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COMMENTARY: Safeguarding financial-firm cultures: five focus factors for directors

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NEW YORK (Thomson Reuters Regulatory Intelligence) - Ten years ago, early signs of what would become the greatest financial crisis in recent history began to surface and the world bore witness to the turmoil that ensued. Fortunately today, due to increased capital and liquidity requirements, recovery and resolution planning, and other enhanced prudential standards imposed on the largest banks, the financial system is much stronger, more resilient, and better positioned to weather the next crisis.

Yet, even though the stability of the financial system has been significantly enhanced, pubic trust in financial institutions has been eroded by multiple post-crisis violations of trust, including scandals involving London interbank offered rate (LIBOR) manipulation(here), foreign exchange (FX) trading(here), fraudulent accounts(here), and others. While the vast majority of banks operate with integrity, the financial system relies so heavily on public trust that violations by even a small number of firms casts a shadow over the entire industry.

Averting such violations of public trust is one of the most important responsibilities of the directors of financial institutions. Directors typically work diligently to fulfil that important obligation by ensuring that their institution complies with all applicable laws, regulations, and supervisory guidance. But, if focusing on compliance is the extent of their oversight, they ignore a blind spot that factors as the single most important lever in ensuring operational integrity: company culture.

One of us (Silva) has personally supervised a systemically important financial institution (SIFI), served as an executive leader in the SIFI C-suite, and is currently external counsel to multiple financial institutions. The other (Filabi) has empirically studied culture as executive director of Ethical Systems, a research collaboration studying the social science of business ethics. These personal experiences and study of existing and emerging research on the role of culture have demonstrated that culture is the single most important driver determining whether an institution contributes positively to a trusted financial system.

(NOTE: Azish Filabi, co-author of this article, will be an panelist at a forum of industry leaders and regulators on "Bank Culture Reform & Behavioral Science" at Thomson Reuters Times Square. The forum is Monday, April 9. For more information and to register, please follow this link(bit.ly/2uKuLll).)

Regulations, rules, and internal procedures serve as important guardrails for the prevention of misconduct and ethical lapses, but culture is the foundation upon which those guardrails are set. The stronger the culture of integrity, the sturdier the guardrails and the better the organization is able to withstand the pressures of profit-and-loss (P&L) demands, poorly designed incentives, rogue employees, weak audit and compliance programs, and other factors that often provide the motivation and opportunity for misconduct and ethical lapses.

Our personal experiences and study suggest that there are five factors directors can focus on to promote their institution's culture of integrity:

1. Assess whether employees believe that management acts with honesty and integrity(www.nber.org/papers/w19557), ideally by conducting a robust organizational culture assessment. Research shows that perceptions of ethical culture and integrity correlate with stronger financial performance and reduced observations of misconduct. Some things to keep in mind when assessing culture are that it is best to have a trusted third party manage the process (which helps ensure confidentiality among employees), and that you must have meaningful buy-in from leaders at all levels of the organization about its importance and your intent to take actionable steps to remediate any issues uncovered;

2. Evaluate and manage factors that promote a speak-up culture at the organization(here), which includes efforts for openness by supervisors in informal interactions, as well as ensuring anti-retaliation for reports received through formal reporting channels. A weak speak-up culture is often indicative of two main factors: fear among employees – of retaliation, but also that they will be shunned or may breach loyalties – as well as futility, the sense that raising issues is pointless because the organization would not actually do anything to resolve the underlying problems. Senior leaders

need to make concerted efforts to understand and change these management tendencies.

3. Establish efforts to promote diversity at senior levels of the organization, both demographic and viewpoint diversity(here), coupled with an inclusive environment that integrates such diversity(here). Diversity can certainly be measured in terms of the numbers of people representing various demographics (gender, race, etc.), but it can also extend to data about the processes that exist at the organization. For example, is there a diverse slate of candidates for each role? In areas where there is low representation, have you conducted focus groups to understand why?;

4. Establish that the firm has zero tolerance for bullies(here) – high-performers who are abusive to other employees; and

5. Promote organizational fairness(here) by ensuring that the company enforces violations of norms and internal rules consistently and proportionately, irrespective of rank or other factors, and is transparent about doing so.
While comprehensive treatment of creating a culture of integrity exceeds the scope of this writing, there are strategies and assessment tools that boards can avail themselves of to promote each of the above elements.

Integrity-related penalties have cost the largest banks tens of billions of dollars in the last several years, in addition to unquantifiable reputational costs. A strong culture of integrity is not only the best protection against such costs, it can also be a very significant competitive advantage with consumers and contribute to better overall risk management.

That trifecta suggests that building and maintaining a culture of corporate integrity should be one of the very highest priorities of directors.

(Michael Silva is a partner and chair of the financial services regulatory practice of DLA Piper. He joined DLA Piper from GE Capital, where he served as the chief compliance and regulatory affairs officer, leading a 700-person global staff. Prior to GE Capital, Mike had a long career at the New York Fed, where he held many leadership roles, including as chief of staff for Tim Geithner during the financial crisis, a senior supervisory officer for a systemically important financial institution, and lead in-house international counsel.

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