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Regulation, Corporate Culture and Individual Responsibility in Banking

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In this SUERF Policy Brief we consider the role of institutional culture and individual responsibility in banking and the role and focus of regulation. An issue that has not been sufficiently addressed is the extent to which the focus is to be individuals or financial institutions should be the focus of regulation, supervision, accountability, and sanctions when problems emerge as a result of the behaviour of banks or other financial institutions.

INSTITUTIONS v. INDIVIDUALS

Decisions (good and bad) are made not by institutions and companies per se but by individuals and groups (such as committees) working and operating within them. And yet (applying the principle of Athropomorphisation whereby human characteristics are assigned to inanimate objects and organisations) the focus is usually on institutions rather than the incentive structures of those within them who make the decisions.

The significance of focussing upon individuals as decision-makers rather than the organisations in which they operate is fourfold: it influences the culture of an organisation, it focusses on the need for appropriate incentive structures within them, it has implications for the appropriate focus of regulation, and re-directs accountability towards individuals as well as institutions. In order to understand an institution's or company's decisions, the incentives faced by individual decision-makers need to be identified and understood. In the UK in the area of finance some tentative moves in this direction have recently been made with the Senior Managers Regime.

TRUST AND CONFIDENCE IN BANKS

It is now over ten years since the most serious banking crisis in generations and one that imposed enormous economic and social costs on a wide range of stakeholders. Along with other forms of misconduct, trust and confidence in banking has been compromised. There is market research evidence indicating that the reputation and esteem of banks has been badly affected. In the words of the Group of Thirty: "the reputation of banking and the broader financial sector has deteriorated since the financial crisis, and is now at an historical low in terms of trust on the part of clients and customers". The impact on trust is also seen in the 2017 Edelman Trust Barometer.

There is also criticism in some circles that those responsible for the crisis and other bank misconduct seem not to have been adequately punished if sanctioned at all. While this is not altogether true, the perception is understandable.

Four types of misconduct can be identified: cavalier risk management, mis-selling of financial products to potentially vulnerable consumers, violations of national and international rules on, for instance, money laundering, and manipulation of financial markets. In other words, the crisis of 2008 is not the only factor. Other much-publicised examples of misconduct include: mis-selling of Payment Protection Insurance in the UK, pensions mis-selling, instances of rogue trading, the manipulation of LIBOR, and examples of money laundering. As a result, massive fines have been imposed on banks. But where is the incidence of the fine? Who ultimately pays the fine is a central issue – is it shareholders, individual bankers, employees generally, customers?

This is important because trust and confidence is crucial in banking for several reasons: we do not purchase some financial products frequently which means there is limited opportunity to learn from experience; there is a principal-agent relationship between financial firms and their customers; the value of many financial contracts are not known at the point of purchase and so it is not always clear precisely what we are buying; given the long-term nature of many financial contracts, the behaviour of the financial firm after the transaction has been made impacts on the ultimate value of the contract; and there is often a lac k of transparency in complex financial contracts. Furthermore, many financial transactions (e.g. investments and pensions) are long- term in nature and trust is always important in long term contracts. Any erosion of trust is therefore serious.

We can look at a multitude of specific factors that have led to bad behaviour by financial firms and many specific factors have been analysed to explain why the crisis occurred. But is this focus on institutions the right approach? Ultimately, and abstracting from these specific causes, it is a matter of the underlying culture of the bank, the incentive structures within it, and the degree to which individuals are held accountable.

ROLE OF INSTITUTIONAL CULTURE

Culture is central in all firms when considering corporate responsibility. Different authors have offered a wide variety of definitions of "culture". For our purposes we refer to that given by Allison Cotterall (Chief Executive of the UK's Banking Standards Board): "Collective assumptions, values, beliefs and expectations that shape how people behave in a group". The group focus is important because we learn from a study of *Identity Economics* (and our own personal experience) that people behave differently in different environments. We all of us have multiple identities: in the family, in the company in which we work, amongst friends, in a group, etc and behaviour is often different in each case. In a given situation, behaviour is shifted towards those norms that are associated with the more salient identity at the time. We can assume that those bankers who attempted to illegally rig interest rates would not take money from the collection box at their church service on Sunday. Would a sales officer in a bank knowingly sell an inappropriate product to his or her friends and family? As people behave differently in a group than they do acting alone, Group Culture becomes a central issue.

The culture of any firm or any organisation is important to an understanding of individual and collective behaviour: it creates business standards and influences employees attitudes and behaviour and generally establishes norms of behaviour. This is turn provides a link with consumer trust and confidence. This is particularly important in banking and finance because of the pivotal role that financial firms in general and banks in particular play in the economy.

REGULATION AND SUPERVISION

The biggest banking crisis for generations spawned the biggest change ever in the regulatory regime. But is this the right approach? Regulation of banks is a necessary though not sufficient condition for good behaviour. There needs to be a greater focus on the underlying culture of banks because if this is hazardous no amount of regulation will prevent misconduct. At the heart of many instances of misconduct (including the failure of risk management in the run-up to the

banking crisis) are a combination of hazardous culture, perverse incentive structures within financial firms, weak internal governance arrangements, and a lack of individual responsibility and accountability.

When considering the banking crisis and other examples of hazardous behaviour, two issues immediately come to mind: **who** was responsible and **why?** When focussing on the "who" dimension it is a question of whether the focus is to be on the institution or the individuals actually making decisions. As already emphasised, it is not banks *per se* that make decisions: but individuals within them. Who should be held responsible for bad behaviour: the financial firm or individuals who made the decisions?

This is where the link between culture and individual behaviour comes to the fore and provides the link between corporate culture and individual responsibility. The two interact in a complex way: behaviour can influence culture and established culture influences individual behaviour. It is also a question of effectiveness: what is likely to influence future behaviour more – a £10 million fine on the bank or a £20,000 fine on individual employees who can be identified as making the "bad" decisions or behaved in a hazardous way towards customers. Perhaps the focus has been wrong and should be more on individuals than firms (in practice it should be both) and a regime that makes individuals responsible and accountable for their actions.

Focussing on the role of culture, we can establish five main influences that can create "bad" behaviour: (1) the culture of the firm, (2) the culture of the industry, (3) peer group pressure on individuals – especially those new to a firm, (4) specific incentive structures (e.g. sales targets within an organisation where a person's salary or bonus is determined by the number of sales made irrespective of whether they were appropriate to the innocent buyer), and (5) internal governance arrangements within the firm and the extent of individual accountability.

Reform is needed though this is difficult given the complex interaction between corporate culture, individual responsibility, and official regulation and supervision. Within this nexus culture needs to become a supervisory issue (in that supervisors should examine the underlying culture of financial firms), and a greater focus needs to be given to individuals and the incentive structures they face including when sanctions are imposed. Individuals need to be made more accountable for their actions and decisions.

A welcome move in the UK comes with the Financial Conduct Authority's *Senior Managers Regime* which has recently come into force. Regulators now require that all relevant employees within financial firms are covered by a set of conduct rules and act with integrity, due skill, care and diligence….and pay due regard to the interests of customers and to treat them fairly." In addition, "senior management is subject to additional conduct rules requiring them to take reasonable steps to ensure that the business of the firm is controlled effectively." This means that individuals are to be held responsible for their actions with the possibility that they may be individually sanctioned.

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About the Author

David T Llewellyn *is Professor of Money and Banking at Loughborough University and an External Member of Kellogg College at the University of Oxford. He is a member of the Council of Management and former President of SUERF. Until recently he was Chair of the European Banking Authority's Banking Stakeholder Group and was formerly a Public Interest Director on the Board of the UK's former retail investment regulatory agency – the Personal Investment Authority. David has also had career posts as economist at Unilever, HM Treasury, and International Monetary Fund and has served as a consultant to financial institutions, international agencies, and regulatory authorities in the UK and abroad. David served as part-time Consultant Economist at ICAP plc for several years. Other positions have included Visiting Professorships at universities in the UK and elsewhere in Europe.*

David has researched and published extensively in the area of banking strategy, competition in financial systems, and banking and financial regulation. In 2016 he was awarded an honorary doctorate for his contributions to banking regulation.

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