk analysis; and encoding policy and regulatory requirements into cross-border payment protocols. All of these efforts have been performed in conjunction with partners from the private sector.

It is up to the public sector to collectively think of ways to bridge the gap between its processes and peculiarities and the private sector dynamics.

The work undertaken by the BIS Innovation Hub provides a role model for increased public-private partnership in overcoming the challenges faced by financial authorities. By understanding and articulating the issues most pertinent to financial authorities, this provides the opportunity for the private sector to bring their skill to co-creating solutions. This is a critical ingredient in supporting successful collaboration to support and promote global financial stability.

Cecilia Skingsley became Head of the Bank for International Settlements (BIS) Innovation Hub in September 2022. She is a member of the BIS's Executive Committee. Previously, she held the position of First Deputy Governor of Sveriges Riksbank since November 2019.

Bank for International Settlements

INNOVATION HUB

In a keynote speech at a conference in October 2023, Cecilia Skingsley, Head of the Bank for International Settlements (BIS) Innovation Hub, highlighted the transformative impact of emerging technologies on the financial sector. While advocating for progress and modernization, Skingsley stressed the importance of maintaining public trust in the financial system as financial assets become increasingly abstract.⁶²³ ► **PAGE 381**

The BIS Innovation Hub was established in 2019 as a collaborative platform for central banks. Since its inception, the Hub has worked on 29 projects. Skingsley highlighted three key themes of the Hub's work: improving retail payments, safeguarding the system against financial crime and cybersecurity threats, and providing better services to society. "We have a number of projects that are looking into using technology to improve detection of financial crime, to strengthen cyber security and to create new and improved tools for supervisors and regulators," she said.

Skingsley concluded by encouraging stakeholders to embrace innovation and stay ahead of developments in the financial sector. "Don't let the train of enthusiasm run through the station so fast that people can't get on board," she quoted from English travel writer H. V. Morton.

"This is something we are conscious of at the BIS Innovation Hub," she assured. "Our research and innovation projects set out the art of the possible. But ultimately it is up to others to decide not only which trains to board but which tracks to lay."



FROM OUR 2022 Compendium

Cooperation Is the Only Way to Win the Race against the Machine

by Francesca Hopwood Road
Head, BIS London
Innovation Centre

"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... 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."



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In a speech delivered at the Innovate Finance Global Summit in April, Cecilia Skingsley called for public-private partnership to drive supervisory technology (SupTech) development. "We, as in the public sector, need to join forces with you in the private sector to build technology solutions that can shape the future of supervision and support financial stability," Skingsley argued.⁶²⁴

Acknowledging that some vendors may struggle to engage with the public sector due to a lack of clarity around objectives, specifications, and priorities, Skingsley encouraged public sector entities to become "better customers."

"We need to better articulate our needs to the market and find ways to be more inclusive," she said. "In this way, we benefit from all the choices available in the

SupTech marketplace and continue to be up to date with the latest technologies. We might be missing a lot. We don't know what we don't know."

Another key pillar of encouraging SupTech innovation will be transparency and honesty, Skingsley stated. Central banks and supervisors face many challenges as they seek to modernize their systems, technology infrastructure, and supervisory tools. If these organizations are not able and willing to honestly assess and communicate where they stand in these regards, digital transformation will be much more difficult.

"[I]n our view, Suptech innovation continues to be essential to safeguarding our financial system," Skingsley concluded. "All of us — central banks, supervisors and regulators, the private sector — need to focus on this important task. To best achieve it, we need to operate within a framework that combines recognising the needs of multiple stakeholders with working more effectively with the private sector."

Basel Committee on Banking Supervision

2023 "BANKING TURMOIL"

In October 2023, the Basel Committee on Banking Supervision (BCBS) published its report on the regulatory and supervisory implications of the 2023 "banking turmoil." The BCBS argued that the bank failures exposed widespread shortcomings in risk management and culture, highlighting the need for more effective supervision to assess such concerns.⁶²⁵

"The first and most important source of financial and operational resilience comes from banks' own risk management practices and governance arrangements," the report read. The collapsed banks fundamentally failed in this area, demonstrating

faulty risk management, inadequate business models, poor risk culture, and insufficient response to supervisory action.

"A core element of supervisory work is therefore ensuring that banks have effective and robust governance and risk management," the BCBS wrote. Supervisors must be able to assess matters of culture, governance, and risk management. This necessitates that supervisors exercise supervisory judgment to ensure firms comply with the spirit of regulation, the report argued.



FROM OUR 2021 Compendium

The Changing Role of a Bank Supervisor

by **Carolyn Rogers**
past-Secretary General,
Basel Committee on Banking
Supervision

"If the last decade of bank supervision was about designing rules that lead to more resilient bank balance sheets, the next will be about designing supervisory tools and strategies that lead to more resilient bank cultures."



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Supervisory agencies must also empower supervisors with the right tools to drive real change within banks. "Supervisory authorities could also review whether the guidance and processes given to individual supervisory teams appropriately incentivises a willingness to act early, accompanied by a clarity of process on how to do so," the report read.

In a speech at the Eurofi High Level Seminar in February, Pablo Hernández de Cos, Chair of the BCBS, argued that the bank failures of 2023 made clear the need for adherence to Basel III standards and a commitment to effective supervision.⁶²⁶

“[T]here is one recurring theme throughout crises: it is strong and healthy banks that are able to withstand crises and continue to lend,” de Cos said. “That, in turns, requires having robust regulation and strong supervision as a foundation... This is why, in response to last year’s banking turmoil, the Committee is prioritising work to strengthen supervisory effectiveness and identifying issues that could merit additional guidance at a global level.”

De Cos acknowledged the need to keep up with the evolving financial system, including the structural developments related to the digitalization of finance, climate change, and the growth of non-bank financial intermediation. However, amid these transformative forces, “we cannot lose sight of the fundamentals of banking supervision,” he cautioned. It is for this reason that the BCBS consulted last year on updates to its Core Principles for Effective Banking Supervision, which we discuss in some detail later in this section.

“Regulators are often accused of fighting the last war,” de Cos concluded. “Yet in the case of implementing Basel III, it is the dragging on of the process — with attempts to reopen past reforms and battles — that will divert important resources from banks and supervisors to deal with current and emerging risks instead.”

CORE PRINCIPLES

In July 2023, the BCBS initiated a public consultation on proposed revisions to its Core Principles for Effective Banking Supervision. The Core Principles, originally established in 1997 and updated in 2012, are the recognized minimum standards for prudent regulation and supervision of banks and banking systems.⁶²⁷

The BCBS embarked on a review of the Core Principles in April 2022, aiming to incorporate changes reflecting advancements in supervision and regulation, structural shifts impacting banking systems, and insights garnered from Financial Sector Assessment Programs (FSAPs). FSAPs are reviews conducted by the International Monetary Fund (IMF) and World Bank into the resilience of a country’s financial sector.

“Reflecting evolving risks and broader medium- and long-term trends, it is critical that banks institute a sound risk culture, maintain strong risk management practices, and adopt and implement sustainable business models,” the BCBS wrote in the consultative document. We cover how the final version of the Core Principles suggest that supervisors test for such later in this subsection.

In a speech at the Eurofi Financial Forum 2023 in September 2023, Neil Esho, Secretary General of the BCBS, discussed the proposed revisions to the Core Principles in light of recent banking crises. To ensure that the revised standard reflects the global experience of banking supervision, the BCBS established a task force comprising member and non-member jurisdictions, as well as the International Monetary Fund and the World Bank, to carry out the review, Esho explained.⁶²⁸

“Our objective — and also our challenge throughout this process — is to raise the bar for supervisory and bank practices, while also keeping the principles universally applicable,” Esho concluded. “While full implementation of the Core Principles by all countries is not a guarantee against bank failure, it provides a good basis for developing effective supervisory systems, and it would be a significant step towards improving banking system resilience and financial stability both domestically and internationally.”

At the 23rd International Conference of Banking Supervisors in April, delegates from banking sector supervisors and regulators across more than 90

jurisdictions endorsed the BCBS revised “Core Principles for Effective Banking Supervision.” The revisions primarily aim to:

- Embed learnings for mitigating financial risks and to strengthen the macroprudential aspects of supervision;
- Promote operational resilience;
- Reinforce corporate governance and risk management practices; and
- Address new and emerging risks, including the digitalization of finance and climate-related financial risks.⁶²⁹

A key aspect of these efforts will be an increasing attention to governance and culture. “Reflecting evolving risks and broader medium- and long-term trends, it is critical that banks institute a sound risk culture, maintain strong risk management practices and adopt and implement sustainable business models,” the document read.

The Core Principles now feature guidelines for the supervision of bank culture, recognizing its importance to risk management and resilience by integrating it into two core principles: CP14 on corporate governance, and CP15 on risk management processes. These additions are in the form of new “essential criteria” — guidelines for effective supervision that can be used in self-assessments and FSAPs.

In CP14, these new criteria include that supervisors determine that the “bank’s board approves and oversees implementation of the bank’s strategic direction, risk appetite and strategy, and related policies, establishes and communicates corporate culture and values.” And CP15 requires supervisors to determine that banks “have appropriate risk management strategies that have been approved by the bank’s board.” Supervisors must also verify that the board ensures that “a sound risk culture is established throughout the bank, to promote the development and execution of its strategy.”

“While responsibility for designing and implementing sustainable business strategies lies with a bank’s board, supervisors have an important role to play, as assessing the robustness of banks’ risk culture and business models is a key component of effective supervision,” the BCBS wrote.

In his speech at the International Conference of Banking Supervisors, Agustín Carstens, General Manager of the Bank for International Settlements, commended the BCBS’ work on the Core Principles. “Indeed, these are viewed today as the gold standard for bank prudential regulation and supervision and have been adopted in over 120 jurisdictions,” Carstens said. “You have set the benchmark for other global standard setters and forums.”

However, he encouraged the BCBS not to take its past success for granted. In that direction, he posed three questions for discussion and reflection:

- How can the BCBS best contribute to a safer and more integrated global financial system?
- How can the BCBS address the risks posed by non-bank financial institutions (NBFIs)?
- And should the BCBS and its members spend more time thinking about how they can use technological innovation to meet their mandates?

“The BIS Innovation Hub has already pursued several projects aimed at using technology to strengthen supervision,” Carstens said. “I would encourage the Committee to further consider whether additional projects would assist it in meeting its mandate.” ▶ **PAGE 381**

INNOVATION AND AI

In a January 2024 interview with the *Financial Times*, Pablo Hernández de Cos called for a coordinated response to the risks posed by AI, warning that the current pace of development “could change the course of history, not necessarily for the good.” He

pointed to the global collaboration surrounding financial regulation as an example, which allowed regulators to keep the financial system stable amid the Covid pandemic and the myriad geopolitical disruptions that have occurred over the past several years.⁶³⁰

De Cos said that the BCBS would publish a report on the financial implications of AI in the coming months. "Financial stability is only one dimension, there are many other potentially more important consequences related to AI," he said. "If we are not able to give a coordinated global response, the likelihood of getting the right solution to these challenges will be reduced."

De Cos repeated a similar sentiment in his speech at the Institute of International Finance Global Outlook Forum in April 2024. "Digital innovation will further fuel cross-border and cross-sectoral financial interconnections," he said. "Safeguarding global financial stability will therefore require ongoing collaboration to ensure that we achieve an appropriate baseline regulatory and supervisory approach to overseeing the use of AI/ML in banking and beyond."⁶³¹

Financial Stability Board

In a June 2023 speech, Klaas Knot, President of De Nederlandsche Bank and Chair of the Financial Stability Board (FSB), emphasized the importance of learning from past crises to prevent future ones. "Our financial system has to be able to absorb change, to withstand shocks and address vulnerabilities," he said. "In other words: the global financial system has to be resilient."⁶³²



FROM OUR 2022 Compendium

Sound Governance for Navigating the Changing Financial Landscape

by **Klaas Knot**
Chair, Financial
Stability Board

"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."



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Knot reflected on the lessons learned from the Global Financial Crisis of 2008 and the subsequent reforms in his speech. "This agenda has proved its worth time and again, helping us navigate many challenging new events," he said. "But there is still plenty of room for improvement."

Knot stressed the need to address the vulnerabilities present in the financial system. In particular, the failures of Silicon Valley Bank (SVB) and Credit Suisse in 2023 exposed deficiencies in internal controls, risk culture, and governance.

Supervisors and industry leaders must be forward-thinking to anticipate and mitigate risks, Knot argued, highlighting the importance of resilience and adaptability in the financial system and the continuous improvement needed to address the challenges and complexities of the modern world. "Regulation, supervision and banking should be seen as living things that have to go with the flow and

move with the times,” Knot concluded. “Our financial system must become more resilient and future-proof. And we must always keep in mind: events are opportunities to learn — to improve is to change.”

Financial Stability Institute

In a March 2024 paper entitled “Under Pressure: Taking Stock of Supervisory Resources,” the Basel-based Financial Stability Institute (FSI) reported on the results of its study comparing supervisory staffing and budgets to total banking sector assets in 57 jurisdictions. The FSI found that banking supervisors in major financial centers face substantial resource constraints.⁶³³



FROM OUR 2023 Compendium

Holding Bank Executives Accountable for Misconduct

by [Raihan Zamil & Ruth Walters](#), Senior Advisors,
Financial Stability Institute

“It goes without saying, but it is individuals and not abstract corporations that commit corporate wrongdoing. So, the question becomes, who is to blame? While individuals who commit the alleged infraction should obviously be held to account, bank executives should also be held personally accountable if they contributed to the broader context that enabled such breaches to occur or if they failed to properly oversee individuals in their areas of responsibility.”



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“While technology can certainly help increase its productivity, banking supervision is inherently labour-intensive,” the FSI’s Rodrigo Coelho and Rebecca Guerra wrote in the report. Although supervisors of globally systemically important banks (G-SIBs) have more staff and bigger budgets, jurisdictions without G-SIBs tend to allocate more resources relative to total assets.

Emerging markets often have proportionally larger staff pools and budgets than those in advanced economies. Perhaps unsurprisingly, supervisory bodies that can levy penalties on firms also tend to have more financial resources. “In contrast, authorities relying exclusively on funding from the government will likely face fiscal constraints,” they explained.

The authors highlight the crucial role of supervisors in safeguarding financial stability, emphasizing the need for adequate resources to mitigate the societal costs of financial crises and protect broader economic interests. “It is, therefore, imperative not only from a financial stability perspective but also from a broader economic standpoint for public authorities to ensure that banking supervisors have adequate resources to properly fulfil their responsibilities,” the report read.

International Monetary Fund

In September 2023, the International Monetary Fund (IMF) published a report entitled “Good Supervision: Lessons from the Field,” which emphasized the importance of effective banking supervision and discussed what can be done to achieve it.⁶³⁴

The bank failures of spring 2023 have been widely attributed to failures in risk management that deteriorated trust and confidence in those institutions. Some have focused on heightened capital requirements in the wake of these collapses, but the IMF report was clear that “an institution can never have enough capital or liquidity if there are material flaws in its risk management practices.”

Instead, supervisors must be able to identify these deficiencies early, and be empowered to compel an institution to resolve them quickly, the IMF argued. This will necessitate a greater supervisory focus on governance, risk management, and business models — the problems at the root of the bank failures. It may also require that supervisors fill data gaps and adopt risk-based, forward-looking analytical tools.

Supervisory agencies must also attend to their own culture to ensure that their supervisors can take action quickly. In the case of Silicon Valley Bank, examiners had identified the bank's risk management deficiencies but failed to compel the firm's leadership to rectify them. "Supervisors that fail to follow through in supervisory intervention allow weak banks to continue problematic business strategies and actions," the IMF wrote.

"Supervision is essential," the IMF concluded. "As the dozen United States senators who wrote to the Federal Reserve Board, 'Irresponsible and excessive risk taking by SVB [...] should serve as a clear reminder that banks cannot be left to supervise themselves.'"

Financial Markets Standards Board

The Financial Markets Standards Board (FMSB) seeks to support well-functioning, trusted global wholesale financial markets that in turn support sustainable economic growth for governments, corporations, and investors. It issues industry-developed Standards, Statements of Good Practice and Spotlight Reviews primarily focused on market practices, such as large trades and pre-hedging, and conduct and ethics topics, such as the three lines model and culture. To support FMSB's work, Starling became a Partner Member in September 2023.

FMSB FROM OUR 2022 Compendium

Financial Markets Standards Board: A Change Agent at the Heart of Wholesale Financial Markets

by **Ted MacDonald**, Senior Technical Specialist, and **Christopher Rich**, General Counsel

"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."



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In July 2023, FMSB, in collaboration with Oliver Wyman, published "Conduct & Culture MI: Boundaries of Current Practice," a spotlight review of current practices surrounding culture and conduct management information in the financial industry.⁶³⁵

Twenty-four FMSB members compiled and submitted information on the strategic rationale for addressing conduct and culture concerns and the data and metrics used to assess them. They also submitted examples of dashboard-style management reports revealing the specific metrics and information used for assessing culture.

Through this research, FMSB identified the stages of progress in monitoring and managing conduct and culture, as firms evolve from primarily responding to misconduct after the fact to utilizing advanced analytics to assess the behavioral health of the firm as a whole and adopt outcomes-focused behavioral change.

“Having established the boundaries of current practice rather narrowly on management information,” the report concluded. “FMSB may extend this initiative with a focus on exploring how conduct and culture more broadly drives better outcomes for all market participants and the steps that firms can take to further evolve existing practices.”

Additionally, over the past year, FMSB has published:

- One Standard on documentation and processes related to client onboarding⁶³⁶
- A Statement of Good Practice for the Application of a Model Risk Management Framework to Electronic Trading Algorithms⁶³⁷
- Three further Spotlight Reviews on: The 3 Lines Model: A Lens on Risk Management Frameworks,⁶³⁸ Data and Transparency in Precious Metals Markets,⁶³⁹ and a Compendium on Precious Metals Market Evolution⁶⁴⁰
- Its 2023 Annual Report⁶⁴¹



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Learn how to see; and realize that
everything connects to everything else.

LEONARDO DA VINCI



The Academy

Evolution Evolving: Recent Biological Findings Shed New Light on Human Behaviour

By: KEVIN N. LALA



Kevin N Lala



University of
St Andrews

in which novel forms of adaptability and their associated dynamical feedback loops play central roles. This 'new biology' has implications for comprehending human social dynamics. Predicting human behaviour accurately requires the right evolutionary foundations. And this has relevance to policymaking around behavioural risk.

To most readers, the 2023 banking turmoil will seem a million miles from the study of evolutionary biology. Yet, much like banking sector supervisory policies, evolutionary theory is currently undergoing something of a revamp, as biologists come to terms with a rush of striking findings that challenge the orthodox narrative.

A new consensus is beginning to crystallize,

Scholars in fields such as economics, anthropology, and sociology have paid scant attention to evolutionary biology.

Humans have evolved through natural selection but, despite this, they can be meaningfully described as unique.¹ These twin claims ought not to be contentious, but a surprisingly large fraction of the population deny one or other.

Evolution sceptics treat our uniqueness as evidence against evolution, while the scientific case for evolution often downplays human uniqueness. Yet our species truly is exceptional. We occupy virtually every corner of the terrestrial planet, in numbers that are orders of magnitude greater than that typical for mammals of our size. Compared to other animals, our ecological footprint is astounding, our technology is off the scale, our capacity for communication is unprecedented, and our cognition is unmatched.²

One might imagine that the social sciences would draw heavily on evolutionary biology to try to understand these components of human uniqueness, but that has not been the case. Scholars in fields such as economics, anthropology, and sociology have paid scant attention to evolutionary biology. Why this should be is both complex and multifaceted,³ but undoubtedly part of the problem was that it was not until the 1970s that evolutionary biology began to devise adequate tools for understanding complex social interactions,⁴ and not until recent times that evolutionary biology has matured to the point that it can do justice to the richness of human social behaviour.⁵

For social scientists in economics, business or management science, current understanding remains dominated by a 'rational actor' conception of human behaviour, in which individuals are envisaged to be almost exclusively motivated by personal financial gain. Other social scientists have eschewed biological explanations altogether, mindful of past abuses of evolutionary theory in human affairs that led to social Darwinism, eugenics and the bolstering

of prejudicial stereotypes. This has not prevented newspapers and popular science writings being awash with crude biological explanations for human behaviour. Most are speculative stories providing evolutionary historical explanations for societal stereotypes. But none of these approaches provides the correct foundation for understanding humanity.

Evolutionary theory is changing, and science can now do justice to human social complexity. Among the most important advances in evolutionary understanding is the realization that the evolutionary process itself evolves.

Evolution is evolving

Part of the beauty and simplicity of Darwinism is that all organisms can be understood as evolving through natural selection. Yet, recent research demonstrates that organisms differ greatly in how good they are at evolving. If all organisms evolve through the same mechanism, why should this be? The answer is that natural selection is not something that just happens to organisms: their activities and behaviours contribute to whether and how it happens. The form that natural selection takes depends critically on the mechanistic details of how each organism operates — its development, physiology and behaviour.

There are three requirements for natural selection: (1) there must be trait variation among individuals in a population (phenotypic variation), (2) individuals with some variants must leave more descendants than others (differences in fitness), and (3) offspring must resemble their parents more than they resemble unrelated individuals (inheritance). These requirements hold for all organisms, but how they are met differs from case to case.

Numerous species transmit learned knowledge through imitation and other forms of social learning.

Take inheritance, for instance. Historically, biologists tended to assume that this requirement largely reduced to the transmission of genes from parent to offspring, but it turns out to be far more complicated.

A profusion of resources other than genes are now known to be passed down the generations, including hormones, symbionts, epigenetic changes, antibodies, ecological resources, and learned knowledge. And this variation, too, can be selected, and generate adaptation.

For instance, the DNA in cells is not naked but cloaked in a variety of chemically attached molecules that affect the expression of nearby genes. Sometimes these 'epigenetic' attachments are inherited. In plants, for instance, epigenetic variation has been found to alter many important traits, such as flower shape or root length. Experiments have shown that inherited differences in plant morphology can be linked to epigenetic variation. Sometimes, when biologists conduct experiments that select for particular characteristics, it is the frequency of epigenetic attachments rather than gene variants that change. Such studies show that epigenetic variation is not just inherited, but subject to natural selection.

Animal culture provides another example. Biologists have long been aware of cultural inheritance in humans, but regarded it as a special case. However, in the last fifty years, vast evidence for culture in other animals has emerged. Numerous species transmit learned knowledge through imitation and other forms of social learning, including dietary information, feeding techniques, predator avoidance methods, and learned migratory pathways. Familiar examples include chimpanzees fishing for ants and termites with sticks, birds drinking from milk bottles, and birds and whales transmitting songs.

Culture allows groups of animals to adjust their behaviour to match their environment.

This very report — the Starling *Compendium* — is named after the dramatic murmurations of starlings and the metaphor they provide for the spread of information in human organizations. In fact, the parallels between bird and human behaviour are stronger than you might imagine.

I have spent much of my career studying cultural inheritance in a range of animals, including primates, birds, rodents, fishes, and humans. Nearly 20 years ago, my research group studied the spread of learned information through populations of birds, including starlings. We were able to devise statistical tools to determine whether behavioural innovations, such as novel foraging habits, spread among close associates in a social network. Today those same methods are widely deployed; for instance, they are being used to show that “lobtail feeding”, an innovative method of feeding on fish shoals, has spread through populations of humpback whales in the Gulf of Maine.

Such studies show animal culture does more than contribute to inheritance: culture allows groups of animals to adjust their behaviour to match their environment. Here, the adaptations needed to hunt locally abundant prey do not arise through genetic mutation and genetic inheritance, but through behavioural innovation and cultural inheritance.

Until recently, biologists would have regarded such instances as intriguing natural history, but irrelevant to evolution. However, times are changing. There is now extensive evidence, both from the experimental laboratory and from natural populations, for adaptation occurring through the selection of epigenetic, symbiotic, cultural, and other forms of heritable variation. Biologists are coming to the realization that such phenomena are not analogous to biological evolution, they *are* biological evolution — evolution where the requirement for heritable variation is met by something other than genes.

Culture is not something that separates humans from nature, it is a critical part of our nature.

Historically, biologists had been misled into thinking that extragenetic inheritance was insufficiently stable to play an important role in evolution. That missed the point. Organisms need to be able to cope with environments that fluctuate on all temporal and spatial scales. Change in genomes (over hundreds to thousands of generations), cultural knowledge (over tens of generations), epigenetic modifications (over a handful of generations), and phenotypic plasticity (in the current generation) all contribute to adaptive evolution. Extragenetic inheritance is what allows populations to adjust to rapidly changing aspects of their world. It is significant precisely because of its instability!

Lesson 1: The evolutionary process has itself evolved. Much extra-genetic inheritance, including human culture, functions to allow for rapid adaptation.

Understanding human evolution

We can now understand why species vary in their ability to evolve — it’s because of differences in their biological properties. Epigenetic inheritance may be more important in plants than animals, for example, because the former don’t have the option to adapt to rapid environmental change through cultural learning. And we can also now understand why humans have culture in the first place. Culture is not something that separates humans from nature, it is a critical part of our nature. It’s a biological property whose function is to allow humans to adapt to rapid change.

However, there is more to the evolution of the evolutionary process than the emergence of alternative inheritance pathways. Organisms have also evolved different abilities to generate and modify fitness differences, and thereby shape the direction of natural selection. Here again, how organisms develop and what organisms do makes a difference.

For illustration, consider how desert termites evade desiccation by constructing a mound and ‘mining’ water from deep below the surface, which they transport to the nest as dollops of wet soil. In doing so, the termites change the direction of natural selection: selective advantage that might have accrued to evolving thick cuticles that limit desiccation, as seen in other termites, now accrues to the ability to build mounds and dig deep into the soil. Likewise, butterflies are known to respond flexibly to low food availability as caterpillars by developing stronger thoracic muscles, which enables them to fly to better habitats; in doing so, they switch natural selection away from coping with low food availability to favour traits enhancing dispersal.

Different capabilities to modify environments (a.k.a. ‘niche construction’) and to develop flexibly (a.k.a. ‘phenotypic plasticity’) further underpin variation among species in evolvability. Humans are champion niche constructors. Our ancestors didn’t just evolve to be suited to the world; they shaped the world. The landscape of human evolution did not pre-exist us; to a large extent, we built it ourselves.

Cultural transmission is widespread in animals because it enhances the efficiency of learning: individuals can rapidly ascertain what to eat, how to process it, or how to escape a predator, by observing others. There is now good evidence that this increment in efficiency was the driving force behind the evolution of the large brains, and advanced cognition, as well as the language and cooperation, of humans. Through the invention and cultural spread of techniques to access high-quality foods, food-processing and cooking, our ancestors’ reliance on culture shifting the balance of fitness costs and benefits from favouring relatively larger guts and smaller

The landscape of human evolution did not pre-exist us; to a large extent, we built it ourselves.

Almost all human learning is socially guided and set in a social context

brains to favouring relatively small guts and large brains. In doing so, they imposed direction on natural selection.

Almost all human learning is socially guided and set in a social context, and that is also likely to have been the case for our hominin ancestors for millions of years. Our ancestors repeatedly acquired new knowledge from others, and expressed it in their social and ecological environments. In turn, these activities modified the natural selection acting back on the human genome, a form of feedback known as ‘gene-culture co-evolution.’⁶

The dynamic interplay between genetic and cultural processes is now regarded as central to human evolution. Recent explanations stress a positive feedback loop, sometimes known as the “cultural drive hypothesis,” in which accurate and efficient social learning enhanced the payoff for technical competences, including tool use, which benefited not just learners but also their relatives and group members. This feedback is thought to have favoured the expansion of those (“executive”) brain regions and circuits associated with computation, decision making, working and long-term memory, and mental simulation.

A heavy reliance on social learning also led to increased sociality, as bigger groups and more time spent in the company of others increased the opportunity for effective copying. Selection for increased sociality also probably favoured a particular interest in, and sensitivity to, social cues. Culture is not the only important driver of brain evolution, but without recognizing its key role it is difficult to explain the large brains and complex cognition of the apes, and particularly hominins. The remarkable success of our species, our enhanced capacity to adapt, our

astonishing diversity, the bewildering amounts of information that we have generated, and our large-scale cooperation, all follow directly from our heavy reliance on social learning. Human minds were not just built for culture, they were built by culture.⁷

Acceptance that the evolutionary process evolves allows rich explanations for human evolution to be based on scientifically validated and widely observed natural processes, including for humanity's unique features. For instance, that human technology is off the scale is not unexpected once the manner in which dynamical feedback loops between hands, brains, and social groups create physical and developmental environments is appreciated. A key take-home message is that humans do not simply react to change, they are active agents who co-direct their own evolution.

Lesson 2: Humans are active agents who frequently create the conditions to which they themselves adapt, generating dynamical feedback.

Cultural norms and large-scale cooperation

The contribution of gene-culture coevolution to human adaptation was probably initially modest but became more important over time, as our ancestor's cultural capacity expanded and their control of the environment increased. However, their self-built spaces, be they social environments, such as homes, workplaces and schools, or physical spaces, such as farms, terraces and urban landscapes, created new challenges. For instance, crowded urban conditions promoted the spread of infectious diseases, generating natural selection for resistant genetic variants.

Human minds were not just built for culture, they were built by culture.

Today, human evolvability is dominated by cultural evolution, with genetic adaptation trailing in its wake.

However, in the modern era, cultural evolution dominates completely, as increasingly powerful culturally transmitted practices provide the means to solve culture-derived problems, such as when the construction of hospitals, vaccines, and sanitation practices alleviates the spread of disease. Today,

human evolvability is dominated by cultural evolution, with genetic adaptation trailing in its wake. For our species, cultural solutions dominate because culture is the component of our evolutionary adaptability that functions to cope with rapidly changing features of the environment. Were we plants we might adjust to rapid change through epigenetic or symbiotic adaptation, and if we were bacteria our short generation time would allow us to adapt genetically.

And as technology gets more complicated, for most individuals, the prospect of independently devising novel solutions alone, without any help or guidance from others, not even artefacts such as books or the internet, becomes vanishingly small. Even lone inventors and rogue traders must occasionally look to others for guidance. Both mathematical theory and learning experiments with humans and other animals show that mental heuristics, such as copying the behaviour of others when uncertain, conforming

to the majority, or mimicking successful individuals, generally provide highly effective solutions. However, when most individuals in a population are utilizing such social learning strategies, the population-level outcome are behavioural traditions that exhibit frequency-dependent properties. Sometimes these traditions are extremely stable, even to the point of preserving arbitrary and even maladaptive behaviour, and other times they rapidly flip from one state to another.

A further complication is that there is now extensive evidence that humans are not acting solely to maximize immediate self-interest. At some juncture in our history, our ancestors began systematically to correct the behaviour of the individuals they taught; in the process, they shifted their society away from reliance on mere conventions and toward governance through norms. People stopped illustrating *a* way to behave and began insisting on *the* way to behave. Eventually, each society was characterized by a particular set of norms that dictated how individuals should behave.

With the advent of norms, our social life became transformed from simply living in groups to identifying with the group, belonging to the group, abiding by its rules, and privileging in-group members. From that point onward, our ancestors lived in a society structured by cooperatively created and enforced norms for how to behave, many of which evolved into rule-governed social institutions. Studies show that teaching, language, copying, conformity, norms, and punishment of nonconformity, all operate to stabilize group differences, in the process supporting diverse forms of cooperation.

Both the diversity of human societies and the scale of human cooperation are unprecedented in large part because uniquely, compared to other animals, they are built upon socially transmitted norms. Personal gain remains a driver of human behaviour, but such motives are frequently overridden by the requirement to comply with institutional norms.

There is now extensive evidence that humans are not acting solely to maximize immediate self-interest.

For our species, the most important incentives are compliance with societal norms.

Lesson 3: Humans are normative creatures. For our species, the most important incentives are compliance with societal norms, which we both readily adopt and enforce, and which when enforced can override immediate personal gain.

Understanding human social behaviour

In recent years, behavioural science has fallen into disrepute. There are many reasons for this, but one important consideration is a failure to build on the correct biological foundations.

Human rationality is bounded, but it is not meaningfully bounded by ancient instincts, nor by selfish genes: it is bounded by norms. That this key insight should remain underappreciated is perhaps understandable, given that it is only in recent times that biologists have

recognized that the evolutionary foundations for each species can be starkly different, even when all arise through natural selection. Humans do not evolve like mice, fruit flies, or yeast. We interpret natural selection differently because we develop differently, interact with the world differently,

and inherit selectable variation differently. Those differences matter, because the way humans are set up to evolve determines how they will respond in a crisis.

I am a biologist, and I leave it to better-qualified others to judge how best to capitalise on these insights within the financial sector. I do believe, however, that the finance industry and management science will be stronger if they pay attention to the lessons highlighted here.

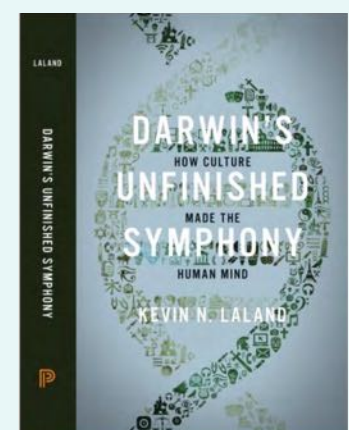
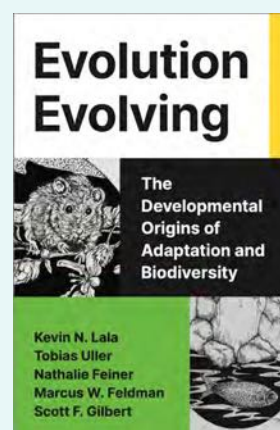
Rational self-interest remains an important predictor of human behaviour, but we must expect culture to influence organizational performance strongly, since culture is our species first port of call for dealing with change. When challenged, when threatened, when in unfamiliar terrain, when we don't know what to do, humans look to others for guidance. Yet, at the same time, plurality belies this semblance of conformity. Many copy the majority, some follow the highest payoff, others mimic the top cat, a few are just contrary, and a fraction stubbornly plough their own field. Almost all adhere to norms when adequately enforced, yet some take advantage when governance is weak. As active agents, all are capable of proactively seeking out and exploiting new opportunities, and as plastic developers, all are capable of revising their strategy in the light of new information. Theoretical and empirical tools exist for delineating the alternative learning strategies deployed, and this knowledge can be incorporated into predictive models of population-level outcomes alongside established predictors.

Ultimately, a deeper understanding afforded through attention to normative behaviour could underpin the development of more comprehensive risk-management strategies, and help to ensure more timely and ameliorating responses. We would be wise to consider the risks implied by humanity's imitative proclivities, as, under differing circumstances, highly frequency dependent copying can lead to trends, stagnancy, dramatic switches in outcome, and chaos. Those same imitative proclivities will also impact the social context in which any institution operates, leading to trends in voting patterns and social media reactions, the spread of calm or panic among stakeholders, and tit-for-tat copying between organizations.

A deeper understanding afforded through attention to normative behaviour could underpin the development of more comprehensive risk-management strategies.

Perhaps, with a deeper understanding of risk management, with the establishment of the appropriate behavioural norms for individual and institutional behaviour, and with effective penalties for failures in management and regulatory systems, governance and supervision can be made more effective before crises erupt. Perhaps. All I know for sure is that you can't get the social science right without the right evolutionary theory.

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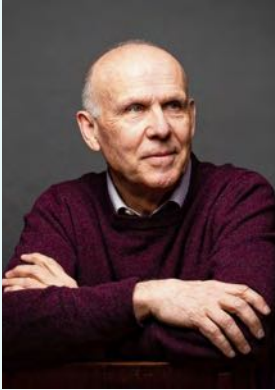
All of the claims made in this article are supported by extensive scientific data documented in two of the author's books. To find out more about recent developments in evolution theory, read Kevin Lala's upcoming book *Evolution Evolving*. To learn more about how culture drove the evolution of the human mind, see Lala's earlier *Darwin's Unfinished Symphony*. Both books are published by Princeton University Press.

ENDNOTES

- 1 It is trivially true that all species are unique, but my claim is a stronger one: in fundamental respects (e.g., cognition, powers of communication, demographics, ecological impact, technology, etc) humans are strikingly different from anything else that has evolved on Earth. Humans are uniquely unique (Laland, 2017 *Darwin's Unfinished Symphony*. Princeton University Press).
- 2 For an accessible introduction to humanity's unique features, and an understanding of how they evolved, see Laland (2018) 'An Evolved Uniqueness' *Scientific American*.
- 3 For an overview of the different ways in evolution has been used to study human behaviour, and of past abuses of evolutionary theory in human affairs, see Laland & Brown (2011) *Sense and Nonsense: Evolutionary Perspectives on Human Behaviour*. Oxford University Press.
- 4 For instance, inclusive fitness theory, evolutionary game theory, conflict theory, and various mechanisms supporting cooperative behaviour.
- 5 Such as recognizing the significance of cultural inheritance, plasticity-led evolution, and niche construction, in human evolution.
- 6 a.k.a. 'culture-gene co-evolution'.
- 7 Laland (2017) *Darwin's Unfinished Symphony*.

The Academy

An Interview with Richard Wrangham



Richard Wrangham



Q: You open your book, *The Goodness Paradox*, with a pithy observation: “We can be the nastiest of species and also the nicest.” This is the paradox. And you argue further that society modifies tendencies in both directions. Can you explain that a bit? What should we take away from your claim that “society influences

what we care about, but evolution has produced the fact that we care.”

A: For centuries scholars have been puzzled by the contrasts in behavior that you bring up. People are sometimes appallingly violent and at other times endearingly kind-hearted.

The traditional argument is that only one of these opposed tendencies can reflect human nature. If we are naturally competitive, as the 17th century political philosopher Thomas Hobbes argued, our cooperative tendencies must come from our growing up under pressure to behave better. But if we are naturally cooperative, as the 18th century political philosopher Jean-Jacques Rousseau thought, our aggressive tendencies must result from society having malign and corrupting effects.

Both our bad and our good sides are grounded in our human nature.

To Hobbes, we are a bad species improved by experience. For Rousseau, we are a good species made worse by experience.

Hobbes’ and Rousseau’s views have long seemed irreconcilable. The problem is that the behaviors they were concerned about have tended to be treated as if they lie along a single dimension, from bad to good. If humans are naturally “bad” (selfish, competitive, violent), so the argument has gone, they cannot also be naturally “good” (altruistic, cooperative, peaceful). And vice-versa.

So, scholars have had to choose. Are we nasty or nice? People are still writing books arguing which aspect of our behavior comes from our nature. The problem has long seemed insoluble.

In fact, however, there’s an easy solution. Contrary to conventional wisdom, both our bad and our good sides are grounded in our human nature. The paradox is solved by realizing that “nasty” and “nice” are not the opposites that they have long been assumed to be. Instead of lying at either end of a single scale of behavior, they represent points on two different scales of behavior. We are high on the proactive scale of aggression, and low on the reactive scale.

Q: I get the distinction between proactive and reactive aggression, but how does that tip the balance in “nasty” and “nice” terms?

A: The “nasty” side of us reflects humans’ strong tendency to use proactive aggression, which has also been called premeditated, or predatory. Like a few other animals, humans can plan to conduct vicious attacks on competitors. Proactive aggression is the predominant kind of violence both in hunting and war, for example, so it is responsible for a high proportion of human killings.

Our “nice” side, by contrast, reflects a different type of aggression called impulsive, defensive, or reactive. This is the kind of violence most often seen when it is fueled by alcohol or testosterone, when individuals lash out spontaneously at someone threatening them. Compared to most other species humans have an astonishingly low tendency to use reactive aggression. Episodes of physical reactive aggression occur hundreds of times less often in humans than in our closest relatives, chimpanzees or bonobos. We lose our tempers occasionally, but such events are so rare that they tend to be occasions for excited gossip.

So, we are naturally high on one scale of aggression, and naturally low on the other. That solution to the classic Hobbes-Rousseau debate is supported by much evidence that proactive and reactive aggression (respectively) are produced by different neural processes and have different genetic underpinnings, in humans as in other species.

Q: Well, that raises a fascinating question of its own: what led to our species having these contrasting tendencies for premeditated and reactive aggression? Why would evolution solve for this?

A: The persuasive answer that has emerged through recent research draws attention to some critical social dynamics with huge influences on the evolution of human nature.

The origins of our species, *Homo sapiens*, can be traced to about 300,000 years ago. Fossils show that, at that time, our ancestors began developing a lighter build, narrower faces, and smaller teeth than before. Such features would become increasingly exaggerated as time went on. And these changes marked the beginning of a unique trend. For the first time, our ancestors’ anatomy was changing in a way that indicates they were becoming less *reactively* aggressive.

Human societies are led by coalitions.

The reason we can associate those anatomical trends with a reduction in reactive aggression is that the changes seen in humans echo those also seen in domesticated animals. Breed a species like dogs or pigs for reduced reactive aggression, and their anatomy changes in much the same way as it did in *Homo sapiens*.

That remarkable finding gives extraordinary meaning to the anatomical changes that characterize *Homo sapiens*, because it reveals the origin of our species as a time when the tendency for reactive aggression was being reduced. But there is no equivalent evidence, on the other hand, for any change to our tendencies for proactive aggression. If anything, as we became *sapiens*, our ability and motivation to hunt, stalk and kill might actually have increased.

So why would reactive, but not proactive, aggression have declined? A critical clue comes from comparing male dominance hierarchies between humans and other primates. Compared to all other primates, our male dominance hierarchy is unique in a very particular way.

Human societies are led by coalitions. Primate societies are led by single individuals.

Q: So you’re saying that a reduced tendency towards reactive aggression supported collaboration?

A: In apes and monkeys the alpha male can bully anyone, but that’s not true for humans.

In small-scale societies such as hunter-gatherers, the situation is particularly clear. A leader depends on his allies. If he tries to bully them, he gets into trouble. He is gently reminded not to behave despotically. Normally he learns his lesson quickly.

But if he persists too long and too boldly, he will be corrected. At the extreme, if he doesn’t change his violent ways, he will be killed by those he was attempting to bully.

And this is the key: the ‘bullied’ learned to collaborate well enough to collectively kill a bully. Their skill at cooperating in premeditated, *proactive* aggression — long learned in hunts and in war — made these co-conspirators deadly. The procedure of dispatching a bully was undertaken in a safe and predictable way, leaving the victim no chance to fight back: a modern example would be a hit conducted by strangling a victim sitting helplessly in a car’s passenger seat.

This ability for a set of allies to control their leaders by killing them is characteristic of humans but it is absent in other primates.

Even chimpanzees, for all their relatively high intelligence, can’t manage this kind of collaboration.

There is an obvious reason: chimpanzees and other primates cannot talk. Words are needed to organize a plan as tricky as a safely coordinated execution. Without words, animals are stuck accepting a tyrannical alpha male who feels free to direct physical violence at anyone he chooses. The result is impressive: all adult male chimpanzees, other than the alpha, are regularly chased and pummeled.

Among humans, by contrast, resentful victims of a tyrannical alpha male can do something about it. Our language ability allows us to gossip and conspire. When the words of others leave us confident that we will be supported, we take action against the bully. As a result, leaders who tyrannize their own group are in danger. The reason that the head that wears the crown lies “uneasy,” in Shakespeare’s words, is not just that humans are very good at organizing to kill domineering tyrants. It is also that our ancestors have been doing it for around 12,000 generations. Fear of being killed for being a bully, and the determination not to be seen as a selfish loner, have been bred into human nature.

Human leaders
cannot survive
without supporters.

Until language changed everything, the most successful males had been the bullies who used their reactive aggression to rise to the top and stay there for as many years as they could. In the newly linguistic species, by contrast, the males who were most reactively aggressive were killed by their group-mates (who used proactive aggression to plan and carry out their attacks).

With the advent of sufficiently sophisticated language, in short, the ancient strategy of being a bullying alpha male no longer paid off. The direction of evolution changed towards a gentler, kinder, less aggressive, more cooperative male, albeit one still capable of using proactive aggression to kill, when sufficiently frustrated.

Sigmund Freud labeled the primate style of male hierarchy as one based on Might, compared to the human style being based on Right. For 300,000 years, then, humans have created a new kind of social world in which, at the top, Right has replaced Might. “Right” is the power of the community. “Might” is the power merely of a single individual, and it is no longer enough, even for a Stalin or a Hitler. Human leaders cannot survive without supporters. ►PAGE 421

The shift from Might to Right was a huge part of what gives human social groups their especially human quality.

Q: You discuss this in terms of “gene-culture” co-evolution. How should we understand the cultural element in this discussion? Is that more Hobbesian, Rousseauian, or something else altogether?

A: Well, perhaps a bit of both. This takes some explaining. Gene-culture coevolution is a process by which the introduction of a new “culture” (or style of behavior) leads, over many generations, to genetic changes and new evolutionary adaptations. Gene-

culture evolution seems to have played a major part in creating *Homo sapiens* out of our predecessor species, *Homo heidelbergensis*.

Here is a way to imagine what happened. The process would have been initiated when several *Homo heidelbergensis* males, frustrated by being physically assaulted and out-competed by the alpha male of their group, gossiped, conspired and removed him, as described above.

We can conjecture that, for the first score of more of generations, this procedure would have become a cultural tradition, related in tales around the campfire. Generation by generation, linguistically skilled hunters faced with a tyrant would be given an inherited formula for controlling him; and they would take action accordingly.

As the generations rolled by, those males who tried too persistently to dominate others were the losers. Being executed for bullying, they died young, leaving fewer offspring than others. Genes for domineering tendencies and highly reactive aggression therefore became less frequent, and the species became less reactively aggressive. The change allowed for more cooperation.

Over time, *Homo sapiens*' strange combination of tendencies became clearer. Premeditated aggression was still present, used in hunting, war and, when needed, to execute the antisocial bully. But reactive aggression was on the wane. And, so, a process that was initially dependent only on behavior came to change the very genetic constitution of the species.

The cultural tradition of executing excessive bullies made humans like a domesticated animal. A new formula came into operation: *Homo sapiens* was to previous species of *Homo* as a dog is to a wolf. The

The cultural tradition of executing excessive bullies made humans like a domesticated animal.

In the end, we became creatures who care immensely about belonging to our social group.

coevolution of genes and culture produced a species that would puzzle followers of Hobbes and Rousseau for centuries. It would confront us with endless social complexities, seen in the clash between leaders and their powerful subordinates.

Among the many consequences of this was a big increase in the need to conform. The single alphas that had previously dominated their social groups merely bullied: they could not kill. But now women, children and young men were all vulnerable to the domination not of a bullying alpha, but of an alliance with the power to kill. If the community of allies could safely kill an alpha male, they could equally well arrange to kill anyone.

Ethnographic accounts of small-scale societies, whether hunters and gatherers or farmers, are littered with stories of such executions. Many of the victims, who could be any age or sex, were dispatched for challenging the norms of their society. This is Hobbes' account in action.

But gene-culture coevolution was also responsible both for the relentless erosion of genes underlying the domineering behavior of would-be alphas, and for promoting genes underlying a positive commitment to the community. Those genetic trends changed the direction of our evolution. They made us more amenable and less threatening to each other: more Rousseauian.

In the end, we became creatures who care immensely about belonging to our social group, both in our own self-perception as well as in the perceptions of others. This ultimately flowed from a fear of the deadly consequences of being seen as a competitor, or an outsider. Gene-culture co-evolution made us intensely

communal and gave us social networks whose mix of competition and fearfulness would come to contribute much turbulence to our complex social lives.

Q: You take this “self-domestication” story pretty far, arguing that what we refer to as ‘morality’ in fact evolved from peer pressure to conform to group norms — or else! As you put it, “Our ancestors moral senses helped protect them from being killed for the crime of nonconformity.” Surely we’ve evolved beyond that. Haven’t we...?

A: Ever since Charles Darwin, morality has been a puzzle. Morality means behaving according to a sense of right and wrong, adhering to the dictates of one’s internal conscience. No other species is known to behave morally in the sense of having a conscience, but conscience-based morality is a critical feature of all human societies. What made humans different from other animals?

Until Darwin persuaded the world that humans had evolved without the action of a divine hand, the question of why humans are moral could be referred to God. But, after Darwin, the question became a thorn in the evolutionists’ flesh.

The benefits of morality are clear: moral individuals help each other so predictably that on average, everyone in a moral group tends to benefit. But there is a problem. Why does everyone tend to help each other, given that failing to help would seem to be a winning strategy? Individuals could benefit from the kindnesses of their selflessly moral peers, for example, while themselves remaining selfishly immoral. Economists refer to this as the “free-rider” problem. Accept donations of food, but never contribute yourself.

Conscience-based morality is a critical feature of all human societies.

Conforming socially is a survival strategy.

Gene-culture coevolution has left us as individuals who readily criticize non-conformists.

Why don’t we all behave like that? The problem is so severe that, for most theorists, including Darwin himself, the evolution of morality has long been inexplicable.

But once we appreciate the power of Right over Might in the evolution of society, the same logic that explains how humans lost their reactive aggressiveness readily explains how we gained our morality. The alliance of adult males who discovered that they could control a despot by collaborating to kill him became all-powerful. Call them the ‘alpha alliance.’ By relying on each other’s support, the alpha alliance could impose the shared wishes of its members on everyone.

Suppose, for instance, the alpha alliance decided that they would be better off if everyone in their group respected one another’s possessions: no petty stealing. The alpha alliance could impose this decision on everyone else by creating a simple system of law: thieves will be punished; insistent thieves will be killed. Rules imposed by the alpha alliance, such as a rule against theft, could benefit the group as a whole, in which case almost everyone would be happy.

But the power of the alpha alliance could also be used for more selfish ends. Patriarchal rules such as “women’s sexual behavior must conform to the desires of senior males,” or domineering rules like “women and children are not allowed to eat the best parts of animal prey,” would suit the men in the alpha alliance more than others.

These kinds of rules would vary from group to group, of course: children learn the rules particular to their society. But, thanks to gene-culture coevolution, the motivation to learn society’s rules does not itself have to be learned.

The desire to copy elders is found among children all around the world. It is part of human nature, instilled by 300,000 years of selection against cultural rebels.

The main reason that children readily copy the behavior of their elders was once thought to be learning critical skills, like the right diet and how to stay warm at night. But the desire to conform socially now seems even more important. Conforming socially is a survival strategy: rule-challengers and rule-breakers could all too easily end up dead. Morality might feel pure and cooperative. In many ways it is. But it has a dark side that comes from a time when those who were immoral were less likely to pass on their genes, because they would have been killed for the crime of non-conformity.

Gene-culture coevolution has left us as individuals who readily criticize non-conformists, and who are rightly fearful of being identified as a non-conformist. When we signal our social virtue by being kinder to others than any less moral species would be, we are playing out tendencies that were favored during our evolution due to the fear of the alpha alliance's power. We are moral, it seems, because the failure to be moral carried the risk of paying the ultimate cost.

Q: Our readers will be interested in your thoughts on how all of this plays out in the workplace. You write about the importance of trust and belonging and describe how the fear of ostracism produces a coercive dynamic when it comes to our behavioral proclivities. Does the proverbial “tone from the top” shape organizational behavior, do you think, or is it peer pressure that’s most compelling?

A: Given that today’s workplaces have no capital punishment, my emphasis on the importance of executions might lead you to think that the

evolutionary dynamic described above is largely irrelevant to contemporary social organization. But that idea would be wrong.

Although execution is increasingly confined to the past, its long practice has produced a species in which the need to belong is a hugely important driver.

Although execution is increasingly confined to the past, its long practice has produced a species in which the need to belong is a hugely important driver.

All around the world, for example, people who have been brought up in small-scale society fit awkwardly into capitalist work-places.

Such workers in Asia, Africa and South America, having witnessed or experienced the pain of social rejection, often refuse to be promoted above their peers: their

need to belong overcomes their desire for material benefits. Such fear makes sense, because those who are perceived as being too selfish can face real consequences from their fellow workers. But it can frustrate managers with a Western ethos, of course, who are surprised when higher wages are less motivating than being accepted by one’s peers.

Managers will forever have to take the need to belong into account.

Workers’ desire for social acceptance can thus come into conflict with a company’s goals. This happens routinely in any organization. It has long been recognized that individuals who deviate from a group’s norms tend to be marginalized and ostracized, and that as a result, they

often change their own values or perceptions in order to conform to the majority opinion. For example, people sometimes “play dumb” as a way to increase their acceptance by peers who are less technically skilled. The result can be a lowering of achievement by their workgroup.

A similar process leads to ‘groupthink,’ which occurs when individuals fail to discuss a problem as openly as they should, resulting in a bad decision that is more strongly influenced by social factors than it should be. These cases can reflect such a desire

to be accepted that people support decisions that they don't personally agree with. The origins of such groupthink lie in the very real ability of groups to coerce individuals perceived as deviant, and in a human psyche that has been prepared by evolution to be highly sensitive to signs of social rejection.

The importance of showing loyalty to a workgroup can lead to other kinds of unhelpful behavior beyond sacrificing efficiency. One way to boost one's standing with one's group is to derogate other groups, with obvious possibilities for reduced cooperation or rejection of useful ideas.

The human concern to be accepted by one's peers has long been recognized by social psychologists as a key motivator in life in general. Its effects on the relative importance of "tone from the top" or peer pressure in shaping behavior in the workplace will depend on many aspects of the design and management of the organization.

What is increasingly clear, however, regardless of the specific context, is why the need to belong is so influential. It has been bred into us by our evolutionary history in a way that for many generations has made our response to it into a matter of life and death. It is not surprising, then, that managers will forever have to take the need to belong into account, if they are to successfully juggle their workers' deep psychological needs with their company's goals.

Richard Wrangham is the Ruth B. Moore Research Professor of Biological Anthropology (retired) at Harvard University and founded the Kibale Chimpanzee Project in 1987. He has authored several books, most recently [The Goodness Paradox: The Strange Relationship Between Virtue and Violence in Human Evolution](#). His research focuses on primate ecology, nutrition, and social behavior.



The Academy

An Interview with Paul Seabright



Paul Seabright



Q: Published 20 years ago this year, *The Company of Strangers* chronicles the evolution of a uniquely human ability to trust in and collaborate with strangers. “Nowhere else in nature do unrelated members of the same species — genetic rivals incited by instinct and history to fight one another — cooperate on projects of such complexity and

requiring such a high degree of mutual trust as human beings do,” you wrote back then. This is territory where one typically finds evolutionary anthropologists at work, yet you’re an economist. What triggered this line of inquiry for you?

A: A fortuitous meeting of two ideas, really. First, I was struck by how often I would talk to economists and sociologists and political scientists and realize each of them had a theory about the fundamental nature of human beings without ever having asked whether the empirical evidence backed them up.

Economists would say, “I know people don’t care only about material benefits but it’s a good working hypothesis to start with...” Political scientists would say, “I know people don’t care only about power but...” Sociologists would say, “I know people don’t care only about social norms, but...” And so on. But there’s now a mass of empirical evidence about this — we don’t have to stay stuck in armchair philosophizing!

The second thing that triggered the book was the desire to explain to my kids what I do for a living. They had schoolfriends who were studying economics because it was useful — usually under pressure from their parents. They knew me well enough to realize I wouldn’t spend my life doing something for a living just because it was useful. But they still couldn’t quite see how economics could be fun, let alone inspiring. So, I set out to show them.

Q: Describing effective, collaborative groups, you emphasize the principle of reciprocity and highlight a distinction between trust and liking. You also observe that “trust between any two people rests on a web of trust between each of them and the others with whom they also deal.” Can you illustrate this for us?

A: Yes! A couple of days ago I sold my car, on a website run by a firm I hadn’t previously heard of. I would never normally have gone to a stranger and handed over my car in the expectation of getting cash in my bank account a couple of days later.

What persuaded me was the whole infrastructure — the web of trust — established by the site, the fact that it was recommended by my local car dealer from whom I’d originally bought the car, and by good press reports and online ratings.

But — and here’s the paradox — I was much more comfortable doing so because the person I saw took real trouble to explain to me the thinking behind how they functioned and how they made their price offers. And he did so in a way that was both reassuring (in a definable way) and also charming (in an indefinable way).

I trusted him because it made sense that he would not have an interest to cheat me, but also because he was trusted by others, and because I liked him. So, my heart and my head were both engaged, in a way that would not have been possible with only one or the other.

Q: You describe the formal and informal institutions that underpin markets as operating to make trust among strangers possible. Can you explain this, with a view to cause and consequence?

A: Like all group-living primates, human beings respond to explicit threats and promises in their social environments, but also to signals of esteem. People will do wonderful and terrible things to achieve the esteem of others. You can make people work for peanuts if they're sure of your esteem, but you can't use that knowledge to exploit them, as nothing destroys their sense of esteem faster than their feeling that you've taken them for fools.

Paradoxically that's why people often seem to care more about financial incentives than makes sense, like employees worrying about minor pay differentials with their colleagues, or CEOs negotiating pay packages for vast sums they will never be able to spend. When I ran a research institute, I was astonished how much importance some of my colleagues attached to small differences in the relative size of offices.

Similarly, in market transactions, people will go the extra mile to provide excellent and reliable service in a setting where they sense the respect of others. The truly scarce resource is esteem, and you can't buy that, at least not in the market.

Q: You argue that "most individuals cannot survive outside a working environment," and note that, in the US at least, only a tiny fraction (about 0.5%) of companies have more than 100 employees, and yet they employ some 60 percent of all workers. How do you view these ideas about trust in the context of these large workplaces, particularly given the emphasis on teams in most management thinking?

A: The institutions of modern capitalist society are widely caricatured as privileging ruthless competition between individuals over all other values. But the truth is that most people work in teams. And they spend

much more time each day with their collaborators than with their rivals. Sure, you still need trust between team-mates. You also need to work out how to build teams, and how to induce people to join each team. But it's a more complex and a more hopeful exercise to build it than merely looking to build trust between people who are purely rivals, let alone enemies.

Trust within a team becomes harder to build as the team grows, as Robin Dunbar has repeatedly emphasized ▶**SEE ROBIN DUNBAR ON STARLING INSIGHTS.** But so many of the processes of modern life yield rewards to scale that we need to find ways to scale trust in order to match these opportunities.

Large teams (armies, corporations, nation states) often manage to nest smaller units within larger ones, so that people project the illusion of small-scale cooperation onto the larger scale. Soldiers, for example, have to be motivated to risk their lives for their country. But in practice they mostly say they do so for their buddies. ▶**PAGE 141**

One of the biggest challenges for cooperation within teams is not so much the classic free-rider problem. It's the fact that your team-mates on one project may be your rivals in some other dimension — for a promotion, say. And you may discover that someone you thought could be a partner has no interest in this — as the West has discovered with Vladimir Putin, for example. Still, in most working environments, we don't face the challenges of the outside world alone — even if sometimes we need to be reminded of this.

Q: This report is principally concerned with the governance and supervision of cultural and behavioral risks that may undermine desired organizational and institutional outcomes. In *The Company of Strangers*, you explain that human beings evolved to construct "social rules" for behavior, and you describe institutions as "sets of rules for social behavior, both formal and informal." How do such 'social rules' drive behavior within

an organizational context, and how might this idea inform effective governance and supervision?

A: People will make much bigger sacrifices for the esteem of others than for mere money. But sometimes, sadly, they only believe that others esteem them if those others are prepared to pay them a lot of money. There would be much less wasteful consumption in the world if we had credible tokens of the esteem of others that could replace private jets and gas-swallowing cars.

Effective management often works by reassuring members of an organization that they're respected by their colleagues. It also needs to show them clearly what they need to do to transform mere *respect*, which is a baseline requirement for people to feel comfortable in a group, into *esteem*, which is what people need to feel not only comfortable but positively happy. I think of social rules as descriptions of how appropriate behavior will be rewarded by both respect *and* esteem.

An organization that can deploy social rules effectively doesn't necessarily need to throw a lot of money at its employees to encourage desired behavior. But the rules themselves must signal the very respect they seek to elicit. If, for example, managers promulgate rules by which they themselves do not even try to abide, they undermine the credibility of the managers' claim that they are treating their employees with respect.

Q: You discuss the broad extension of social and institutional trust as having formed the basis of the peace and prosperity we've achieved as a species. And yet you describe this trust infrastructure as fragile and warn, "When the whole structure of a modern society rests on such a foundation, it is not surprising that the collapse of trust that can follow a banking scandal, a political upheaval, or the exposure of corruption among trusted public

figures can take on the dimensions of a major social earthquake." In the US, we have seen prominent examples of all three in the last year. Your thoughts?

A: There are almost too many examples to cite, though all three types of scandal have many precedents, so you might wonder why this time should feel any scarier than previous times, like the 1930s.

One reason may be that, in the feverish atmosphere stoked by social media, many people spend their days in a state of permanent anger, longing to find a way to upset and hurt others whom they dislike, resent or despise. In a well-ordered society it's costly for them to do that. But Donald Trump and other influential public figures have given them an easy way to indulge that anger.

People will make much bigger sacrifices for the esteem of others than for mere money.

If you think the chaos that he will cause may not harm you personally, then why not indulge in the pleasure of voting for him, if that will really upset a number of people you resent and despise? In that atmosphere,

the traditional social imperative of contributing to social trust by behaving well, so as not to cause hurt to others, becomes unimportant. Your priority instead is to indulge the guilty pleasure of undermining what social trust already exists. ▶ **PAGE 421**

In the first case, a scandal makes you wonder whom you can really believe. In the second case, the scandal legitimates your wish to destroy what you see as hypocritical appeals to trust by authority figures you have long resented. These two types of scandal can have quite different impacts on social trust — causing apathy and disengagement in the first case, and active sabotage in the second. Organizations facing crises of trust need to figure out which of these situations applies to them. ▶ **PAGE 437**

Q: The sudden failure of a number of banks last spring called to mind the central argument of your 2011 *Foreign Policy* article, “*The Maginot Line*.” Coming on the heels of the Financial Crisis, you argued then that, “the intellectual and political architects of the system that failed us were not naive at all but immensely clever and subtle.” You went on to claim that it was precisely this that undid them.

A: My suggestion was that the more sophisticated the analysis by regulators of the causes of previous bank crises, the more they lulled everyone (including themselves) into a false sense of security about future crises.

It was not that (as Michael Gove absurdly claimed in 2016) “the...public has had enough of experts”. It was, rather, that everyone — public and experts included — had come to rely on experts to do all the heavy lifting in evaluating investment risk. The cleverer the regulators seemed to be, the more everyone trusted them, and therefore the less aware we all were of the dangers that investment systems, even the best-regulated, will always pose.

Similar points apply to crises in other areas. The Covid pandemic has now receded into the past as far as many members of the public are concerned, and more worryingly as far as many policymakers are concerned. Public agencies remain woefully under-prepared for future pandemics which might be much nastier than Covid (imagine, for example, a virus no deadlier than Covid on average, but which killed children at the same rate as Covid killed the very elderly).

Q: You also argued that the regulatory and supervisory infrastructure of the day “failed at its strongest not its weakest point.” What did you mean at the time, and what does that suggest for those thinking about whether and how our regulatory and supervisory regimes may need bolstering after the banking sector turmoil we experienced last spring?

A: The analogy I developed in that article was with the German breakthrough of the Maginot Line, in May 1940. This occurred not at the line’s weakest point, but at Fort Eben-Emael, its strongest point — which was therefore where an attack was least expected.

The bank runs we saw in 2008 were the consequence of a previous, highly sophisticated consensus that retail, not professional investors, were the greatest threat to the system — which in turn left us utterly unprepared for risks posed by the newly expanding shadow banking system.

The collapse of Silicon Valley Bank last year had a wholly different cause, but in a similar way it was related to the fact that, in learning from previous crises, the macroeconomic and financial authorities had seduced themselves into believing that they would work together to ensure macro policy in a way that would never lead to banking system weakness. This was actually true — until, suddenly, it wasn’t.

And that’s before we even get into crypto, which would surely never have led to the disaster of FTX if there had not been an insatiable demand for narratives about incredibly clever tech entrepreneurs who would fix the weaknesses in the existing financial system...

Q: Let’s turn to your newest book, *The Divine Economy*, which was just released. “Religion is about belief and about belonging,” you argue, and you describe religions as “platforms” that facilitate the creation of communities of members who join to pursue a mix of individual and joint aspirations. You open with the story of a poor Ghanaian girl who gives much of her small income to a wealthy pastor, in exchange for the belongingness she feels as part of that church community. Why is belonging so valuable?

A: I talk in the book about the biblical insight, from a sermon of St. Paul preached at Ephesus, that “it is more blessed to give than to receive”.

I suggest that this should be understood not as an exhortation to do something that doesn't come naturally to us, but instead, "it's better understood as a profound insight into the nature of human fulfilment — we are more truly ourselves when we give to others than when we are the passive recipients of their benevolence".

There's evidence from forager-horticulturalists in the Bolivian Amazon that the strongest predictor of depression and anxiety, after physical ill-health, is the inability to give to others — not the inability to receive, but the inability to give. We're a profoundly social species. Giving to others is a deep part of who we are. Take that away from us and we're miserable, just as miserable as if we're deprived of food, or sex, or love.

Many religious movements understand that very well, and have accumulated enormous economic power as a result, as my book documents in detail. But the converse is also true: many economic enterprises also flourish through tapping into the need among their employees not only to belong but also to give deeply of their time, energy and resources.

Q: You also argue that religions compete for people's time, attention, and money in much the same way as businesses and politicians do, writing that "religions, in short, are businesses." Is the reverse true? Can businesses be compared with religions, understood as competing in the market for the 'faithful' — among customers, employees and investors? Should the erosion of trust in business that we've seen in recent years be viewed as 'a crisis of faith' in the market, or at least in its 'high priests' and principal 'temples'?

A: Many people point out to me that religions are never "just" businesses. They're right — but most secular businesses are not "just" businesses either. They need to inspire employees, motivate them to go

the extra mile, give them a narrative about how this work makes sense for them and for their lives, and provide comforting rituals that help to convince them that they belong. They need to build trust — and, yes, they can and often do exploit that trust. Like some of those that look after your life savings, for example...

Q: You argue that successful religious institutions leave their members feeling "special," observing that, with this comes a fear of ostracism that often leads to a sense of vulnerability and a readiness to do whatever it takes to maintain community belonging. This, in turn, implies opportunity for abuse. How do you see this playing out in "toxic workplaces" where employees complain of bullying, harassment, or worse?

A: The film-maker Judith Godrèche went public in February 2024 with accusations that she had been groomed and abused by Benoît Jacquot while she was a child actor. She explained how he had been able to work his way into her confidence by posing as her "protector", in an industry notorious for its ill-treatment of actors, especially young ones.

You might have thought that the most subtle abusers would seek to lower the guard of their victims, by reassuring them that the world is a kind place and therefore they can afford to be trusting. In fact, abusers typically do the exact opposite: they tell their victims that the world is an incredibly dangerous and evil place, and therefore only they — the abusers — are to be trusted. This illustrates something pervasive about trust and abuse.

It's precisely the people that protect us from abuses by others who leave us most vulnerable to abuse at their own hands. After all, in protecting us, they come to have an intimate understanding of our weaknesses. I'm not suggesting they always or often exploit that understanding for abusive purposes. But the temptation is there.

The strongest predictor of depression and anxiety, after physical ill-health, is the inability to give to others.

This explains why abuse in the workplace can easily snowball. A toxic workplace culture creates a demand for protection, and those who supply that protection, even if they begin with noble motives, come to be exposed in turn to an awareness of how easy it might be to exploit the weakness of those they are protecting.

It also explains why it's a myth to think that certain people are "born victims". If you've been a victim once, you have an entirely reasonable need for help. And your helpers are, statistically, the people most likely to make a victim of you again. It illustrates how careful organizations must be when they are trying to act to clean up a culture of abuse.

It's not enough to raise awareness — it's essential to ensure that the victims who need help are not placed in a situation of enhanced vulnerability by the very system that encourages them to speak out. In particular, an entirely understandable wish to act discreetly so as to protect victims can lead to victims becoming dangerously dependent on those few people who are really aware of what has happened.

Q: In closing, let me return to the *Company of Strangers* where you write that "large numbers of people tend under many conditions to behave in much more regular ways than do any particular individuals of which such crowds are composed," adding that "it is the sheer number of us that makes our behavior predictable." Can we anticipate the behavioral tendencies within groups of people, with a view to predicting the performance outcomes such groups are likely to

experience? How might this help us to penetrate the "cultures of secrecy" or "cultures of silence" that you write about in *The Divine Economy*? And how might these ideas inform those concerned with the governance and supervision of such risks?

A: Organizational crises tend to provoke a sense among those involved that their case is quite special, and not like anything that has happened anywhere else. This is a mistake.

It's precisely the people that protect us from abuses by others who leave us most vulnerable to abuse at their own hands.

Reading the literature on abuse in religious organizations has made me very aware how depressingly repetitive are the patterns of abuse we see everywhere. Cultures of secrecy (where some people have information that others don't) and cultures of silence (where everyone knows what is happening, but it is taboo to talk about it) are damaging in very similar ways across a vast range of organizations in a wide variety of sectors.

Leaders who are serious about improving the culture of the organizations they work in need to take a hard look at what has been happening in organizations elsewhere, even ones they would never have considered to be relevant examples.

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The Academy

Network Structure, Culture & the Division of Labor

By: EMILY ERIKSON



Emily Erikson

Yale

Adam Smith was so captivated by the division of labor that he allegedly fell into a Glaswegian tanning pit while describing its properties to a friend, Charles Townshend. While describing how tasks were split up between laborers in the tannery, Smith reportedly walked straight off a plank suspended above a foul mixture of fat and lime. Luckily for us, he survived the fall

to continue his exploration of the idea, and that of morality in human relationships. When he published his great work of political economy, *An Inquiry into the Nature and Causes of the Wealth of Nations*, the core idea, and the answer to the puzzle posed in its title, was the relationship between the division of labor, productivity, and wealth.

For Smith, the idea of the division of labor was endlessly fascinating because it creates an unintended but remarkably beneficial side-effect of human interactions. Individuals and nations did not trade with each other to benefit society or their fellow human being, but to benefit themselves. And yet, the division of labor helps everyone. The division of labor remains a primary engine of economic growth

and central to firm productivity. So it is important to ask, *do we have to rely entirely upon an invisible hand to bring it about?*

My research on organizational and social networks explores this question. Using computational models and historical records, I have sought to understand the benefits of balancing centralized and decentralized control, and I have explored this tradeoff in a variety of contexts, some from different centuries.

My first book, *Between Monopoly and Free Trade*, considered the balance between centralized control of the firm and the strong decentralized control exerted by the captains of the East Indiamen vessels that carried Europe's trade to the East. I found that the strong autonomy of the ships' captains aided the firm — both by increasing its flexibility while also promoting a robust channel of communication between captains. The partial surrender of centralized control made the firm a powerhouse over the long term.

In my second book, *Trade and Nation*, I discuss how merchant efforts to control the state — that is, an attempt by decentralized actors to influence a centralized system — led them to formulate new economic ideas that ultimately grew into classical economic thought.

In each case, I found that a delicate balance between decentralization and centralization fostered productivity, growth, and innovation. Neither complete centralization, nor complete decentralization, would have had yielded the same effect.

The Ins and Outs of Coordination

Smith conceptualized the division of labor as a problem of decentralization — the original '[emergent effect](#)' — a mysterious, heavenly harmony produced as if "led by an invisible hand." Smith was concerned with this in the macroeconomic context of course, but

we also see a managed approach to the process of dividing labor and creating teams in organizations and firms. So we might ask whether a balance between decentralized and centralized control might be struck here as well?

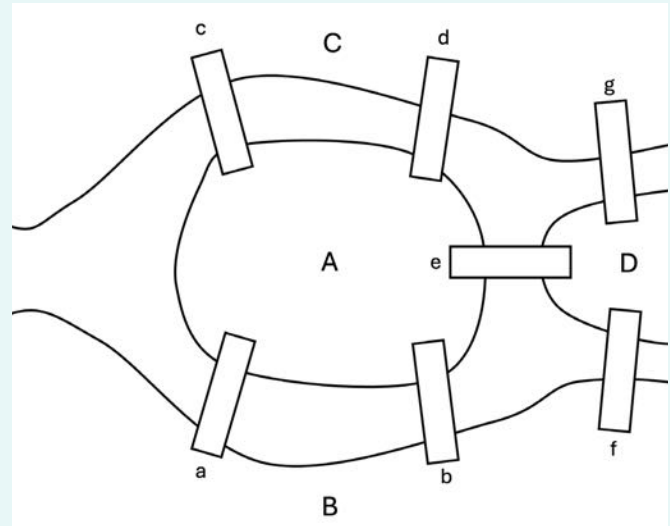
The division of labor is a very particular problem because the individuals — and the skills and talents they bring to the group — should be complementary. Each person brings a necessary skill to solving the problem at hand. Take for example, the process that captivated Smith. Tanners usually split the complicated process of producing leather into five separate tasks: pre-tanning, tanning, selecting, dressing, and finishing. Quality leather requires expertise in all of the stages of the production process — not just one stage and not even four of the stages will suffice for a finished product. Similarly, you need all the parts of a car for it to work properly. There is no leaving out the brakes or the ignition and scraping by.

You might think of the process in terms of a potluck dinner. If a group of friends get together for dinner and everyone brings a dessert, this will not be a successful get together. Or imagine that everyone brings a salad, but no one brings a main course. A proper meal won't come together unless all the important bases are covered. This coordination problem can be difficult to solve without some direction; for example, one person to assign dishes.

The difficulties involved in spontaneously solving such coordination problems may be why a division of labor often takes place in companies. In this context, managers may be able to find the right mix of skills, but there can be drawbacks to centralized control of the process: team chemistry is hard to predict; needs shift rapidly; different types of expertise are needed to succeed and teams often have a better grasp on what's needed than do managers.

Ideally, teams will combine diverse perspectives, competencies, and skills. But in a complex workplace, how can managers make it easier for teams to

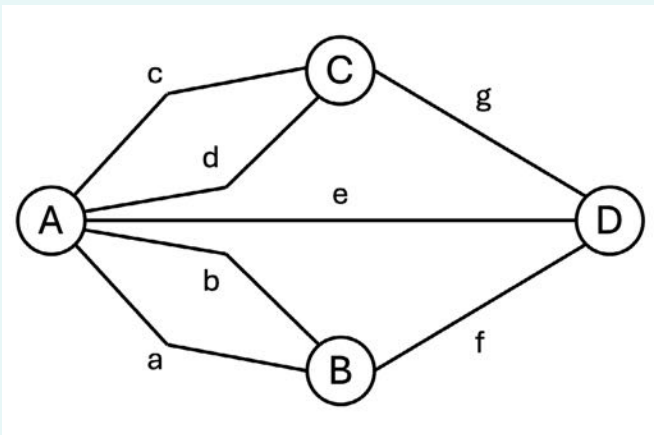
assemble the right mix of people? The answer can be summarized through two important concepts: networks and culture. But before diving into more specifics, let me start a short, possibly familiar, story to illustrate the source of these insights.



Königsberg Bridges Schematic

The river Pregel cuts through the picturesque city of Kaliningrad, Russia. The Pregel splits into two on the western side of the city and reconnects via a channel before the Old Pregel permanently heads into the southern reaches of the outlying areas. Before two world wars and a series of territorial reconfigurations, seven bridges once linked the divided areas of the city center. Back then, the city was called Königsberg, and its people had an old challenge they liked to pose to visitors and one another: can you walk across all of the city's bridges without crossing any of them more than once?

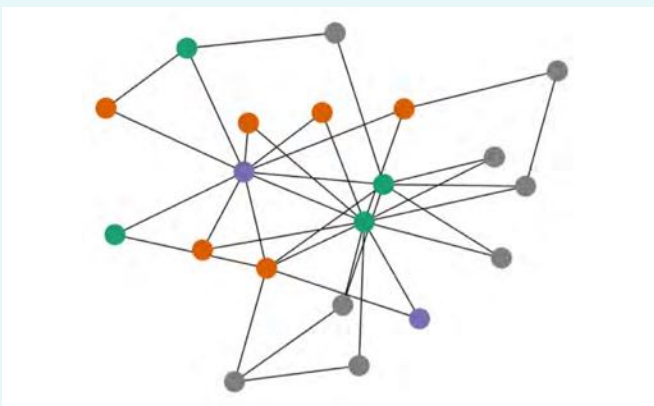
Famously, Leonard Euler solved the puzzle and, in so doing, invented graph theory. Euler put an end to the discussions by treating the different bodies of land as points on a graph ('nodes' in graph theory lingo) and the bridges as arcs connecting the points ('edges'). This simplified the problem well enough for him to prove convincingly (and mathematically) that it was a physical impossibility for someone traveling by land to visit all the different areas of Königsberg without crossing some bridge more than once.



Königsberg Bridges Graph Theory

Similarly, the small-world model — or “six degrees of separation” — helped us to understand why the world can feel both small and big at the same time. Taking this same approach, we can use graph theory to simplify and explore the problem of the division of labor.

The division of labor problem maps very well onto a graph theory game that uses colors to distinguish nodes, called “the map-coloring game.” It mattered to mapmakers and to graph theorists alike. When we look at a map of countries, we want to be able to distinguish them countries from each other easily, so each should ideally be rendered in a color different from that of each of its contiguous neighbors. A budget-conscious printer would want to know how many colors are necessary to satisfy this requirement.



Color Node Game

Graph theory treats each nation as a node connected to its neighbors and makes it much easier to solve this problem than just trying out different colors. In the map coloring game, nodes (countries) must be differently colored than all neighbors to achieve complementarity. But the division of labor involves a slightly different process.

Here, nodes must also be complementary — connected to all the other colors. So, if there are red, blue, and green nodes, a red node needs to be connected to a blue and a green node to successfully solve the division of labor. Or to illustrate differently with our potluck meal, a person bringing wine needs to be connected to a person with cheese and a person with bread for a perfect Parisian picnic. This illustration allows us to draw a few important lessons.

Culture Complementarity & Complexity

The first has to do with culture. Culture is often used to refer to the goals and values embraced by an organization. And many leaders try to foster cultures of respect, inclusivity, and excellence in their organizations. But this is not the kind of culture that I mean here.

Culture also provides the categories, or ‘lenses,’ through which we perceive the world. For example, Inuit language famously has many more words for describing snow than does English. And several languages do not distinguish between the colors blue and green. These are basic categorical schemes that can vary from culture to culture and shape our experience of the world. These categorization schemes matter: Linnaeus proposed a new system of categorizing organisms that changed our understanding of the relationship between species.

The graph model of the division of labor demonstrates very clearly that the categorization scheme used to describe roles, tasks, or skills matters quite a lot to people's ability to solve the division of labor problem without central coordination — and, indeed, the categorization scheme one chooses can make the problem more difficult for a central coordinator as well.

Lesson 1: The more specializations, the harder the coordination problem.

The more roles, i.e. specializations, that exist, the harder it is for people to complete their teams. The more specializations there are, the more connections you need in order to find all of the people with those different specializations, and the less likely you are to be directly connected to them all. Teams will also have to be larger and they will be harder to staff.

This finding suggests that there is an unexplored balance between the gains to specialization in a division of labor and difficulty in matching people with complementary specializations. It follows from this that a company culture which provides a consistent way of splitting tasks and expertise into a reasonably small number of categories will make it much easier for people to compose successful teams. This returns us to network considerations.

Network Niceties & Nuisances

Social networks have an outside impact on social life. We use networks to get jobs. They channel information, trust, reputation, and direct the flow of formal and informal resources. And we know that highly clustered networks with a small number of random connections are great at spreading things that are easily transmissible, like gossip — or, worse — viruses.

But we also now know that some things which are harder to transmit — influence, beliefs, and normative

behavioral commitments — spread more rapidly in a different kind of network environment than do those which facilitate the swift spread of simple information. People don't usually change their strongly-held beliefs unless a lot of their other friends also feel the same. So, a Democrat in a blue state is unlikely to become more conservative, but a Democrat who moves to a red state may experience a rightwards shift in their thinking.

The question I have been working on, therefore, is not just whether networks affect the flow of information, but whether they also affect our ability to cooperate. If different network structures produce different effects, then we can ask what type of network structure best facilitates the division of labor?

Random connections are easy to add to a social network. Randomly reassigning a small number of people to new offices or desks can achieve it. People will retain relationships with those beside whom they used to work, and will also form new connections with their new neighbors. We know that adding random connections like this will increase the rate at which information travels throughout a network. But we have also found that randomizing relationships in this way does *not* help people to coordinate a successful division of labor.

To the contrary, we have observed that random connections *disrupt* the stable patterns that people used to orient themselves to other potential partners or team members. Unexpected new connections, to new people and their new skill-sets, creates more choices. And these additional choices can make it harder to find the optimal situation for all teams. People in this situation can get lost in a thicket of possibilities, and choosing a suboptimal outcome is easier in such circumstances than is the case in situations characterized by more constraint.

Adding random connections is a little bit like taking off the guard-rails. And this can make the process of coordination harder rather than easier.

In social network research, some networks are called ‘preferential attachment networks.’ These are characterized by a high degree of inequality, in the sense that a small number of nodes have a super high rate of connections to others (i.e., they are ‘highly embedded’), while most nodes have fairly low rates of connection (i.e., they are not well embedded).

This model captures a lot of existing networks: the network formerly known as Twitter, for instance, or the Instagram network. Christian Ronaldo has 627 million followers on Instagram. His closest rival, in soccer, life, and social media, is Lionel Messi, who has 502 million followers. I also have an Instagram account, but I don’t use it. I have 146 followers. 146 is pretty low, but not that different from an average user. On Instagram, and many other networks, a very small number of people have a tremendously large following, while a very large number of other people have far fewer connections.

This type of network structure does not help us to solve the division of labor problem. When people have a lot of connections, they are likely to get lost in the thicket of possibilities that make solving the division of labor problem more difficult. Conversely, those with too few connections are often insufficiently well connected to link up a team adequately equipped with all the specializations necessary for a particular task — or a potluck dinner.

The greater the inequality in the network — that is, the more extreme the difference between the number of connections a well-connected person has to those of an average person — the harder it is to solve the division of labor problem. And the more extreme the difference in such connectedness, the lower the rate at which successful teams are formed. Conversely,

more equally distributed network embeddedness facilitates the self-organization tasks that one often encounters in division of labor problems.

Conclusion

Though it has fallen a little out of popularity, the division of labor remains an important problem. Complementarity is the essence of the benefits of teamwork and requires a special kind of cooperation.

It matters for firms, teams, and across global value chains.

There are important cultural and structural dimensions to the division of labor problem that even Adam Smith had not understood nor explored. Understanding these

dimensions of the larger coordination challenges involved can help to guide and strengthen the emergent process to which Smith called our attention.

By using our newly achieved understandings of network structure and culture, we can create environments that encourage the creation of effective and diversified teams. The “invisible hand” can be tipped to make specialized cooperation easier for everyone to achieve.

Lesson 3: Equal degrees of network embeddedness make self-organization tasks easier.

Emily Erikson is the Joseph C. Fox Academic Director of the Fox International Fellowship and a Professor of Sociology and the School of Management (by courtesy). She has authored several books, most recently [Trade and Nation: How Companies and Politics Reshaped Economic](#).



The Academy

Nero-Moments: How Collapse of Social Trust leads to State Breakdown

By: PETER TURCHIN



Peter Turchin

Complexity Science*Hub

trust in the state's institutions undermines its ability to keep internal peace and order.

As the legitimacy of our institutions wanes, the stability of our society becomes increasingly tenuous. However, as our historical research shows, people typically fail to recognize that their society might suddenly crumble around them. As I argue in my recent book, *End Times*, complex human societies, including our own, are fragile. They are held together by an invisible web of mutual trust and social cooperation. This web can fray easily, resulting in growing social dysfunction and, in worst cases, state collapse.

Public trust in the US federal government has sunk to a new low. According to Pew Research Center, the proportion of Americans, who said they trusted the government "just about always" or "most of the time," declined from a peak of 77% in 1964 to just 16% in 2023.¹ This negative trend has huge implications, because the collapse of

Complex human societies are held together by an invisible web of mutual trust.

What I'd like to do in this article is to illustrate this general and somewhat abstract idea with several historical examples.²

Nero Wakes-Up Alone

On a summer night in AD 68, Nero Claudius Caesar Augustus Germanicus, ruler of the Roman Empire, woke up in his imperial palace in Rome and found that all his guardsmen had disappeared. Nero went looking for his supporters in their palace apartments, but they all were gone. When he returned to his bedroom, Nero discovered that the rest of his servants had fled as well, "taking with them even the bed-clothing and the box of poison," as is related in his biography by Suetonius. Nero realized that it was time to end his life but, alas, his fleeing servants had stolen the poison that would have allowed him to do so painlessly.



States die in a great variety of ways. Some go out in an explosion of violence; others unravel quietly and die with a whimper. The Julio-Claudian dynasty, which had ruled Rome from 27 BC to 68 A.D., ended with Nero muttering, "What an artist dies in me."

Public intellectuals, politicians, and, well, people in general commonly and severely overestimate the power of rulers. This is reflected in commonly used language, such as "Saddam Hussein gassed his own people." Did Hussein fly the bomber plane and throw gas canisters on the Kurdish villages himself?³ Of course not.

At best this is lazy language, at worst it is bad sociology, which can lead to mistaken policy when politicians obsess about the motivations of a single individual rather than seeking to understand

the power-networks within which any ruler is necessarily embedded. As Nero's example shows, the emperor of a mighty empire is a nonentity as soon as he is abandoned by those who make up his power-network.

In Nero's case, his power decayed by stages. First, there were rebellions in far off provinces, such as Palestine, and then in those closer to home, like Gallia and Spain. Legions in Germania had attempted to proclaim their commander emperor, though he refused the job. But when another pretender arose in Spain, Nero's personal Pretorian guards switched their allegiance to the Spanish usurper. Nero attempted to flee to safety in his eastern provinces, but military officers refused to obey his orders. Suetonius reports that, when Nero asked to use a military ship to make his escape, they replied with a line from Virgil's *Aeneid*, hinting less than subtly that it was time for Nero to bow out gracefully: "Is it so dreadful a thing then to die?"

And, so, Nero returned to his palace, only to wake up in the middle of the night to find that he had been abandoned by everyone, his servitors included. Accepting his fate, he summoned the courage to drive a dagger into his own throat, and bled to death.

State collapse — the sudden and catastrophic disintegration of central authority — is a frequent occurrence in history. A vivid and more recent example of such was the Cuban Revolution, which became an accomplished fact on January 1, 1959, when the dictator Fulgencio Batista simply ran away, taking a plane to the Dominican Republic. Revolutionary forces thus entered Havana meeting no opposition. A still more recent example was the collapse of the Islamic Republic of Afghanistan on August 15, 2021. Here again, top officials — from President Ashraf Ghani on down — simply ran away. Army soldiers melted away or defected to the Taliban. Police officers deserted their posts leaving no one

to stop rampant looting in Kabul. As in Cuba, the void left at the center was swiftly filled when Taliban troops entered Kabul unopposed.

State collapse is a frequent occurrence in history.

Such "Nero moments" as those experienced by Batista and Ghani have been with us since the first states evolved some 5,000 years ago, and such moments are sure to be seen again. It would be a grave mistake

to believe that the mature democracies in North America and West Europe are entirely immune.

Social Breakdown: sociological vs. psychological approaches

What explains social breakdown? Why do states collapse? How do civil wars start?

There are two opposed approaches to these questions. The sociological approach ignores individuals to focus instead on impersonal social forces that push societies into breakdown. But many people (who are not sociologists) find this approach unsatisfying. They want to know who was responsible. Whose fault was the French Revolution? Was it Louis XVI? Or Marie Antoinette? Or maybe Robespierre?

The alternative psychological approach asks what leaders — like Louis XVI, Nero, or Gorbachev — "did wrong." Rooted in the so-called "Great Man" theory of history, it neglects the fact that even history's most powerful leaders have had to contend with impersonal social forces. This theory was particularly popular in the 19th century, and regrettably remains the default mode for most pundits, politicians, and the lay public.

In the past few decades social scientists have devoted much effort to studying the causes and preconditions of civil wars. They approach this question in an admirably scientific way, collecting large datasets and running statistical

analyses on them. In the US, the most influential research project of this sort is the Political Instability Task Force (PITF), funded by the Central Intelligence Agency.⁴

The Task Force involves scholars such as Ted Robert Gurr (University of Maryland), Jack Goldstone (George Mason), and about twenty others. One, Barbara Walter — a University of California at San Diego political scientist — recently published a book, *How Civil Wars Start — and How to Stop Them*, which summarizes the insights gleaned by the Task Force and explains what they mean for the United States.⁵

From the point of view of policy makers, the most interesting question such projects explore is whether it is possible to predict the onset of a civil war, say, two years in advance. For a country currently at peace, what is the probability that it will still be peaceful two years hence? What is the probability that it will have instead slipped into civil war?

In an effort to answer this question, the PITF collected data on the onset of political instability across the globe, from 1955 to 2003, and developed a statistical model that related particular country characteristics to the probability of a civil war having started there. The results of this study were published by Goldstone and his co-authors in 2010.⁶

The PITF researchers discovered that their model was capable of predicting the onset of instability with some 80 percent accuracy. What came as a surprise, however, was that even though they had tested about 30 various indicators of instability, their model needed information regarding only three or four country characteristics in order to achieve this level of accuracy.

Factors associated with an increased probability of civil war, the PITF analysis showed, included high infant mortality rates, armed conflict among bordering states, and state-led repression against minority groups. But a critical factor was “regime type.” PITF researchers sought to place a country on an autocracy-democracy spectrum focusing, in particular, on “partial autocracies” — states attempting to transition from autocracy to democracy — and on “partial democracies,” those moving in the opposite direction. An additional important characteristic was factionalism: “sharply polarized and uncompromising competition between blocs pursuing parochial interests at the national level.”

Factionalism: “sharply polarized and uncompromising competition between blocs pursuing parochial interests at the national level.”

Partial democracies marked by high levels of factionalism proved to be exceptionally unstable; these countries were the ones most likely to descend into a civil war. Partial autocracies, by contrast, offered an intermediate degree of political and social stability, while the remaining regimes — full autocracies, full democracies, and partial democracies not troubled by factionalism — were seen to be relatively stable.

There is much of value in the approach advocated by the PITF and similar such analyses.⁷ But there are also important limitations. The most important is that we cannot understand the cause of social breakdown without a deep analysis of the power structures within societies.

As with Nero’s crumbled power-network we must consider questions like: Who makes up the most influential interest groups? What are their agendas? Their own sources of social power? How much social power do they wield with which to advance their agendas? How cohesive and well-organized are they? How is their internal cohesion maintained? And so on.

What Does History Teach?

I illustrate how such a power analysis can be used for understanding state breakdown (or the lack of it) in *End Times* (Chapter 9) by examining the divergent trajectories of three countries, all of which were created in 1991 when the Soviet Union collapsed: Russia, Ukraine, and Belarus. In 1991, all three were quite similar according to a variety of criteria: all were “anocracies” transitioning from autocracy to democracy;⁸ all were characterized by ethnic divisions; and all were subject to the same “accelerants” of instability that followed from the rise of the internet and social media after 2000.

Despite these similarities, however, their trajectories diverged dramatically.

Ukraine experienced not one but two successful revolutions after 2000. Russia and Belarus also each experienced a massive wave of antigovernment demonstrations — in Russia after the 2011 parliamentary elections, and in Belarus following its 2020 presidential election — but neither experienced state collapse. This leaves us with the somewhat ironic observation that, of the three East Slavic republics formed by the collapse of the USSR, the most democratic one, Ukraine, has proven to be the most impoverished and unstable, while the most autocratic of the three, Belarus, has enjoyed relative prosperity and stability.

What are the implications of this observation? A perhaps obvious one might be that autocracy works better than democracy.

This is, however, quite simply wrong: there are plenty of dysfunctional autocracies that “host” deeply impoverished populations. Many such regimes have collapsed in the past, and more will no doubt do so in

the future. Moreover, the best-governed countries — those marked by high levels of well-being enjoyed by the vast majority of their populations, like Denmark and Austria — tend to be democracies.

A sounder conclusion, therefore, is that not all states characterized by the trappings of democracy are run for the benefit of broad segments of their population.

Not all states characterized by the trappings of democracy are run for the benefit of broad segments of their population.

Such “pseudo-democracies” are often easy to spot, as when state officials decide which parties will participate in elections and who is going to win before elections are held. But this was not the case in Ukraine. There, politicians and state officials were not

the controllers of socio-political events; they were instead closely controlled by private interests — “the oligarchs.” Why is this important?

Sometimes a ruling class is deposed (even exterminated) as a result of losing a war to an overwhelming force. This is the case in successful external invasions, such as when Chinggis Khan’s Mongols rode in, killed everyone, and piled their heads in a pyramid. Alternatively, state collapse may result from attacks by organized internal groups of revolutionaries or putschists. Chilean president Salvador Allende died in a hail of bullets, assault rifle in hand, fighting to the death against General Pinochet’s troops as they stormed the presidential palace. But the most frequent cause of state collapse

is an implosion of the established ruling network — “Nero Moments.”

The most frequent cause of state collapse is an implosion of the established ruling network — “Nero Moments.”

In the case of both the Cuban Revolution and the collapse of Afghanistan, for instance, pressure from external power networks played a part, but the ruling

networks in both countries disintegrated well before insurgents ever entered their capitals. Incidentally, the 1917 October Revolution in Russia followed the same scenario. Soviet propaganda may have glorified

the Storming of the Winter Palace as the decisive breaking-point, but in fact the Provisional Government had already been abandoned by most of its troops and its head, Alexander Kerensky, had run away well before Bolshevik forces entered his seat of power.

Political regimes may also collapse under pressure from massive public protests, as was the case in Ukraine in 2014. In this regard, the contrast between the successful 2014 Ukrainian Revolution and the unsuccessful 2021 uprising in Belarus is particularly instructive. The main factor explaining these divergent outcomes is the nature of the ruling groups: in Ukraine, this was a collection of economic elites —“oligarchs”— who hated one other, plotted against one other, and were willing to abandon a sinking ship at a moment’s notice; in Belarus, a cohesive administrative-military elite weathered public protests without wavering.

Ultimately, the difference between these two East Slavic countries stems from the different political-economy trajectories they experienced two decades before the revolutionary circumstances of 2014 and 2021, respectively. In Ukraine, the mass privatization of previously state-owned corporations created a “wealth pump” that immiserated most of the population while fueling an “overproduction” of oligarch elites.⁹ This was followed by inter-oligarchic conflict and repeated state collapses. Belarus saw no similar wealth pump, no oligarchs, no intra-elite conflict, and no state collapse.

Beware the “Wealth Pump”

What is the take-home message from this analysis of past instances of state collapse? Simply this: political authority over complex human societies is far more fragile than a cursory glance might suggest.

Political authority over complex human societies is far more fragile than a cursory glance might suggest.

All complex societies are vulnerable to the disintegrative force of “elite overproduction,” which is why they all experience periodic social breakdowns. But plutocracies, Ukraine serving as a rather extreme example, are particularly vulnerable. The main problem is that plutocrats, acting in their own selfish interests, tend to create institutional arrangements that favor the operation of the “wealth pumps” that further enrich them.

Such wealth pumps increase popular immiseration, on one hand, while on the other they fuel continued elite overproduction, creating ever more and wealthier plutocrats. In other words, what I call a wealth pump is one of the most destabilizing social mechanisms Humanity has ever known.

America is no Ukraine, of course. The American ruling class is organized in accordance with a set of overlapping institutions that facilitate a beneficent separation of powers.¹⁰ And as seen during the Progressive and New Deal eras, the American ruling class is capable of suspending its own narrow selfish interests for the sake of common well-being. But the country’s ruling elites today appear to share little in common with those who navigated the Great Depression and World War II and who established the pre-conditions for the unprecedented prosperity that was shared widely in the three glorious decades after 1945.

The elites ruling America today have no direct experience of the great challenges that shaped the Great Civic Generation. Starting in the late 1970s, they turned the wealth pump on, which greatly enriched them. They have since blithely assumed that the current economic-political system, which has benefited them so, can operate indefinitely. In the process, as I argue in Chapters 5 and 6 of *End Times*, America has become a plutocracy — perhaps not as extremely so as Ukraine in 2014, but certainly moving in that direction.



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The American people are not stupid. They rightly perceive that elite selfishness and government dysfunction are entwined phenomena that have grown increasingly worse over the past four or five decades. As Matt Taibbi recently wrote on *Racket News*:¹¹

Elite selfishness and government dysfunction are entwined phenomena.

Especially in the last two decades, the public has been served one financial “shit burger” after another. They’ve been ripped off by everyone: banks that sold defective mortgage securities to their retirement funds, pharma companies that charge them thousands per course of medication, private equity titans who strip healthy firms for assets and vaporize jobs, all phenomena that widened inequality and were enabled by hyper-aggressive monetary “rescues” and stimulus programs like Quantitative Easing.

Collapsing trust in the state institutions, as well as in the economic and financial elites that now control it, is but one outward sign of this realization. The exploding frequency with which we see anti-government and “anti-establishment” demonstrations is another.¹² When “Proud Boys” descend upon Capitol Hill and the police descend upon college campuses, one might fairly ask: Are we nearing our own “Nero Moment”?

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ENDNOTES

- 1 <https://www.pewresearch.org/politics/2023/09/19/public-trust-in-government-1958-2023/>
- 2 What follows is an excerpt from Chapter 7 of *End Times: Elites, Counter-Elites, and the Path of Political Disintegration*, by Peter Turchin (2023: Penguin Random House).
- 3 For a discussion of how Hussein wielded power, see *War and Peace and War*.
- 4 <https://www.wilsoncenter.org/event/political-instability-task-force-new-findings>
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- 8 <https://www.jstor.org/stable/25749246>
- 9 For a detailed explanation, see *End Times*, Chapter 3.
- 10 discussed in *End Times*, Chapter 5.
- 11 <https://www.racket.news/p/a-new-elitist-craze-fixing-the-publics>
- 12 <https://journals.plos.org/plosone/article?id=10.1371/journal.pone.0237458>



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The Academy

Just Profit: The Business of the Future

By: COLIN MAYER



Colin Mayer



Capitalism

Capitalism is the most powerful engine of prosperity we have ever invented.¹ And business is the most important component of it. It clothes, feeds and houses us. It employs us and invests our savings. It is the source of economic prosperity, the growth of nations and the alleviation of poverty around the world.

But at the same time, it has been a cause of increasing environmental degradation, biodiversity loss, inequality, social exclusion and mistrust.

Above all, it has been a cause, as well as a cure, of crises. We have had the financial, climate, species extinction, pandemic, energy, inflation, and food crises, to which business has to varying extents contributed as well as contained.

Crises are growing in frequency, intensity and prevalence around the world. And they will accelerate in the future as artificial intelligence, genetic engineering, and the interaction between the two come on stream.

We are
misconceiving
the nature
of profit.

The record of business has been a very mixed, and increasingly problematic one. The reason is the fuel that drives capitalism and business — profit. Profit is both the source of the resource that powers capitalism, and the incentive that drives it. Without profit, there is no capital in capitalism.

However, we are misconceiving the nature of profit. Profit derives from the Latin, *proficere*, *profectus*, to advance and progress. That is what profit should come from. But too frequently it comes from neither advancement nor progress but at least in part also decline and regress.

To understand this, we need to lift up the bonnet of capitalism and look at the engine below the hood.

Profit

Profit as conventionally measured is the difference between the revenue of a company and its operational (for example, employee and supplier) and capital costs. However, this does not reflect the detriments it may impose on its employees by paying them below living wages or its suppliers below fair-trade prices or the environmental detriments it causes through emitting pollution or global warming gases.

In particular, the measured profit does not account for the costs of avoiding the detriments or remedying them where they occur. In other words, it does not include the costs of “cleaning up the mess” the company creates. As a result, measured profit is at best incomplete in that it does not record the true costs of a firm and it does not therefore reflect a just or fair profit.

Arguably, when companies report their financial statements as being a “true and fair” representation of their financial condition, they are doing no such thing. They are neither true in reporting true costs nor fair in reporting a fair or just profit.

It is not just a matter of overstatement of profit. It is also understated where companies cannot capture revenue from the benefits they confer from, for example, training their employees, investing in their communities, and enhancing the environment. Whereas companies can and arguably should incur the costs of cleaning up the mess they create, they cannot just magically conjure up revenues from all the benefits they provide. They need to find innovative ways of commercializing them.

As a result of misdiagnosing the problem, we are prescribing the wrong public policy solutions.

Externalities

These problems are conventionally regarded as just “externalities” — they are external or extrinsic to business. They are a reflection of failures of markets — of competition, regulation, taxation and reputation. However, they are not external or extrinsic; they are internal and intrinsic to business. As a result of misdiagnosing the problem, we are prescribing the wrong public policy solutions.

Competition fails because “good” companies that do recognize and pay for the costs of avoiding or cleaning up the harms they create earn less profits than “bad” companies that do not. Capital therefore flows from good to higher-earning bad firms. Far from competition promoting a “run to the top”, it encourages a run to the bottom and a Gresham Law of bad firms driving out the good.

Regulation and taxation often fail because some companies use their substantial resources and influence to lobby against the imposition of regulation and corporate taxation, and employ consultants to advise them on how to circumvent regulation, relocate to low tax regimes and, if possible, turn both to competitive advantage.

Far from reputational damage creating consensus, it is a source of divisions.

Reputation fails because, while we accept companies earning high profits and admire them for doing so when they derive from conferring benefits on us, we are outraged when they do not. We were appalled by what the financial crisis revealed about the conduct of banks, and by water companies in the UK dumping untreated sewage into rivers, lakes and seashores.

However, while there is consensus about the outrage, there is not about the response. The socialist left and environmental activists advocate more regulation and stringent enforcement. The libertarian right and the anti-woke brigade see this as an infringement of liberty and freedom and undermining investment, growth and jobs.

Far from reputational damage creating consensus, it is a source of divisions. It is a primary cause of the polarization of our politics and societies, and it is imposing unmanageable burdens on our democratic system. We will not solve the problem so long as we regard it as an externality. We should recognize that the damage that business does to politics and societies from the pursuit of excess or unfair profits is intrinsic to the nature of business and profit.

Purpose

We need to raise our sights and ambitions from wading in the weeds of exploitation, expropriation and unjust enrichment of profiting at the expense of others. Instead, we should surf the waves of incurring true costs and earning just profit from initiative, innovation and inspiration.

When one does that then two striking things happen. First, competition promotes runs-to-the-top not the bottom, as good firms are outcompeted, not by bad ones, but by better ones. Second, the interests of

firms in earning just profits from incurring true costs are aligned with those of the public sector in the public interest and the not-for-profit sector in social and environmental benefit.

It is the basis of a partnership between business, government and charities around a common purpose of shared prosperity and support for business in making positive externalities — the benefits that business confers on individuals, societies and the natural world but cannot fully capitalize — commercially viable.

Key to this is the purpose of business and a recognition that the reason why business exists is to help solve problems — problems that we face as individuals, societies and the natural world — and to do so in a form that is commercially viable and profitable. In other words, the purpose of business is “to produce profitable solutions for the problems of people and planet, not profiting from producing problems for either”.²

This elevates the sights and ambitions of business from wading through the weeds of exploitation and expropriation to surfing the waves of innovation and inspiration because it implies that a profit derives from producing solutions not problems. It therefore aligns the incentive of profit with our individual, social and natural world wellbeing and flourishing.

It creates consensus where there are currently divisions and it addresses the conflict that has undermined private finance initiatives, public-private partnerships and privatizations around the world. That conflict derives from a divergence of interests of the public sector in public benefit and the private sector in profit. However, if profit comes from delivering solutions not problems, then conflict is converted into consensus. Far from this being academic dreaming, pie in the

sky and wishful thinking, it is not only practically possible, it is practically happening and has been for a long period.

Foundations

In 1936, Henry Wellcome died leaving the company he had founded, not to his heirs or family, but in a foundation. The Wellcome Foundation (and later, the Wellcome Trust) grew to become one of the largest charitable foundations in the world, and one of the largest funders of medical and scientific research in the UK.

The company held by the Trust — the Wellcome pharmaceutical company — prospered until, in 1985, the Wellcome Trust began to sell shares in the Wellcome company. In 1995, the Trust sold the last block of shares in the company to another pharmaceutical company, Glaxo, to form Glaxo-Wellcome, which then merged with SmithKline Beecham, in 2000, to create GlaxoSmithKline (GSK). The Wellcome company was an example of what is termed an “enterprise foundation”, namely a company that not only has a foundation but is actually owned by the foundation.



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There is one country in the world in which such enterprise foundations are particularly prevalent. It is one of the most successful countries in the world, with one of the highest GDP per capita, lowest levels of inequality, best employee relations, and it is one of the happiest countries in the world. It is also home to what is currently the largest company by stock market capitalization of any firm in Europe. So, its success is reflected not just in its macroeconomic performance but in the micro performance of individual firms and the benefits this confers on its citizens.

The country to which I refer is Denmark, where approximately 40% of its stock market capitalization is associated with enterprise foundations. The company to which I call attention is Novo Nordisk, which produces insulin used in the treatment of diabetes. It is listed on the Copenhagen and New York Stock Exchanges but it has a dominant controlling shareholder — the Novo Nordisk Foundation, which owns approximately 28% of the share capital and 77% of the voting shares in Novo Nordisk.

Not only is Novo Nordisk the largest company by stock market capitalization in Europe but the Novo Nordisk Foundation is the largest charitable foundation in the world by assets under management — larger than the next two combined — the Bill and Melinda Gates and the Wellcome foundations.

The charitable purpose of foundations gives their enterprises precisely the long-term stable ownership and financial security they require to surf the waves of profiting from producing solutions not problems for others. Critical to this is the supporting enterprise foundation law, which ensures that foundations do not abuse their privileged position as philanthropic organizations but, instead, uphold the purposes of their founders in perpetuity, not just for the 50 to 60 years of the Wellcome Trust.

This is just one example of how ownership and law can promote corporate purposes and just profits from producing profitable solutions not problems for people and planet. Equally important are leadership and measurement.

Leadership

One of the most unsuccessful sectors of the last two decades since the financial crisis has been banking.³ One of the most successful European banks over the last 40 years has been the Swedish bank, Handelsbanken. It has been a very stable bank, with strong credit rankings, liquidity, and capital ratios, and it needed no bailing out during either the Swedish banking crisis at the beginning of the 1990's or the financial crisis of 2008.

But it was not always so. Indeed, at the end of the 1960's Handelsbanken faced an existential crisis that led to a fundamental restructuring under the new leadership of Jan Wallander. This involved inverting the traditional hierarchical structure of a bank, delegating control from the board down to the branches to a point that the mantra of the bank became “the branch is the bank”. Branches, and in particular branch managers, were granted a great deal of discretion in how they managed their operations and customers within their localities.

A second distinguishing feature of the bank was to eliminate bonuses to employees, at least until they retired at the age of 60, at which stage they were eligible for a share in the bank profit sharing scheme, called *Oktogonen* — a very long-term incentive scheme! Instead, the bank emphasizes its culture and values in a document entitled “Our Way”.

What this does is to allow the bank to place trust in its branch employees to make decisions that do not have to be referred up the bank for approval. That in turn permits the branches to build relations of trust with their customers, in particular their



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small and medium sized enterprises. They can look their borrowers in the eye and determine whether on the basis of their business plans they can be trusted.

In essence what Handelsbanken has done is to establish old style relationship banking in a modern international bank. Instead of transactional banking of selling products at as a high a profit margin as possible, Handelsbanken grows its business by expanding with its customers. One of its most successful markets is the UK, where relationship banking disappeared towards the end of the 19th century when local banks, which funded the industrial revolution and made Britain “the workshop of the world”, merged and shifted their headquarters to London.

The importance of delegation is that the board of directors of a company cannot possibly know the local conditions and needs of their customers, communities, suppliers and distributors. It is those on the shop floor, in the localities, branches and subsidiaries who can build relations of trust, provided the organizational structure entrusts and empowers them to do so.

It is only when remuneration, recognition and promotion of employees conform with the corporate purpose that employees regard it as core to the business.

Measurement

Everyone from the board to the shopfloor should not only understand the meaning and significance of their corporate purpose but appreciate their part in contributing to its fulfilment. This requires incentives as well as cultures of organizations to be aligned with problem-solving purposes.

It is only when remuneration, recognition and promotion of employees conform with the corporate purpose that employees regard it as core to the business and a genuine determinant of the corporate strategy. Achieving that requires internal systems of measuring, reporting and accounting for delivery of the corporate purpose in addition to a conducive organizational culture.

There have been many initiatives to promote external reporting of sustainability, and environmental, social and governance (ESG) factors. Most prominently, the International Financial Reporting Standards (IFRS) foundation has established an International

Sustainable Standards Board (ISSB) to enhance international standards on non-financial reporting. It recently brought out its first sustainability standards, S1 and S2, regarding disclosures of firms’ governance, strategy, processes, and performance to monitor, manage, and

meet sustainability-related financial risks and opportunities. Likewise, the Securities and Exchange Commission (SEC) in the US is requiring corporations to report climate-related disclosures material to investor risks.

The European Union (EU) approach differs in three respects. First, it requires reporting of the impact of climate-related risks not just on investors but also on those affected by a company’s activities. Second, it extends reporting beyond climate-related risks to

human and social issues, especially human rights. Third, it moves beyond disclosure and reporting to include regulation of corporate and investor activities.

All of these initiatives focus on the risks of corporate activities for investors in the case of the ISSB and the SEC, and for all stakeholders in the case of the EU. In the process, they raise concerns about their impact on firms' costs, economic activity, growth, investment and jobs, particularly in developing and emerging markets.

The reason is that they fall short of measuring corporate purposes and therefore the true costs and just profits of firms. While some institutions, including several sovereign funds, seek to promote a positive approach to reformulating corporate purpose around profiting from solving instead of creating problems and measuring their success in achieving that, several (not least Blackrock) have felt the headwinds of trying to do that. ►PAGE 77

What is required is something much more straightforward and in line with companies' strategies of solving problems, incurring costs of avoiding detriments, and reporting conventional cost accounts. Those engaging with customers, suppliers and communities establish that they are solving and not causing problems for others, they allocate the resources required to do that, and in turn report their associated true costs and profits.

In the process, firms create new problems. They recognize and acknowledge rather than deny their existence, incur the costs of remedying them and find ways of resolving them profitably. That, in turn, creates further problems that need profitable solving, and so the world advances and progresses. This provides a context of well-functioning markets and minimal regulation in which business can work with maximal freedom to choose purposes of profiting from producing solutions not problems for others.

Conclusion

To conclude, and in the context of the foregoing, allow me to repeat some of the core arguments set forth in my recent book, *Capitalism and Crises: How to Fix Them*⁴:

"We have created a system that promotes self- over common interest, ideology over pragmatism, profit over purpose, nation states over global concerns. We have lost sight of where we are going, how we should get there, and how collectively and collaboratively we can address the immense and growing problems we face." (p. xvii)

"It is not in general the character of the individuals that is at fault but the system that forces them to take on guises in their workplaces that they would never dream of adopting in their domestic surroundings." (p.69)

In seeking to address this, we recognize that "the public sector has the advantage that in principle it promotes the overall wellbeing of society rather than, as in the case of the private sector, just a small segment of it. However, in being accountable to everybody it suffers from no effective governance by anyone." (p.12) Instead, "We need a system that encourages business to have an intrinsic interest in the common good, not just rely on it being imposed from above by fictional, socially minded guardian angels in the guise of governments and regulators." (p.13)

"Trust cannot be sustained in circumstances where individuals are inherently self-interested in the absence of powerful sanctions to adhere to it." (p.79) "The corporation is the transformer of the system, converting individual self-interest into a collective endeavour by injecting financial investment into a problem-solving purpose." (p.109) "Profiting from producing solutions not profiting from producing problems aligns the private incentives of property with the collective interests of society." (p.84)

Corporate law should thus establish the “duty of directors of companies to determine their company purposes, define the problems they are seeking to solve, ensure that they have the resources and means to deliver on their purposes, measure their performance against delivery on their purposes, consult with relevant and affected parties in evaluating their performance against their purposes, and incur the costs of avoiding inflicting detriments on others.” (p.90). Courts of law should adjudicate claims of wrongdoing brought against the company and derivative actions taken by shareholders against directors.

In sum, we must “Stop measuring just the inputs that companies use and the outputs they sell”. Rather, we must “Start from the question of what are the changes that the firm’s activities are bringing about and the impacts they are having on others.” (p.185)

This is the path to just profits and the business of the future.

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ENDNOTES

- 1 This article is based on a recently published book by Colin Mayer (2024), *Capitalism and Crises: How to Fix Them*, Oxford: Oxford University Press.
- 2 British Academy (2021), “Policy and Practice for Purposeful Business: The Final Report of the Future of the Corporation Programme”.
- 3 The FTSE 350 Bank, for example, records how bank stocks have remained at well below their pre-financial crisis levels and during the Covid pandemic fell back below their post financial crisis low point.
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The Academy

Cultures of Trustworthiness: The Role of the Regulator

By: HENRY FARRELL



Henry Farrell



Regulators usually focus on things that are visible, formal and quantifiable rather than blurry, informal and qualitative. Clear rules and formal targets are utterly necessary to the healthy functioning of complex societies. But they are not sufficient. When trust and trustworthiness evanesce, formal rules are at best fragile and inadequate and, at worst, actively pernicious.

Here are the things that regulators need to know about trust. First — that trust can't be reduced to crude economic incentives. When we trust others, it is because we think that they have internalized our interests — at least in part. Second — that trust isn't completely divorced from incentives either. Our trustworthiness, to some people on some questions, is circumscribed by our selfish interests. Third — that trust and trustworthiness can't easily be engineered. They depend more on broad cultural expectations than on specific formal rules. Finally — that trust and trustworthiness are nonetheless crucial.

Regulators need to think about strengthening cultures of trustworthiness.

Hence, if they are to do their jobs well, regulators need to think about strengthening cultures of trustworthiness — that is, organizational cultures in which people behave trustworthily and may reasonably expect others to do the same. They also need to consider the broader culture that they themselves operate in, and whether the public does or does not trust them. If people lose trust in the system and those who run it — if they conclude that the regulators and other elites do not have their interests at heart — the space for successful regulation shrinks dramatically.

It is understandably difficult for regulators to focus on trust. Indeed, the history of regulation is in many respects the history of efforts to shift away from having to rely on it.

Take, for example, credit — one of the crucial underpinnings of banking and finance. As Bruce Carruthers' recent book, *The Economy of Promises*, explains, Americans used to anchor their business decisions in local trust relationships. In the nineteenth century, Americans regularly relied on personal networks and family ties when they decided who they could trust with their money. When the great sociologist Max Weber visited America at the beginning of twentieth century, he was impressed by how economic relationships were grounded

in trust between co-religionists.

Admission to a local Baptist church was “recognized as an absolute guarantee of the moral quantities of a gentleman,” securing “the deposits of the whole region and unlimited credit without any competition.”¹

Local communities of trust

In this world, which has mostly since departed, trust and culture went together, both in good ways and bad. If you did not subscribe to the appropriate beliefs about Total Depravity and the Perseverance of the

Saints, or if you failed to tout your compliance with the relevant cultural mores, you might find yourself frozen out of your local business community, and unable to raise capital. If you were an immigrant, or a woman, or of the wrong race, you were barred from full community membership, or perhaps excluded completely.

Still, if you were the right creed and color, you could trust your neighbors across a wide variety of different matters, because you were connected to them, and they to you. You saw them at church every Sunday, and knew that they publicly (at least) subscribed to the same values that you affirmed. Your children might play with theirs, and they might grow up to marry each other. In an important sense, your fates were bound together. But perhaps just as important, you knew that your neighbors and fellow parishioners had good self-interested reasons to be trustworthy. By contrast, cheats had a harder time prospering if they ripped off their fellows. They might be expelled from church and run out of town. ▶PAGE 409

As game theorists like Avner Greif have argued, such thick local cultures of trust had great local efficiencies. You could trust those who shared your local culture in ways that you couldn't trust strangers. But for just that reason, local ties provided no way to run a modern economy. You didn't want to deal with people from far away if you could help it. They weren't local folk: how could they be trusted? Commerce was thus largely confined to local communities of trust, with intermediaries providing sparse and not entirely reliable connections between them.

Such local communities of trust still survive in some corners of the economy, where bonds are strong and the actual and psychological costs of exit are high (for example: Hasidic Jews in the [diamond trade](#)). But regulators understandably do not see them as an ideal economic model, and are more likely to treat

them as objects of curiosity or even active suspicion. Those same ties that enable trust may enable collusion. ▶PAGE 401

Trust at scale

Modern regulators usually look to build confidence — clear expectations of appropriate behavior grounded in precise and comprehensive rules, rather than trust. The last century of financial regulation has been a history of replacing personal trust relations between people who knew each other, were related to each other, or belonged to the same local church, with broader impersonal rules that induce confidence, and specialized officials to implement them. Subjective assessments of individual trustworthiness, based on local culture and knowledge, have gradually given way to broader systems such as quantitative credit ratings.

The crucial advantage of the newer approach was it worked at scale. That, in turn, enabled a vast expansion of the financial sector. As regulation expanded, personal trust was no longer nearly as necessary as it once had been. Instead, people could place their confidence in impersonal rules and objective-seeming measures of trustworthiness, lending to, borrowing from and contracting with a far broader pool of economic actors than was possible under the old dispensation.

The new system came with its own costs. Impersonal seeming rules and measures often turned out to be biased in favor of some groups, and against others. Racially biased “redlining” is illegal. Assessing credit risks based on characteristics that are not inherently race-based, but that are statistically associated with specific kinds of people, is not, and is far harder to mobilize against. As sociologists like Marion Fourcade have documented, the modern credit system is based on the classification of people into segregated markets. Depending on how you are classified, you

Thick local cultures of trust had great local efficiencies.

either get offered loans on highly attractive terms, or rely on the uncertain mercies of payday lenders and “bad credit: no problem!” companies that advertise on subway trains.

And like all systems, the new approach worked far better with some kinds of information and exchange than others. The necessary shadow twin of large-scale regulation is the gathering of formal, reproducible, more or less reliable knowledge that can guide it, especially, but not exclusively, statistical information. Forms of exchange that could leverage such knowledge while visibly complying with regulatory rules, tended to prosper. Exchange relationships that were fuzzier, and based on informal ties and trust did not.

Informal information channels never went away — but they were deprecated in favor of formalized communications, sometimes by law. You didn’t want people in the financial industry communicating through non-publicly visible means. When people got to know each other too well, and to establish relationships outside formal channels, they might collude to work around or subvert the rules.

This was all, in a very fundamental sense, necessary. Modern society could not survive without very broad rules-based systems and regulators to implement them. But the danger is that it has led regulators largely to ignore the dark matter of culture and connections, trust and trustworthiness that allow these rules to extend further than crude incentives.

Modern society could not survive without very broad rules-based systems and regulators to implement them.

Regulators have to work not simply on creating formal rules that build confidence. They also have to look to build cultures of trustworthiness around these rules.

The culture conundrum

Sometimes, as regulators worry, cultures of collusion can spring up. But sometimes, instead, culture is a vital complement to rules. After all, explicit expectations and supervision can only go so far in guaranteeing honesty. It is impossible for regulators to completely monitor what people are doing and saying to each other. Cultures of trust and trustworthiness, then, can be invaluable in ensuring that people do what they are supposed to be doing, even when they cannot be seen or supervised. Such cultures, however, can be undermined by excessive insistence on formality and punishment.

What this means is that regulators have to work not simply on creating formal rules that build confidence. They also have to look to build cultures of trustworthiness around these rules, which is naturally a far more difficult undertaking. Even the most basic questions, such as how to tell a “culture of trustworthiness” when you see one, are difficult to answer.

But such questions are not impossible to answer. One starting point — far from the only one — is to begin with basic assumptions shared with much of the modern theory of regulation, and see how far you can push them. These assumptions mostly stem from economic theory, and the claim that people will respond to the incentives of rewards and punishments. Very often, this economic claim is interpreted as a proof that mechanical inducements — crude carrots and crude sticks — are all that you need, so that culture is irrelevant.

But plenty of math says different. In his book, *Managerial Dilemmas*, Gary Miller uses simple proofs to show that such crude mechanisms can't produce the kinds of efficiencies that are attributed to them. Instead, managers need to create a culture of diffuse reciprocity. David Kreps bases his game theoretic account of *corporate culture* on a very similar insight, claiming that it is impossible to create rules that cover every contingency. Hence, you need "culture" — defined as a set of commonly shared reputational expectations about what the corporate entity and its agents will do in circumstances that are not unambiguously covered by the rules. This culture allows others to trust that the corporate entity will do right by them if something unexpected happens.

Miller's and Kreps' arguments help us to see what a culture of trustworthiness looks like. It is one where the default expectation is of trustworthy behavior, even in contingencies that the rules do not cover.

Confidence only extends as far as the situation that the rules explicitly anticipate; *trustworthiness*, however, extends to situations that the rules should have covered, but did not. Such cultures can be helped along by local communities of the sort that supported them in the nineteenth century. But we don't need, and almost certainly don't want, the parochial perspectives that accompanied them. A thinner culture of trustworthiness, in a world of economic relations that are primarily based on rules, is not only acceptable but from some perspectives superior to the past's local communities of trust.

We can get further by trying to encourage cultures of trustworthiness than by trusting to crude incentives on their own.

Cultures of trustworthiness

From a regulator's viewpoint, a culture of trustworthiness is one in which the organization will behave in unanticipated situations just as it might have done had the rules been drafted to cover that situation.

An organization with a culture of trustworthiness doesn't look to comply but to anticipate and understand the intent behind the rules, asking what it ought do according to some reasonable interpretation of that intent. This is importantly different to overcompliance, which interprets the rules in the most expansive sense possible, even when this understanding doesn't really make much sense. Such overcompliance can, at an extreme, verge into deliberate subversion (read Hasek's novel, *The Good Soldier Svejk*).

Of course, ideal cultures of trustworthiness do not exist. Humans, being human, are likely to disagree about what the rule means in unanticipated situations, and not just because they are self-interestedly cynical (here, game theoretic accounts of reasoning are less useful than cognitive-psychological). Equally, we can get further by trying to encourage cultures of trustworthiness than by trusting to crude incentives on their own. But it is very hard work, and it involves the building of trust and trustworthiness between the regulator and the regulated party.

To do its work, the regulator still needs to provide appropriate inducements and punishments to anchor relations and expectations (again: incentives are not everything, but they do matter). But the regulator also needs to demonstrate its stake in an ongoing relationship where, if the regulated party goes beyond the narrow requirements of the rules to behave trustworthily, the regulator can in turn be trusted to take the interests of the regulated party into account. At a minimum, the regulator needs to convincingly

asseverate that it will not take advantage of the regulated organization's trustworthy behavior, and should instead provide some reward for such.

In the ideal case, when the regulated party regularly and visibly goes further than it needs to, it should be rewarded with forbearance on those occasions when it makes genuine mistakes. In practical reality, politics will certainly intrude. Regulators are themselves the subject of oversight, and may be asked unpleasant questions when they let a regulated party off the hook. And indeed, sometimes they ought to be — when relations become too comfortable, capture can happen. Regulators ought to be trustworthy toward the parties they regulate, but they ought not be complaisant.

As an academic and an outsider, I can't and don't presume to offer specific advice about when regulators ought to show forbearance and when they ought not. I don't have direct knowledge of where the envelope of appropriate behavior has its boundaries.

I do see that there are some elements of this understanding already in regulatory practice (e.g., parties that voluntarily disclose regulatory breaches are likely to be treated more kindly than those whose breaches are revealed by third parties or whistleblowers). But, equally, I often come across anecdotal evidence suggesting that regulators frequently focus on the formal aspects of compliance to the detriment of the informal encouragement of appropriate cultural changes. Making practical suggestions as to how to remedy this would require practical experience of a kind that I don't pretend to have.

As academics often do, I am pointing to the problem, and waving my hands in the general direction of solutions, without pretending to have them myself. But there is more. Regulators should not just think about this culture of trustworthiness in terms of their

relationship with regulated entities. They too have parties on whose behalf they are supposed to act. They should hence consider how they themselves can demonstrate their trustworthiness to the broader public, whose trust and goodwill they ultimately rely on. ►PAGE 421

Disinterested expertise in the general interest

The general problem is this. Regulation itself necessarily relies on a broader culture of trust, and specifically a culture of trust in the regulators themselves. *Quis custodiet ipsos custodes?*² If ordinary people don't trust regulation and regulators, then modern societies, with their vast panoplies of interlocking regulatory arrangements, are in serious trouble.

And there is evidence that ordinary people do not especially trust regulators, and that some indeed actively distrust them. Regulators have not thought nearly as much as they ought to about their reliance on some degree of public trust to do their

work. For a long time, it appeared that regulators did not need ordinary people to embrace them, let alone understand them. All they required from the public was confidence and passive acquiescence. As long as people felt confident in the financial system, they would passively assent to the rules and relationships that governed it. But increasingly, these regulatory systems have begun to undermine the political conditions that underpinned their autonomy.

As the economy becomes more complex, so too do the rules, and so does the knowledge that regulators need to master in order to implement them well. As regulators have become more embroiled in their own internal relations, they have become less capable of justifying themselves to the outside world. Their

Regulation itself necessarily relies on a broader culture of trust, and specifically a culture of trust in the regulators themselves.

detachment from public debate temporarily insulated them from politics, but it also means that they now have little public legitimacy to draw upon.

This became starkly clear in the wake of the financial crisis where, despite general (and apparently justified) public belief that widespread fraud had happened, institutions were bailed out and practically no-one was indicted, let alone convicted. Regulators do not have a good reputation right now. There are internally justifiable reasons for both outcomes. Preventing collapse was a reasonable goal, and it is notoriously difficult to prosecute complex financial cases. But it is hard to explain this to a public that is understandably impatient with the usual excuses.

Again, it is much easier to point to the problem than to recommend specific solutions. What I can say is that regulators' focus on preserving stability and credibility, while declining to think about the political consequences, is a recipe for public distrust. Propping up profligate financial institutions, while leaving people in financial distress to fend for themselves; limiting inflation through means that empower capital at the expense of labor; such measures can surely be justified in broad technocratic terms. If you want to prop up the system and protect it as it is, you are likely to opt for the measures that are least distressing for those who have the power to oppose you, dumping many of the costs on those who cannot.

Regulators no longer can shelter behind the shield of apparently disinterested expertise in the general interest.

They are going to have to think much more systematically about cultures of trust and trustworthiness, and not just rules.

Endemic distrust

But strategies with strong technocratic benefits can have sharp political limits. Pushing too far is likely to create anger and distress, which political actors can take advantage of, to press for changes that may stress the system far more severely. Like it or not, financial regulators no longer can shelter behind the shield of apparently disinterested expertise in the general interest. The Fed, Treasury, even the SEC are the topic of everyday political debate, and it is unlikely that they will return to the public obscurity that they prefer.

So how can these, and related institutions, restore public trust? Most obviously, by demonstrating that they are willing to impose pain on the powerful as well as the disempowered, and talking in public about it. The successful prosecution of Sam Bankman-Fried was perhaps a step in this direction. But a lot more is needed.

If regulators are to do their work, they are going to have to think much more systematically about cultures of trust and trustworthiness, and not just rules. A world of oppressive rules and endemic distrust is not only bad in itself, but liable to feed on itself to make things worse, as people behave in untrustworthy ways, and regulators respond through ever more elaborate requirements and punishments.

Regulators should think of themselves, too, as operating in a broader cultural context and ask: how can they demonstrate their trustworthiness to members of the public? How can they show that they can and ought to be trusted to pursue the public interest, even in technically complex controversies that the public and its representatives are unlikely to understand? Answering that question will require regulators to

build a different — and much more directly political — relationship with the public than they have had in the past. That will be uncomfortable, but it is necessary, nonetheless.

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ENDNOTES

- 1 p. 305, Weber, "The Protestant Sects and the Spirit of Capitalism," *From Max Weber: Essays in Sociology*, eds. Gerth and Mills.
- 2 From the Latin, loosely, "Who watches the watchmen?"



The Academy

An interview with Michael Muthukrishna



Michael Muthukrishna



Q: You open your thought-provoking 2023 book, [A Theory of Everyone](#), with a warning: “the forces that shape our thinking, our economies, and our societies have become invisible to us.” And you pose this as an existential problem, adding that, “If we cannot perceive the forces that shape us, we are impotent to shape these forces.”

Were such forces

ever really visible? And, if so, how, and why, and what leaves us “blind” to them today? Can we adopt corrective lenses of some sort?

A: Yes, what I mean by that is that you and I, and everyone alive today, were born into a world that we did not create. This includes our oldest politicians, our smartest scientists, our most successful entrepreneurs, and every other person right across the globe. And it’s not only that none of us created institutions we now take for granted — like the democratic separation of powers, norms like human rights, or systems like the market — it’s that the world is far too complicated for even the smartest among us to *re-create*. We are uniquely fortunate to belong to a species that has inherited — and continues to aggregate — the accumulated wisdom of generations upon generations and many lifetimes of experience.

This was somewhat true in the past, too — even hunter-gatherers inherited particular ways of making weapons and preparing food that they didn’t create and didn’t fully understand. But, in the past, the impact of innovations and societal change were more directly felt and observed. The Chief was a real person whom you knew, a new tool or way of farming had a tangible and sometimes immediately felt and understood effect, and the forces of nature or other tribes were visible and *lived* experiences, because they directly altered the way people worked, and interacted with each other and with their shared environment. But in the modern world — and especially over the last 250 years or so, with the accelerating pace of technological progress and social change — the forces that affect our lives have become harder to perceive within a single lifetime. We are like fish in water, often unaware of the medium in which we swim.

What’s more, many of the most important forces shaping our world today — such as social media algorithms, financial markets, and geopolitical dynamics — are complex, abstract, and causally opaque. They operate at a scale and speed that can be difficult for individual human minds to fully grasp. And by the way, everything I’ve just said also applies to our companies as well as our societies. We join companies with particular rules and ways of working — a “culture” — the origins of which may stem from a founders’ idiosyncratic life experience, or perhaps they may be borrowed from other companies, and they may predate anyone in particular working there.

To start seeing these invisible forces, we need a kind of corrective lens that allows us to go back to first principles, understand how our societies and companies have evolved, and how human psychology, behavior, and culture work. That’s what I hoped to show in my book, which combines insights from evolutionary biology, psychology, anthropology, economics, and other fields to shine a light on how human psychology works and how culture evolves and shapes our perceptions. We need to cultivate a longer-term, multi-generational perspective. And

we need to develop new tools and institutions for collectively perceiving and shaping these forces, rather than being passively molded by them.

Only by making the invisible visible can we hope to steer our cultural evolution.

Q: There's a note of optimism early on as well. Psychological theories of human behavior have traditionally been developed without much attention to the underlying learnings from the natural sciences, and while also failing to take advantage of mathematical tools. But you see this changing, writing that, "human and social sciences are going through puberty."

A: Imagine a world where we understand the intricate but "invisible" rules that govern human behavior and the evolution of our companies and societies. This is no longer a distant dream, but a reality made possible by one of the biggest breakthroughs of the last few decades, achieved at the crossroads of human evolutionary biology and social science.

We now have a "theory of human behavior" — a set of mathematical and computational models that can explain the principles by which we operate and how our organizations and communities evolve. This theoretical framework, known as dual-inheritance theory and cultural evolution, is not just a hypothesis. It's a scientific theory the transformational significance of which is akin to that of the theory of evolution by natural selection or the discovery of the periodic table.

At the heart of this insight lies a revolutionary idea: humans are a unique species, shaped not only by millions of years of genetic evolution and lifetimes of individual experiences, but

also by thousands of years of *cultural* evolution. We are a product of not just impressive brain hardware, but even more impressive cultural software. ▶ **PAGE 401**

Only by making the invisible visible can we hope to steer our cultural evolution.

This cultural evolution encompasses accumulated beliefs, values, norms, traditions, technologies, and entire ways of thinking, from counting and reading to science and reason. The realization of this is as transformative as when we first discovered that the

Earth orbits the sun or recognized the periodic table of elements. Just as the latter insight turned alchemy into chemistry, new understandings of the interplay between genetic and cultural evolution are propelling the human and social sciences into a new era of scientific rigor and practical application. ▶ **PAGE 393**

The combination of "dual-inheritance theory," immense computational power, and unprecedented amounts of data on human behavior, has created an extraordinarily exciting time for the human and social sciences. We are now beginning to apply these insights beyond academia to tackle real-world challenges in business and government.

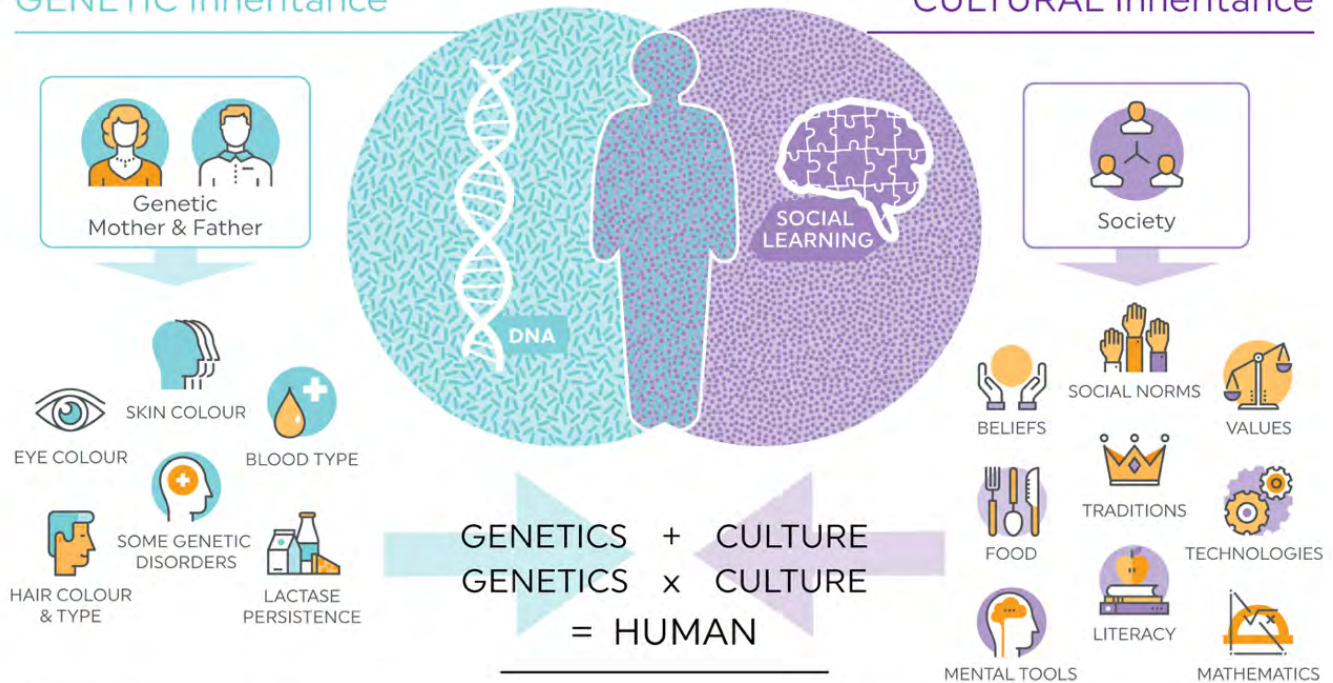
In *A Theory of Everyone*, for example, I illustrate how we distilled insights about innovation into a new strategy for Uber. In the United Kingdom and Europe, Uber faced a clash between the American Silicon Valley approach and the European traditional approach — a battle between preferences for unregulated innovation and innovative regulation. By employing strategies derived from our new theory of everyone, Uber's leadership was able to navigate this complex landscape, finding solutions to some of its most pressing challenges. This included making peace with its regulator in London, expanding its electric fleet, and integrating bikes, buses, and trains into the app.

We are a product of not just impressive brain hardware, but even more impressive cultural software.

DUAL INHERITANCE THEORY

GENETIC Inheritance

CULTURAL Inheritance



CREATED BY VERONIKA PLANT (2019)
in collaboration with MICHAEL MUTHUKRISHNA

Figure from A THEORY OF EVERYONE by MICHAEL MUTHUKRISHNA

The era of guesswork and trial-and-error is giving way to a new age of scientifically grounded strategies-and-solutions. Again, it's like trying to turn lead into gold. Once a science goes through puberty — moving from alchemy to chemistry by becoming grounded in solid science — you can start to develop new technologies. Social technologies in this case. The potential applications of this new understanding of human behavior are vast and far-reaching. Embracing this paradigm shift can provide us with the tools we need to make more informed decisions, drive innovation, and foster thriving organizations in an increasingly complex world.

The era of guesswork and trial-and-error is giving way to a new age of scientifically grounded strategies-and-solutions.

Q: You argue in the book that “Sapiens are still difficult to predict.” But you also suggest that “at least we now know the rules by which we work.” I expect many of our readers will embrace this argument. But how would you address those who’d question whether human behavior is predictable? Is it?

A: Have you ever been talking about something and then you see an ad for it on your phone? It makes you think that your phone is listening to you. It's not. Instead, because your behavior is being tracked when you search the Internet and use social media, companies can figure out what you're interested in and then present you with ads for

things that other people like you are interested in. You're somewhat predictable because you behave like similar people who share your interests.

That's a theory-free computational approach to predicting human behavior that works pretty well, most of the time. It requires a lot of data about someone, but even when you don't have that amount of *individual* data, dual inheritance theory plus cultural evolution — that is, the “theory of everyone” — can allow us to predict the behavior of many people a lot better than we ever could before. It's a little bit like how difficult it is to predict a single molecule of gas, but how easy it is to predict the behavior of the gas as whole thanks to gas laws.

Going back to people, although we have free will, the world is complicated, and we tend to follow psychological rules that we now understand quite well. For example, we tend to do what other people are doing. In my class, I run a small experiment where I arrive early and ask the first few students to stay standing rather than take their seats. As others arrive and see people standing, they also remain standing. In the end, almost everyone is standing before class starts. Norms govern much of our behavior.

Norms, institutions, culture, past experience, and the way people aggregate that social information under conditions of ambiguity, different sized majorities, different prizes, punishments, other incentives and more, can all now be mathematically described and then used to predict overall *future* patterns of expected behavior. In my book, I'm particularly interested in what I call four Laws of Life — the laws of energy, innovation, cooperation, and evolution. Together, these lenses explain and allow us to *anticipate* the patterns of human progress and economic growth.

We tend to do what other people are doing.

Misconduct is rarely the product of a single bad actor.

Q: During a discussion of zero-sum thinking, you write that “cooperation and conflict are two sides of the same coin,” and argue that “we cooperate to compete” and we “compete by cooperating.” Can you illustrate what you mean here, in the context of the workplace?

A: Zero-sum thinking is a good example of how the Laws of Life apply at the meso-scale of companies and societies. We are a cooperative species — and as such, both our greatest achievements and worst atrocities have been cooperative acts. Corruption requires multiple parties. Misconduct is rarely the product of a single bad actor. ► **PAGE 131**

In the context of the workplace, I call these “Enron effects.” As many of you may remember, in the year 2000, the large energy company was flying high with a market capitalization of over \$100 billion and a share price that had risen from \$20 to over \$80. But by the end of 2001, Enron was trading at pennies a share and the company went bankrupt. What became known as the Enron Scandal involved widespread fraud and illegal accounting practices that worked to hide Enron's failures and true value. As a result of the fraud, Enron's collapse also took down its accounting firm, Arthur Andersen. Tens of thousands lost their jobs, investments, and retirement funds.

Enron's CEO, Jeffrey Skilling, was sentenced to twenty-four years in prison, though he was released after only twelve. As it happens, Skilling was actually a huge fan of evolution. His favorite book was Richard Dawkin's *The Selfish Gene*. Skilling attempted to implement evolutionary principles in his business practices and corporate culture.

But too little knowledge is a dangerous thing. Skilling understood that, at the heart of evolution, is selection and competition. But Skilling forgot that there is also diversity and cooperation. Skilling's policies created

a zero-sum environment. One in which one person's failures were a necessary precondition for another person's successes.

One of Enron's more famous policies was "Rank and Yank". Indeed, the policy was used by many companies and was celebrated in business books and media at the time. Performance reviews involved ranking employees on a bell curve. The top 5% were considered superior and received the largest rewards. The bottom 15% were fired. This, combined with a highly competitive culture and characterized by secrecy, led to a toxic culture of destructive competition where people lied, deceived, formed alliances, and undermined one another to avoid losing their jobs.

It's easier to be nice when there's lots to go around. The law of cooperation is that the optimal scale of cooperation is one where my share of the reward, such as equity or salary, is higher in a larger group than it would be in a smaller group, so long as certain conditions are met. It's like a formula where the particular size of a group, working toward the goals of that group, is multiplied by the probability of the group achieving its ends, such that the overall reward must be higher for a larger group than it could be for a smaller group.

If we're all in it together, and we all pull together, the collective reward that we can divvy up upon shared success is greater. Cooperation works to overcome zero-sum mathematics. Skilling didn't invent Rank and Yank, but where it's found, it creates zero-sum conditions conducive to destructive rather than productive competition. People worked hard to harm one another at Enron, rather than working hard to achieve better collective outcomes.

You don't notice your own accent. And companies work like this, too. There are the official rules, but then there's the accent.

Q: This series of reports is fundamentally concerned with the governance and supervision of non-financial risks, particularly those driven by firm culture and the conduct it promotes. You discuss how humans learn rules through social learning and compare this with how children learn grammar. Could you explain? What does this imply for risk management?

A: Our psychology seeks out rules and patterns and much of what we know is implicit. You don't even realize what you know and how that shapes your behavior. It's a bit like grammar. In school you were taught explicit rules, like present and past participles, but those just expose some aspects of grammar. Much of the grammar you use is implicit.

For example, in English there is a rule about the order of words, that you don't even know that you know. It goes like this: opinion-size-age-shape-color-origin-material-purpose noun. So, you can have a lovely little

old rectangular green French silver whittling knife. But, if you're a native English speaker, try moving adjectives around and it just sounds off: a green French old little lovely silver rectangular whittling knife — ugh!

Accent is also a bit like that as well — you don't notice your own accent. And companies work like this, too.

There are the official rules, but then there's the accent — the unwritten rules that people know but sometimes they don't even know they know. They just know "that's how it works around here" or "it just doesn't work that way". Uncovering and making explicit our ways of working is key to seeing an organization as though from the outside, and then deciding what you want to change. Making the invisible visible, as I said at the beginning.

Q: You write that “institutions securitize trust.” Can you explain this? Can they do so when the institutions themselves are not trusted? And what follows where institutions cannot serve this ‘securitization’ function?

A: When I was a kid, I was told to never get in a car with a stranger or go into their house. But I now do it all the time, thanks to Uber and AirBnB. The reason these activities used to be dangerous is because we had no knowledge of the stranger and their reputation to know if we could trust them. But today, instead of trusting millions of strangers, we can instead place our trust in companies like Uber and AirBnB, or in our governments. We trust that they will punish criminals, or people who are doing a bad job, or those who would harm us.

When trust in government falls, so too does our trust in one another.

In this way, they’re securitizing trust. Institutions securitize trust such that, rather than placing our trust one another directly, we instead place trust in our institutions and count on them to protect our interests and to assure that parties to a transaction or exchange act fairly. Knowing that a benevolent “Big Brother” is looking out for us, in turn, allows us to enjoy increased trust in one another.

But the trouble starts when our governments, regulatory bodies like the Food and Drug Administration (FDA), European Medicines Agency (EMA), Centers for Disease Control and Prevention (CDC) or Public Health England, police forces, and justice systems are not perceived as unbiased and impartial in their decision-making. The trouble starts when it feels like the law is selectively applied based on who you know, or on future favors promised, or the delivery of direct financial rewards; the trouble starts when legal systems are undermined by lobbying, political patronage, and personal connections. Under these conditions, the power of institutions to sustain trust and cooperation collapses. ▶PAGE 421

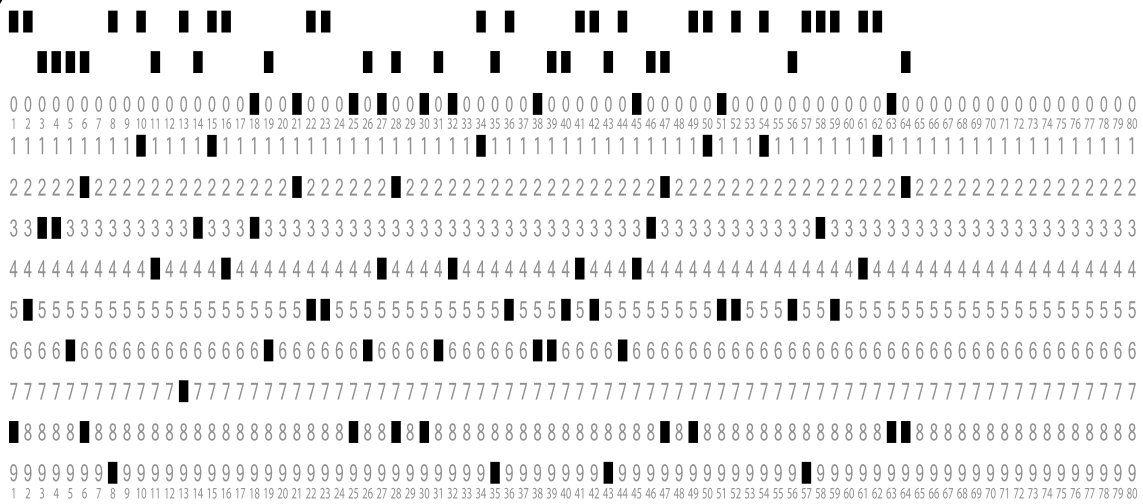
The mechanisms of direct reciprocity and reputation are simply insufficient for all groups in a large diverse society of anonymous strangers to establish trust one another. It’s a bit like how you would stop using AirBnB or Yelp if you felt like they weren’t working to safeguard your interest, or the reviews were fake.

If government institutions are trusted and perceived to be impartial, fair, and legitimate, it negates the need for us to directly trust one another. We simply have to trust the government to punish those who harm our society, or who free ride on the contributions of our hard work. We don’t need to track the reputations of all the people we interact with or directly go after them vigilante style when they do us harm. Instead, we trust the police, courts, and our political leaders. So, when trust in government falls, so too does our trust in one another. ▶PAGE 437

Q: Any final advice?

A: We now know the rules that govern how people decide whom to trust and learn from, how organizations and societies discover new innovations in norms and technologies, the rules that shape our actions when deciding to help or harm others, or when determining who counts as ‘us’ and who we regard as ‘them’. We can use these rules to improve ourselves, our technologies, governments, companies, schools, and societies. We can use them to develop more effective strategies, policies, and interventions. We can employ these “social technologies” to chart a better future.

Michael Muthukrishna is an Associate Professor of Economic Psychology at the London School of Economics. He is the author of [A Theory of Everyone: Who We Are, How We Got Here, and Where We’re Going](#) and founder of [LSE Culturalytik](#).



Closing Comments

Accelerating the SupTech Journey

by SIMONE DI CASTRI



Simone Di Castri







SupTech, short for supervisory technology, is equipping financial authorities with advanced solutions to address the need for more efficient and effective supervision in response to the growing complexity of global, datafied, and decentralized financial systems in the era

of mass consumption of financial services.⁶⁴²

This innovative field emerged from several key factors.⁶⁴³

- Demand for more robust, agile, and data-driven supervisory mechanisms emphasized by the global financial crisis of 2008 as well as by the financial crashes of 2023, which starkly highlighted the shortcomings of manual and fragmented supervision.
- Advances in data science and technology that provide financial authorities with powerful new tools to enable the timely analysis of vast amounts of data, identifying patterns, anomalies, and potential risks that traditional methods might miss.
- Expansion of supervisory mandates, which task financial authorities with a broader and diverse range of supervisory responsibilities — including prudential supervision, market conduct oversight, anti-money laundering (AML), combating the financing of terrorism (CFT) and the financing of proliferation (CPF), environmental, social, and governance (ESG) supervision, and cybersecurity — that agencies must manage with limited resources, making the efficiency gains offered by SupTech indispensable.
- The increased complexity and size of the regulatory landscape, with new rules and guidelines constantly emerging to address

SupTech Generations 2.0

	0G MANUAL	1G MINIMAL TECH	2G DIGITALLY TRANSFORMED	3G ADVANCED TECH	4G BIG DATA & AI
 Data Products	Minimal statistical summaries	Static report generation	Automated dashboards	Dynamic and interactive visualizations	AI-augmented business intelligence tools
 Analytics	No additional analysis	Manual analysis only	Descriptive/Diagnostic Analytics tools	Predictive analytics tools	Prescriptive analytics tools
 Access Controls	Individual access only	Team access only	Department access only	Limited agency-wide access	Agency-wide access
 Storage	Physical media	Centralized file-based storage	On-Premise Relational Databases	Cloud computing Database systems	Big Data tools
 Validation + Processing	Manual or no validation rules after receipt of data	Automated validation errors and warnings integrated into data submission process	Static Task Automation	Robotic Process Automation (RPA)	Advanced Data Processing
 Collection	Manually Submitted	Web portal or File Server	Push API	Pull API or Data Commons	AI-based collection or alternative data sources

Source: <https://lab.ccafi.io/state-of-suptech-report-2023/>

evolving risks, and the heightened expectations of consumers for transparency, accountability, and protection in financial services.

SupTech promises financial authorities increased efficiency by automating data collection and validation processes, significantly reducing the manual workload and expediting the supervisory process. Many new applications enhance accuracy and reliability, leading to more trustworthy datasets and advanced analytics that refine risk assessments and anomaly detection. Some solutions enable proactive supervision through predictive analytics, allowing the identification of potential risks before they materialize.

Several contributions to this *Compendium* have focused on the oversight of governance and non-financial risks. I will use this area to illustrate examples that highlight the transformational power of SupTech.

we are only at the beginning of the journey toward the digital transformation of supervision, and there is still a huge untapped potential

The European Central Bank's (ECB) Navi tool utilizes network graph analytics and visualization to analyze complex data networks. By combining data from numerous sources, Navi provides supervisors with comprehensive insights into bank owners and interdependencies, enhancing the supervision of interconnected financial sectors.⁶⁴⁴

The Office of the Superintendent of Financial Institutions (OSFI) uses scenario analysis and stress testing tools to evaluate the potential impact of extreme but plausible operational risk events, ensuring that banks can manage and mitigate these risks effectively.⁶⁴⁵

The Federal Deposit Insurance Corporation (FDIC) in the United States has automated reporting and data analysis systems that identify emerging risks and trends, integrating real-time analytics and comprehensive data collection to ensure effective operational risk management.

The Financial Conduct Authority (FCA) in the UK uses an AI and machine learning-powered SupTech solution for analyzing large volumes of data to enhance market supervision and integrity, detecting insider trading, market manipulation, and other forms of misconduct.

By leveraging advanced technologies, financial authorities can ensure that banks maintain robust governance structures and effectively manage operational risks, thereby contributing to the overall stability and resilience of the financial system. However, we are only at the beginning of the journey toward the digital transformation of supervision, and there is still a huge untapped potential.

What are the challenges to the maturity of the SupTech ecosystem? Financial authorities across the world have highlighted several difficulties:⁶⁴⁶

1. There is a significant challenge in acquiring the necessary skills to develop and maintain new systems and applications. Training the existing workforce and recruiting qualified expertise are critical yet challenging tasks.⁶⁴⁷
2. Securing the financial resources needed for modernizing tech stacks, training the workforce, and recruiting experts is a major hurdle. Many public agencies struggle to find the funding required for these essential activities.
3. Public agencies need to embrace human-centered design to ensure that the solutions developed are user-friendly and meet the needs of their stakeholders.
4. Replacing traditional waterfall development with agile methodologies is essential for the successful development and deployment of SupTech solutions. This shift requires significant changes in how projects are conceived, managed and executed.
5. Reforming obsolete procurement rules is necessary to allow for more flexible and timely acquisition of fit, cutting-edge technology and services.

6. Investing in change management is crucial to ensure that the workforce and stakeholders are prepared for and supportive of new technologies and processes.
7. Security, privacy, and ethical considerations of the adoption of new technologies such as clouds and artificial intelligence (including risk of hallucinations, the black box nature of algorithms leading to explainability issues, and potential biases in data that lead to discrimination).

To accelerate SupTech, we also need solutions that enable scale and facilitate collaboration between financial authorities, such as secure and swift sharing of code and data. For example, the Cambridge SupTech Lab Data Gymnasium is an online collaborative platform designed specifically for financial supervision that offers a secure space for data analysis and modeling projects, providing access to synthetic and anonymized datasets, cross-platform integrations, chat channels, and community notebooks, and lists open license resources crucial for SupTech development.⁶⁴⁸

Additionally, creating digital twins of financial institutions can help simulate various scenarios and assess the impact of different supervisory methodologies. These digital tools are critical to scale SupTech globally.⁶⁴⁹

Resource sharing can also be an accelerating factor, allowing pooling of resources and expertise to address common challenges and borrowing from the private sector expertise that is not readily available to public agencies.⁶⁵⁰

SupTech is also set to play a pivotal role in addressing climate change, leveraging blockchain, real-time data from IoT devices and satellite imagery to hold financial firms accountable for their environmental and social impacts.⁶⁵¹ It represents a pivotal opportunity to combat financial crime, which is

estimated to funnel \$3.1 trillion in illicit funds through the global financial system each year — with profound social, economic, and humanitarian repercussions.⁶⁵²

Another promising application of SupTech is its ability to harness the power of web and social media scraping for sentiment analysis, which could revolutionize proactive financial supervision allowing authorities to gauge the mood and opinions of the public and market participants in real-time, for instance, detecting early signs of public distrust in a financial institution or a sudden shift in sentiment towards a specific asset class.

And as this report describes, SupTech tools powered by developments in computational social science now allow us to put data-driven, quantitative analyses to the qualitative challenge of managing cultural contributors to organizational conduct. For instance, a Harvard Business School case study describes HSBC's use of such capabilities to anticipate lapses in its three lines of defense (3LoD), identifying leading risk indicators that enabled proactive management.⁶⁵³

Such capabilities allow for superior risk governance, at lower cost, and allow management to provide more timely and reliable reporting up to their boards and on to investors and industry overseers. Supervisors, too, can use these tools to reassure stakeholders regarding the governance of their own organizations. And with the right data-pooling protocols, supervisors might harness predictive behavioral analytics to conduct more effective horizontal peer reviews and perhaps to identify and cure culture-related risks across the financial system as they develop in real-time.

The landscape of financial supervision is undergoing a profound transformation with the advent of SupTech. Digital transformation is expanding the horizons of financial supervision, and SupTech will redefine the very foundations of how we approach regulation in the financial sector and even its architecture. By embracing these innovative technologies and visionary ideas, fostering public-private collaboration and pursuing scalability, we can build a more resilient, transparent, and sustainable financial system for the future.

Simone di Castri is the Co-Founder and Co-Head of the Cambridge SupTech Lab. He is a public policy specialist and frontier digital economy and financial market leader with 15 years of high-impact engagement in the fields of banking, payments, telecoms, and technology. His passion is evidence-based, data-informed policymaking, as well as the use of technology and innovative processes to pursue economic efficiency and social equality.

Appendix

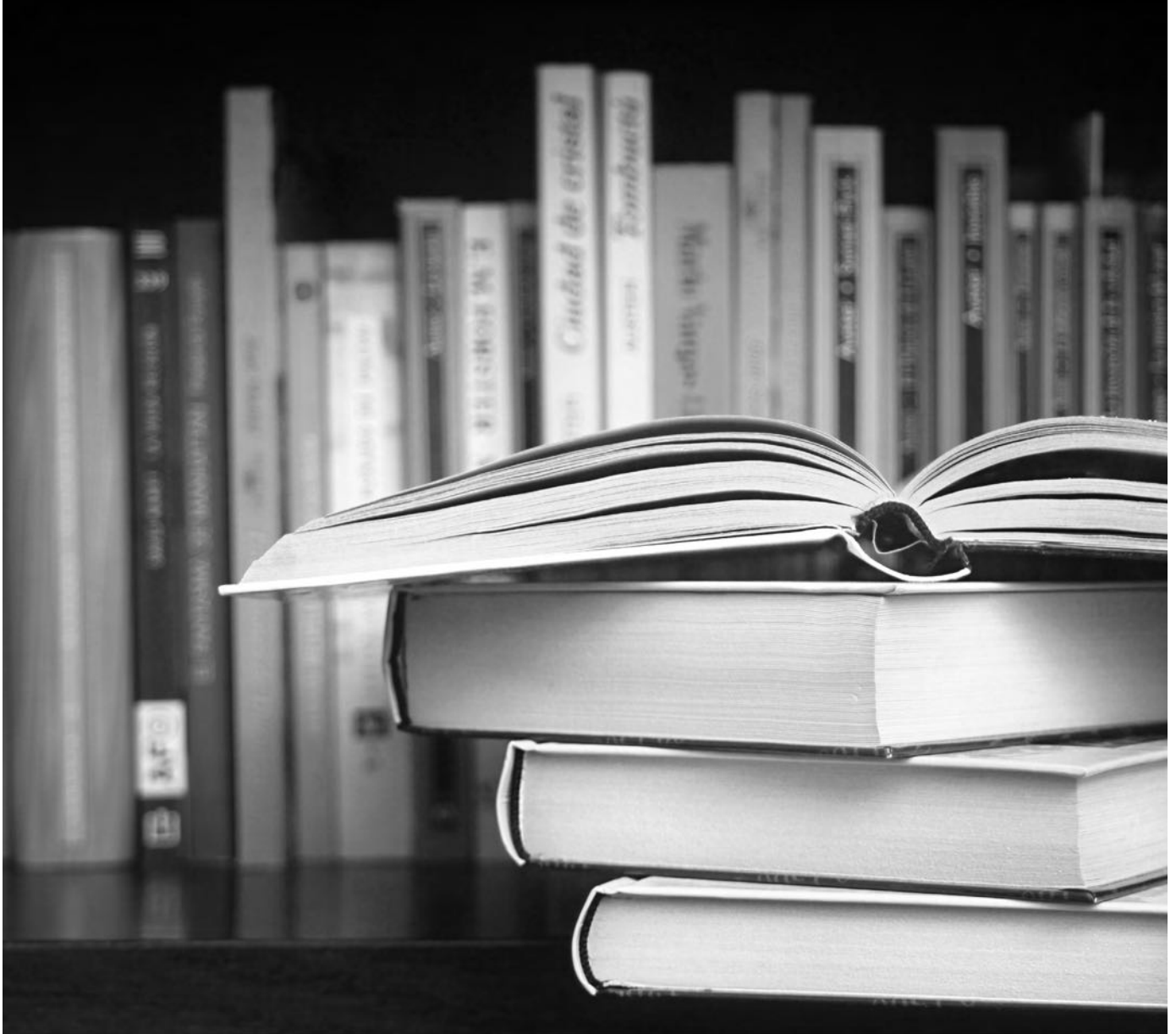
Culture and Conduct Risk Regulatory Landscape

Our Methodology

For the fifth year, Starling offers its Culture and Conduct Risk Regulatory Landscape, summarizing in chart form the degree of emphasis leading global regulators and supervisors are bringing to questions of culture and conduct-risk oversight. Our intent is to provide a broadly objective means of summarizing trends across respective jurisdictions, in a framework that permits for a trend-line comparison as it evolves over time.

As with previous years' charts, the inputs for this analysis were drawn from public as well as non-public 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. We have been grateful for the attention it has generated to date, and we look forward to seeing it evolve in years to come as regulators continue to evolve their approaches to addressing the challenge of culture and conduct risk supervision. We invite reactions at compendium@starlingtrust.com.



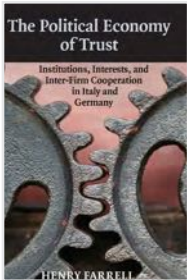
APPENDIX

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 or one of our past year’s reports, noted in bold below.

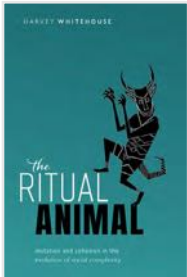
CULTURE & BELONGING



The Political Economy of Trust: Institutions, Interests, and Inter-Firm Cooperation in Italy and Germany

Henry Farrell ◀

“While formal institutions may very clearly support cooperation on a very wide scale, they do so primarily through promoting confidence rather than trust... In contrast, informal institutions may have more direct consequences for trust and cooperation... They will provide practical guidance to actors about how to behave in situations that were not fully anticipated in the relevant institutional rules.”

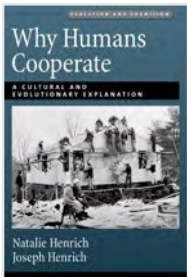


The Ritual Animal: Imitation and Cohesion in the Evolution of Social Complexity

Harvey Whitehouse

“From infancy, we copy those around us in order to be like others, to be one with the tribe. Other primates will copy behaviour that leads to transparent benefits, but only humans promiscuously copy actions that have no instrumental purpose... The main motivation to copy such behaviour is the desire to affiliate, and we imitate with higher fidelity when ostracism threats are cued, apparently as a re-inclusion behaviour.”

“The ritual animal longs to belong.”

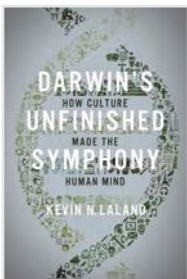


Why Humans Cooperate: A Cultural and Evolutionary Explanation

Joseph Henrich
Natalie Henrich

“Many behaviors are cultural in that they are socially learned by observation and interaction in a social group — social learning can then be understood as the foundational capacity that underpins what is typically glossed as ‘culture.’”

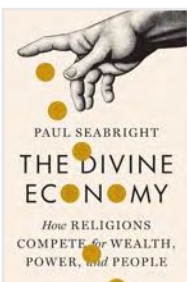
“We argue that both purely genetic and culture-gene interactions have shaped human social psychology such that people cooperate, help, trust, and punish in highly patterned and often contextually specific ways.”



Darwin's Unfinished Symphony: How Culture Made the Human Mind

Kevin N. Laland ◀

“[A]t some juncture in our history, our ancestors began systematically to correct the behavior of the individuals they taught; in the process, they shifted their society away from reliance on mere conventions and toward governance through norms. People stopped illustrating *a* way to behave and began insisting on *the* way to behave. Eventually, each society was characterized by a particular set of norms that dictated how individuals should behave.”



The Divine Economy: How Religions Compete for Wealth, Power and People

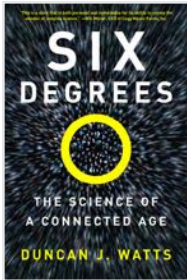
Paul Seabright ◀

“Religion is about belief and about belonging.”

“Religious movements are a special kind of business — they are platforms. Platforms are organizations that facilitate relationships that could not form, or could not function as effectively, in the platforms’ absence.”

“[H]uman beings find purpose in activities that have a collective dimension. Religious platforms create communities that powerfully articulate that collective dimension to our lives.”

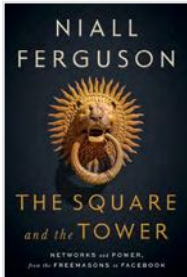
NETWORKS & INFLUENCE



Six Degrees:
The Science of a Connected Age
Duncan Watts

“Whether we are aware of it or not, we rarely, if ever, make decisions completely independently and in isolation... When push comes to shove, humans are fundamentally social creatures, and to ignore the role of social information in human decision making ... is to misconstrue the process by which we come to do the things we do.”

“Lurking once again in the guts of the problem is the network — that ubiquitous web of signals and interactions through which the influence of one person passes to another.”

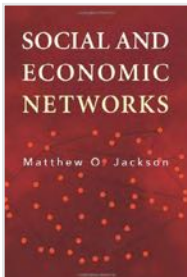


The Square and the Tower:
Networks and Power, from the Freemasons to Facebook
Niall Ferguson

“Often, the biggest changes in history are the achievements of thinly-documented, informally organized groups of people.”

“When hierarchy is the order of the day, you are only as powerful as your rung on the organizational ladder of a state, corporation or similar vertically ordered institution. When networks gain an advantage, you can be as powerful as your position in one or more horizontally structured social groups.”

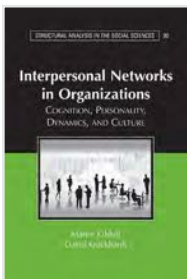
“For the historian, then, the insights of network theory, in all its forms, have profound implications.”



Social and Economic Networks
Matthew O. Jackson

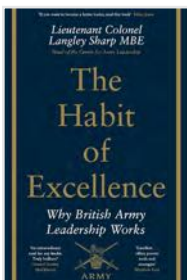
“Social networks permeate our social and economic lives... The countless ways in which network structures affect our well-being make it critical to understand (1) how social network structures affect behavior and (2) which network structures are likely to emerge in a society.”

“Peers exert enormous influence on human behavior. It is easy to cite examples, ranging from the products we buy, whether we engage in criminal activities, how much education we pursue, to which profession we choose.”



Interpersonal Networks in Organizations:
Cognition, Personality, Dynamics, and Culture
David Krackhardt

“To be an effective leader of a social unit is to be aware of (a) the relations between actors in that unit, (b) the extent to which such relationships involve embedded ties including kinship and friendship, (c) the extent to which social entrepreneurs are extracting value from their personal networks to facilitate or frustrate organizational goals, and (d) the extent to which the social structure of the unit includes cleavages between different factions.”

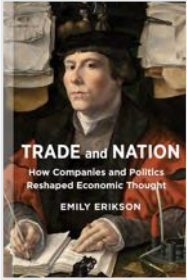


The Habit of Excellence:
Why British Army Leadership Works
Langley Sharp

“Leadership is best understood as a human endeavour whose central concerns are to influence the individual and mould the collective in service of the ultimate mission.”

“Most importantly, it is a habit, the ability to do the right thing and make the difficult decision every single day: an accumulation of countless small choices, interventions and demonstrations that set the example required to uphold standards and drive performance.”

TRUST & PERFORMANCE



Trade and Nation: How Companies and Politics Reshaped Economic Thought

Emily Erikson ◀

“For a reader familiar with the economic literature two centuries prior to the publication of *The Wealth of Nations*, what is most striking about Smith was his reincorporation of philosophical and moral concerns into a literature on trade that had largely left these matters by the wayside... He was trying to reintroduce the moral framework of justice, equity, and benevolence that had dominated the literature in the medieval era but had been discarded by seventeenth-century merchant authors.”



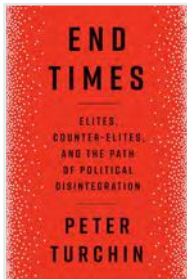
Forging Capitalism: Rogues, Swindlers, Frauds, and the Rise of Modern Finance

Ian Klaus

“Trust, to be simple with our definition, is an expectation of behavior built upon norms and cultural habits ... It is also a process orchestrated through communities and institutions.”

“If new forms of finance, commerce, and risk management were essential to [18th century] capitalism’s vitality, new forms of trust were needed to safeguard that vitality in a world of strangers and speed.”

“A history of vice and capitalism, then, must also be a study of trust — or at least its absence.”

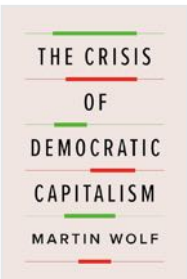


End Times: Elites, Counter-Elites, and the Path of Political Disintegration

Peter Turchin ◀

“[T]he collapse of trust in the state’s institutions undermines its ability to keep internal peace and order.”

“Because the most recent period of social and political turbulence in the United States was the 1960s, which were very mild by historical standards, Americans today grossly underestimate the fragility of the complex society in which we live. But an important lesson from history is that people living in previous precrisis eras similarly didn’t imagine that their societies could suddenly crumble around them.”

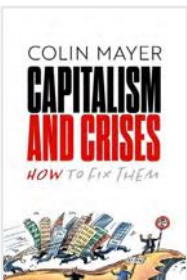


The Crisis of Democratic Capitalism

Martin Wolf

“The health of our societies depends on sustaining a delicate balance between the economic and the political, the individual and the collective, the national and the global. But that balance is broken... A big part of the reason for this is that the economy is not delivering the security and widely shared prosperity expected by large parts of our societies.”

“In short, the liberal democracy and global capitalism that were triumphant three decades ago have lost legitimacy.”



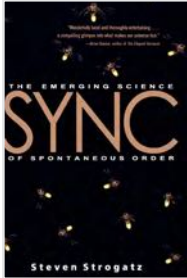
Capitalism and Crises: How to Fix Them

Colin Mayer ◀

“The public sector has the advantage that in principle it promotes the overall wellbeing of society rather than, as in the case of the private sector, just a small segment of it. However, in being accountable to everybody it suffers from no effective governance by anyone.”

“We need a system that encourages business to have an intrinsic interest in the common good, not just rely on it being imposed from above by fictional, socially minded guardian angels in the guise of governments and regulators.”

THE WAY FORWARD

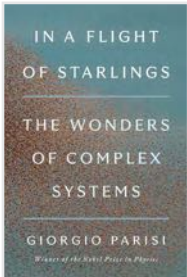


Sync:

The Emerging Science of Spontaneous Order

Steven Strogatz

“For reasons we don’t yet understand, the tendency to synchronize is one of the most pervasive drives in the universe, extending from atoms to animals, from people to planets... On the surface, these phenomena may seem unrelated... But at a deeper level, there is a connection, one that transcends the details of any particular mechanism. That connection is mathematics. All the examples are variations on the same mathematical theme: self-organization; the spontaneous emergence of order out of chaos.”



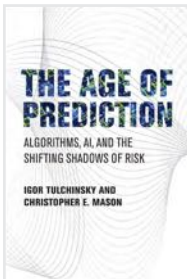
In a Flight of Starlings:

the Wonders of Complex Systems

Giorgio Parisi

“Even if the behavior of starlings is a subject for biologists, the quantitative study of three-dimensional movements of individuals requires the kinds of analyses that can be accomplished only by physicists.”

“When two systems have been well studied, it is possible to apply to one field ... the myriad results and techniques obtained in the other field. In general, when the same formal mathematical system has two completely different physical manifestations, you can use physics insights from both systems to obtain valuable complementary information.”



The Age of Prediction:

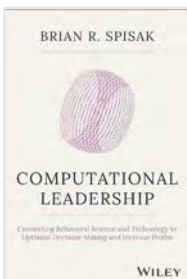
Algorithms, AI, and the Shifting Shadows of Risk

**Igor Tulchinsky
Christopher E Mason**

“Today, prediction can ascribe features and probabilities to each cell of an embryo, to each biochemical change in an astronaut in space, to each cancer patient, to each tendency in financial markets, to complex natural processes, and to social behavior.”

“[M]arkets and biology share deeper affinities that large amounts of data can sometime reveal.”

“[O]ur tools may be revealing the genesis of some elusive and stubborn complexities of human behavior...”

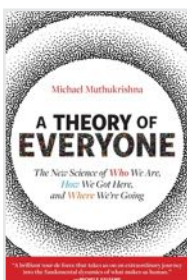


Computational Leadership:

Connecting Behavioral Science and Technology to Optimize Decision-Making and Increase Profits

Brian Spisak

“Leadership is typically thought of as a ‘soft’ intuitive skill, while management is a ‘hard’ science, but those lines are blurring, and the days of purely intuitive decisions are over. Technological innovation, (big) data, an army of analytical experts, and savvy leaders are vaporizing the idea that leadership is purely a soft skill... Business and society is on the cusp of a shift where ALL aspects of leadership ... are overhauled through the application of computational methods, including AI, network analysis, predictive modeling, and simulations.”



A Theory of Everyone:

The New Science of Who We Are, How We Got Here, and Where We're Going

Michael Muthukrishna

“A scientific revolution is starting to bring order to the chaotic world of human affairs... Sapiens are still difficult to predict, but at least we now know the rules by which we work. We know the rules that govern how people decide whom to trust and learn from... We can use these rules to improve ourselves, our technologies, our governments, companies, schools, and societies; to develop strategies, policies, and interventions — social technologies — to chart a better future.”

APPENDIX

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All titles represent contributors' roles at the time of their contribution.

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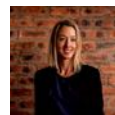
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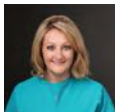
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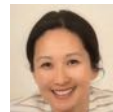
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SIEW KAI CHOY (2020)
Past-Managing Director, GIC



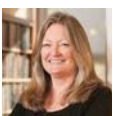
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Professor of Social and Natural Science, Yale



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