

Culture risk supervision and governance: success depends on goal clarity

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Finance market behaviour is culture in action. Those who have produced Supervisors on Supervision are therefore right to identify culture as a key supervisory focus. Indeed, strengthen positive culture and the need for some sorts of blackletter regulation should reduce, making it easier to cut.

Corporate culture is a system of shared values, meanings and norms that shape how people in a firm understand situations and act. A firm's sub-cultures and the character of its people also affect their behaviour, as do wider cultures in which the firm operates. In broad terms, however, corporate culture bears on and precedes its every step, including business activity and regulatory compliance.

It therefore follows that it is crucial to apply the highest possible conceptual, technical and practical rigour to supervisory scrutiny of firm culture, as Supervisors on Supervision advocates. Rigour is essential in ensuring that supervision is both effective and seen to be effective. It is crucial too in defining the realistic role of supervisors in culture risk supervision and governance. Both are relevant to the trust that firms, politicians and the wider public repose in supervisors as, again, Supervisors on Supervision is right to recognise. Also relevant are the objectivity and quality of skill and judgement that supervisors apply, which will be influenced by their own culture.

Conceptual rigour involves clarity about the issue being addressed, technical rigour the quality of methods, tools and measures used in addressing it and practical rigour concerns real world application. While these three are interconnected, the starting point must be conceptual. A consensus or 'common grammar' is needed about what is being addressed, since all else flows from that. And since regulatory supervision involves the supervised, is undertaken to discharge political mandates and may come to be weighed in the wider 'court of public opinion', any regulatory consensus needs to take account of wider understandings of corporate culture and its associated risks. As anyone familiar with the multiplicity of definitions of corporate culture will know, a perfect consensus on this topic is impossible. What is needed is a workable consensus that captures enough of the substantive shared ground. It should, however, draw on the best of the considerable body of wider work on this topic across multiple disciplines.

So, what is 'culture risk supervision and governance'?

First *culture*. As noted, this is essentially a system of shared values, ways of understanding the meaning of reality, and norms that shape how people in a firm interpret situations and act. It is embedded and path-dependent. It is also emergent, evolving as the firm, its units and its people interact with each other and with cultures and sub-cultures beyond the firm. It is inherently difficult to discern, especially for insiders – one reason it is so powerful. Behavioural regularities can be observed in practice. These

¹ Freshfields LLP. Written in a personal capacity. Views are those of the author alone.

regularities can operate to reinforce corporate culture and can cast light on it. However, a firm's culture is not the behaviour alone but what lies behind it: hence, talk of *culture* risk supervision and governance, not *behaviour* risk supervision and governance. Culture is values and meanings in practice; the behaviour expresses those values and meanings.

Second, what is *culture risk*? To talk of risk implies a goal – some sort of aspired outcome that that is not guaranteed. 'Culture risk' is, then, the possibility that a firm's culture will generate behaviour that frustrates a desired outcome. Again, understandings will diverge on what outcomes are desirable from the activities of finance firms: management discharging legal duties to pursue the success of their firm will have one view; regulators discharging regulatory mandates another; politicians who have granted those mandates yet another; and the wider public still others. Those views will also fluctuate over time. However, for regulators, the starting point must be whether a firm's culture operates in a way that does not pose an unacceptable risk to or, more positively, is congruent with, the objectives the regulator has been set by law – frequently, financial systemic stability, prudential soundness of regulated firms and good conduct. It is not that the firm's culture must be designed around those goals. It simply needs to be the kind of culture that generates behaviour reasonably aligned with them.

Given this focus on outcomes, it is worth pausing to pick up on the powerful relationship between corporate goals or purpose and the development of a firm's culture, especially its values and sense of meaning. While there is circularity, values are anchored in a firm's 'why'. Meaning assembles around the process of applying those values in practice to deliver that outcome. It is an organisation's true purpose, not its espoused purpose that counts; Enron's stated purpose was to create efficient energy solutions for growing economies and a better environment worldwide working honestly, openly and sincerely. However, that was not the reality.

Of course, the goals of firms and the expectations of regulators, politicians and the wider public are likely to overlap. There is an obvious social need for businesses to flourish, and it will not be in the interests of firms to ignore the expectations of regulators, politicians and the public in determining their goals. However, the outcomes desired by these groups are not identical. Given how goals drive culture, this also suggests that corporate cultures will not be perfectly aligned with a notional supervisory 'ideal' either; as noted, the issue is whether alignment is sufficient to avoid undue threats to supervisory goals.

Attention to the social licence for financial markets – the idea that market operators have been given a freedom to carry on business within core socially acceptable parameters to benefit themselves and wider society – provides a useful context in which all parties can navigate these overlapping but at times potentially divergent currents.² It is relevant in supervising and governing firm culture and more broadly. Talk of a social licence for financial markets incorporates but transcends the goal of firms' financial returns, recognising the underlying need to nourish the trust and social solidarity on which firms

² 'Building real markets for the good of the people', speech by Mark Carney, June 2015; David Rouch, 'The Social Licence for Financial Markets: Reaching for the End and Why It Counts' (Palgrave Macmillan 2020).

and markets depend, making more salient shared ground and core goals on which there is a broad consensus.

Finally, what of *culture risk supervision and governance*? My own culture risk governance and supervision project is sitting at the back of the fridge. It's a yeast culture. I add it to flour, causing the dough to ferment and inflate. Provided I take a set of basic steps to keep the culture healthy it does its bit to produce bread in a scientifically predictable and consistent way. I control the conditions for it to stay healthy and how active it becomes. I determine whether to release it into the dough and how fermentation then develops.

Manifestly no one has this level of agency over corporate culture, which is not just a biological system but a complex social phenomenon, influenced by intricate wider networks. So, humility is needed in staking out supervisory and governance roles. Legal responsibility for a firm's operations resides in its directors. As firm culture fundamentally affects whether the firm achieves its goals, the directors must supervise and govern the firm's culture to that end; 'tone from the top' is indeed crucial. In a sense, that is directors' primary role. They will know the firm and its business, and the complexities and trade-offs it faces, more intimately than any external agency. English courts faced with claims that directors have breached their duties have consistently recognised this, generally confining themselves to an assessment of, broadly, the reasonableness of directors' processes in arriving at a given decision rather than stepping into their shoes to vet the merits of the decision itself.

The supervisor-firm relationship obviously runs much deeper and, given the purpose of regulation, the role and powers of supervisors are intentionally more intrusive. However, it is still plainly not supervisors' task to run regulated entities. They sit outside those entities. Their culture risk supervision is inevitably limited to ongoing oversight, assessment and evaluation for alignment with regulatory objectives, their governance to, essentially, communicating expectations concerning a firm's culture and requiring remediation of identified shortcomings. Just as these functions must be discharged with technical and practical rigour (and objectivity, skill and good judgement) if supervisors' legitimacy is to be maintained among firms and the wider public, so the extent and limits of supervisors' role must also be widely understood.

Building a rigorous, coherent consensus around the concept of conduct risk supervision and governance is, then, foundational. Close attention to what it is serves to emphasise how culture risk supervision and governance cannot be limited to technical scrutiny of behaviour within a firm but needs to reach far further to the goals and related values that drive a firm's culture. And a good place to start in surfacing those is with the narratives that govern firms' behaviour – not simply what is articulated to the public, but the deeper narratives that are rehearsed in practice. To a large degree, humans comprehend and navigate their physical and social reality through stories. Narratives shape culture. They marshal understanding of reality – give it meaning – by reference to desired goals and values and provide a bridge into action. We cannot understand who we are or how to act without knowing, at some level, what narratives we are a part of. Unsurprisingly, therefore, narratives are also a powerful way of seeking to change culture where needed.

Financial life is often characterised by a set of financial narratives which treat humans as rationally and conflictually pursuing their maximum financial self-interest, a view popularised in the *Wolf of Wall Street* genre of movies. These narratives emphasise narrow private goals and are powerful because they contain an element of truth, but only an element. The understanding that markets have a social licence to carry on business brings a more holistic perspective to bear – one that recognises high levels of interdependency between private and public goals. It casts light on common ground where consensuses on the purpose of finance firms (and their supervision and governance) can be developed, and cultures assessed. It therefore has the potential to be a useful framework as supervisors continue to develop their approach to culture risk supervision and governance.