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Fostering an Ethical Culture in the Banking Industry

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Abstract: The aim of the article is to recommend policies to an promote ethical culture in banking. Top-down regulation cannot prescribe specific ethical conduct and is thus bound to be generic and ineffective. Yet, solely relying on voluntary commitments from banks does not ensure an industry-wide cultural change. Therefore, regulators should focus on a certain kind of principle-based policy to create systemic incentives for banks to foster ethical culture.

Post-GFC Efforts to Foster Ethical Culture in the Banking Industry

The lost growth from the Global Financial Crisis (GFC) was equivalent to 1/6 of global GDP in 2008 **(Oxenford 2018)**. It was, in the words of then Fed chairman Ben Bernanke, "the worst financial crisis in global history" **(Wolf 2018)**. Its far-reaching repercussions appeared to represent "the first crisis of the current era of globalization" **(Pisani-Ferry & Santos 2009)** and the beginning of "a systemic transformation – the end of … neoliberal deregulation" **(Cohen 2009)**.

Although causes of the GFC are not solely limited to the conduct of financial institutions, the overarching criticism against the banking industry, from civil society, like Occupy Wall Street **(Brisbane 2011)**, public regulators, academics and the industry itself, was that bankers behaved unethically. This was partly due to weak regulations and systemic incentives to take reckless risks **(Stiglitz 2010)**. Ethical culture, which influences individual conduct in important ways **(Linklater 2019)**, depends on each bank's formal and informal institutional structure but can be hindered or encouraged by regulators.

Consequently, the post-GFC reformatory strategy to enhance ethical conduct has two directions: top-down and bottom-up. From the top-down, international and national regulators 'fix' the apple barrel by enforcing regulatory frameworks to deter (negative) unethical conduct and foster (positive) an ethical one **(Blair &**

Barbiani 2019). From the bottom-up, banks themselves promote ethical culture, thus obviating the proliferation of bad apples from within **(Weiss 2014)**.

While not possible to have good apples in bad barrels, good barrels do not ensure good apples. An ethically-conducive regulatory framework is necessary yet not sufficient for ethical culture and conduct to emerge, and thus needs to be complemented with internal efforts from banks **(Lagarde 2014)**.

Regulations After GFC

International and national financial regulations did not start with the GFC, although they intensified in its aftermath. Some of the most consequential international regulatory frameworks and organizations established in the last decade are incremental improvements on previous ones. For example, the Financial Stability Board (FSB) and the Basel III agreement indicate an institutional path dependency which affects multilateral efforts in other fields as well. Conversely, important government Acts such as US Dodd-Frank Wall Street Reform and Consumer Protection Act, and the UK's Financial Services Act reverted the pre-crisis neoliberal, deregulatory trend.

How Regulations Improved Systemic Ethical Culture

1. International regulations

    a. Basel III

After the financial crises in Latin America and Asia, international efforts to erect an "international financial standards regime" began with the Basel Accords in 1988 and then with Basel II in 1998-2004 and the creation of the Financial Stability Forum in 1999 **(Helleiner 2011)**. However, the standards agreed in these fora did not regulate financial institutions, such as investment banks, and securitization trends which dominated the financial system in the years to come **(Helleiner 2011)**. **Lall (2012)** points out that Basel II allowed large banks to use internal risk models to set capital levels, effectively resulting in banks minimizing capital reserves in order to maximise Returns on Equity (RoE).

Basel I and II employed market-based mechanisms for valuing risk and assets which suffered from procyclicality **(Helleiner 2011)**. During the boom, risk valuation models drawing on market prices signaled a relatively low-risk environment and thus encouraged further buying. Once the crisis began, however, the same models unleashed a vicious downward cycle by prompting mass selling.

Basel III, its first draft agreed in 2009, imposed more conservative regulatory capital ratios than its predecessors, especially for systematically important banks

(SIBs) **(BCBS 2017)**. Procyclicality was tackled by adding counter-cyclical capital requirements (relaxing during contraction and tightening during expansion) **(BCBS 2017)**.

Basel III addresses systemic incentives detrimental to ethical conduct in banks. Most importantly, provisions concerning stricter capital requirements and more sensitive risk standards encourage risk-culture in banks. Obviously, obviating RoE-driven reckless risk-taking is a pivotal step for the development of an ethical culture in the banking industry.

Nonetheless, as explained later, Basel III cannot alone revert cultural trends in the banking industry.

b. FSB

Replacing the Financial Stability Forum (FSU) in 2009, the G20 established the FSB. Essentially, the FSB has a wider membership than the FSU, allowing for the interaction of a more diverse set of national demands and reinforced international prudential standards **(Helleiner 2010)**

As the FSB website reports, the FSB was established to:

> Assess vulnerabilities affecting the global financial system as well as to identify and review, on a timely and ongoing basis within a macroprudential perspective, the regulatory, supervisory and related actions needed to address these vulnerabilities and their outcomes.
>
> Promote coordination and information exchange among authorities responsible for financial stability.
>
> Monitor and advise on market developments and their implications for regulatory policy.
>
> Monitor and advise on best practice in meeting regulatory standards.
> Support contingency planning for cross-border crisis management, particularly with regard to systemically important firms. **(About FSB 2019)**

As with Basel III, the establishment of the FSB rendered the financial system more resilient to crises but its approach is more sensitive to the internal dynamics of banks and other financial institutions. The FSB, provides banks with advice on how to implement organizational reforms to comply with international standards, hence to foster ethical conduct **(Helleiner 2010)**. Nonetheless, the FSB cannot ensure commitment from countries and from private institutions. Its effectiveness relies on voluntary actions by banks (‘soft governance’) **(Helleiner 2010)**.

2. National regulations: Dodd-Frank, FSA and EU

Counter to the international trend towards financial regulation, deregulation or weak regulation characterized the US financial system. In line with the neoliberalism hegemony in American policymaking circles and epistemic communities, the strong belief that the market had to be left unconstrained and unchecked emerged in their work **(Helleiner 2011)**.

In 1999, Congress repealed the Glass-Steagall Act which, passed after the Great Depression, separated investment and commercial banking. This move is particularly telling of the US ideological configuration because commercial banks administer poor people's money whereas investment banks deal with the money of the wealthy **(Stiglitz 2010)**. Merging the two facilitated the greater participation of commercial banks in the securitization trends **(Helleiner 2011)**. As the GFC showed abundantly clearly, repealing the Act spread the risk-taking culture pre-eminent in investment banks to the new banks and created too-big-to-fail institutions which felt more empowered than ever to gamble with people's savings **(Stiglitz 2010)**.

Furthermore, in 2004, the US Securities and Exchange Commission (SEC) incentivized risk-taking by lifting a 12:1 leverage ratio for investment banks, which reached 33:1 in 2008 **(Helleiner 2011)** "Leverage is the ratio of debt or assets to equity; at 33-to-1 leverage, a mere 3 percent drop in the value of a firm's assets can wipe out its equity" **(Cohan 2012)**). This regulatory failure, in combination with US authorities' ineptitude in stopping subprime mortgage lending practices, allowed Wall Street firms to take unprecedented risks to ensure high RoE. We know how this story ends.

In July 2010, the Obama Administration pushed the Dodd-Frank Wall Street Reform and Consumer Protection Act through. Under the reform, "a whistleblower program was created that instructed the SEC to pay rewards of 10 to 30 percent of the aggregate money over a $1 million threshold recovered in eligible actions resulting from original information provided to the SEC by the whistleblowers" **(Trang 2016)**. The Dodd-Frank tackles also other systemic incentives to risk: executive compensation in banking, information asymmetries (under the CFPB), and capital requirements. Generally, the national regulatory trend shadows the international one, at least until the Trump Administration's reactionary policies **(Dexheimer 2018)**.

The deregulatory trends in the US were echoed in the United Kingdom's "light-touch" regulatory system. Following the crisis, Parliament approved the FSA in 2012, thus foreseeing the replacement of the Financial Services Authority with the Financial Conduct Authority (FCA) and the Prudential Regulations Authority

(PRA). The reforms passed by the UK are qualitatively similar to those mentioned beforehand (e.g. remuneration, differentiation of investment and commercial banking, leverage, risk-assessments), nonetheless the FCA in particular has been exemplary in its efforts to promote ethical culture in speech (cf. FCA Discussion Paper DP18/2) and deeds (2014 FCA decision to ban for life a former Asset Management Managing Director at Blackrock UK for repeatedly evading his train fare) **(Blair and Barbiani 2019)**. As far as leadership accountability, and its importance in 'setting the tone', the UK established the Senior Managers Regime (SMR) – which prescribes a strict set of commitments to banks' leaders.

The Eurozone crisis pushed the EU to adopt new regulations as well. Most notably, the MiFID II (2018) imposes more reporting requirements and tests in order to increase transparency in financial exchanges.

Current situation

Notwithstanding the new regulatory efforts, ethical misconduct is still widespread – as the notorious Forex and Libor scandals attest.

As former IMF Chairwomen, Christine Lagarde (2014), asserted in a speech, changes in the financial sector are not "deep or broad enough". Similarly, the Group of Thirty (G30), a forum of leaders in international finance, declares that "banks are, to varying degrees, still failing to implement desired ethics, values, and behaviors, and weaknesses in embedding values and codes of conduct for all staff are widespread." **(Vigeo-eiris 2017)**.

There are still systemic obstacles to the development of ethical culture in the banking industry that regulators did not preclude. At least two macro-trends are evident: short-termism and risk-taking.

Short-termism is the ruling mindset in finance and it is evident in the industry's flexible labor market and 'transactional' customer relations. In the case of the former, the best way for employees to secure promotions and higher salaries is to hop from one institution to another **(Chan 2015)**. As a consequence, employees do not have time and motivation to identify with the bank. The 'freelancing' attitude of employees is detrimental to the stable formation of an ethical culture and its promotion. As personal bonds are not easily created in such a dynamic environment a result, the relationship between customers and banks becomes transactional. The commodification of banking services dehumanizes the customer, which in any ethical culture should be instead the focus (in the next section we will see what is ethical culture) **(Chan 2015)**.

Excessive risk-taking, inevitably interconnected with short-termism, is the other major systemic obstacle to the development of ethical culture. The flexible nature of the labor market and the absence of ‘ethics’ as an assessment criterion for recruitment contribute to an environment of weak accountability, in which financial performance is prioritized. Two types of perverted incentives contribute to this systemic ethical failure: organizational and individual. Organizational incentives to risk taking refer primarily to the ‘too-big-to-fail’ institutions. If a too-big-to-fail bank takes gambles and wins, it makes profits. If it loses, the taxpayers cover the losses. Hence, banks are structurally incentivised to take risks because they can only gain from them **(Stiglitz 2010)**. At the individual level, the incentive structures for top executives encourage excessive risk-taking. An investment that gets a high return generates a large bonus. If there is a negative return, the banker does not share in the losses **(Stiglitz 2010)**.

In sum, regulations failed to create systematic change in ethical conduct. Given the ‘soft’ nature of the financial regime, it is neither desirable nor feasible that regulators implement one-size-fit all rules on ethical behavior. Indeed, it is difficult to draft precise regulations on complex financial instruments and it is even more demanding (resources-wise) to monitor its enforcement. Instruments like CDOs, for instance, contain far too much information to process **(Blair & Barbiani 2019)**.

The regulators’ focus should therefore be on nudging and incentivizing banks to implement reforms and self-established organizational changes as a response to regulatory expectations. At its heart, financial regulation should create an incentive system to realign interests of the owners of banks (i.e. the shareholders), bank management and customers **(Chan 2015)**.

Fostering Ethical Culture in Banks

Understanding the Meaning of Ethical Culture

In order to reinforce ethical culture, both regulators and banks need to clarify what they mean by ‘culture’ and by ‘ethical’. **McConnel (2013)** expertly defines ‘organizational culture’ as the union of palpable and impalpable elements – schematized below:

Organizational Culture:

- Palpable elements: artifacts and values
  (a) artifacts: that which can be easily observed, such as, buildings, dress codes, logos, mission statements, formal goals, annual statements, etc.;
  (b) Values: or the "norms, ideologies, charters, and philosophies" of the organization;
- Impalpable elements: assumptions

> Assumptions are sets of invisible, taken for granted and often unconscious precepts which regulate employees' daily behaviors. In an ethically sound organization, these assumptions would be set by the top, uniformly understood by the bottom and reified in the firms' practice **(McConnel 2013)**.

In short, organizational culture could be defined as "the pattern of beliefs, values and learned ways of coping with experience that have developed during the course of an organization's history, and which tend to be manifested in its material arrangements and in the behaviors of its members" **(McConnel 2013)**.

What does it mean for a culture to be ethical? The answer to this question should guide the direction of regulations and reforms of the banking industry.

To establish what financial behavior is ethical, we need to describe what makes an action ethical. An array of tests and criteria exist. Is an action ethical because it conforms to deontological principles of Goodness? Is it ethical because it reflects and promotes principles that have been agreed upon to be good? Is it ethical because its consequences are positive and creates wellbeing?

In finance, the teleological method is often applied to discern the ethical soundness of an action **(Lagarde 2014)**. An action is ethical if it reflects the purpose (the telos) of its agent. Hence, a number of finance experts have asked themselves what the purpose of finance should be to understand what ethical finance looks like **(Chan 2015; Lagarde 2014; Tan Bhala 2013; Stiglitz 2010)**. **Lagarde (2014)** claimed that the social purpose of finance is "to put resources to productive use, to transform maturity, thereby contributing to the good of economic stability and full employment—and ultimately, to the wellbeing of people". **Tan Bhala (2013)** writes that the purpose of finance is to "help people save, manage, and raise money." **Stiglitz (2010)** states the function of finance is to "allocate capital and manage risks at low transaction costs".

Certainly, the teleological method depends on definitions of purpose, yet it is still more precise than value-based considerations alternatively used that describe financial ethics in terms of integrity, accountability, honesty, fairness etc.

In sum, an ethical culture is a set of artifacts, values and assumptions that are conducive to the allocation of capital that contributes to economic stability, employment and the wellbeing of people.

The question is: how can regulatory bodies incentivize banks to implement reforms to strengthen ethical culture?

From rule-based to principle-based policies

The financial regime should stop aiming for precision typical of ‘hard’ regulatory regimes with strong enforcement mechanisms and embrace its softness by becoming principle-based. Examples of principle-based regimes are the human rights regime and the climate change regime (to a large extent). Finance, climate and human rights are areas that rely on the voluntary participation and commitment from states, hence they cannot be regulated through precise, strict regulations as that would disincentivize states to ratify treaties.

Especially when it comes to ethical culture in finance, regulators cannot and should not dictate the type of culture a firm has. Each bank is idiosyncratic and the culture it develops should be adapted to its needs **(Thakor 2016)**. There is no one ‘best culture’. Regulators should be focused on the outcomes the culture delivers and its sustainability **(McConnel 2013)**. Standards of integrity cannot be regulated and even if rules affect behavior to a certain extent, banks will find creative ways to avoid them **(Lagarde 2014)**. That is why the regime should aim at creating systemic incentives and expectations to encourage banks to change their culture. Ideally, financial regulators should aim to be redundant. Once a solid ethical culture is established, regulations are no longer needed **(Blair & Barbiani 2019)**.

“*A commitment to ethics is a turn away from rules and towards standards ... It may be a sign, not that financial regulation is beginning to fail, but rather that it is maturing ... rules could be complemented by ethical standards that might be thought of as meant to fill in the gaps and interstices where a … rule cannot reach.*” **(Zaring 2017)**

In sum, regulators should set general principles and expectations under and according to which banks are to regulate. While systemic incentives to ethical conduct from regulators only indirectly impact ethical culture, bottom-up reforms should be its substance.

Policy recommendations

In this last section are some suggestions to revert short-termism and excessive risk-taking to promote ethical culture. Also, the section reviews some bottom-up reforms that banks can implement to directly improve their cultures.

Compensation systems are central in the cultural reform as they provide direct incentives to executives and employees. "Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences” **(FCIC 2011 pp xix)**.

The compensation system should be reformed by regulators in a way that balances risk and reward. The computation of bonuses, for instance, should not entirely depend on RoE but on non-money criteria too, such as credit quality, and positive feedback from costumers. Furthermore, deferred compensation and assessing performance in longer time frames reduces the sensitivity of compensation to short-term results **(Thakor 2016)**.

Certainly, shifting the criteria for remuneration from profit to ethical considerations such as credit quality and positive customer relations also impacts risk-taking directly.

Another general policy to change risk culture is reverting the perverted individual and organizational incentives mentioned previously. These incentives stem from the fact that banks and their employees do not have enough 'skin in the game'. That is why some commentators argue that "bankers [should] be personally liable from their own assets for some of their banks' debts and that they be personally liable from several years of their past, present, and future compensation for some portion of fines and fraud-based judgments (including settlements) against the bank." **(Zaring 2017)**.

Moreover, personal consequences for violations of ethical rules could be imposed, ranging from being barred from working in the industry, to fines, to a necessarily disclosed black mark in the employment records of the banker, visible to future employers **(Zaring 2017)**. The general counsel of the New York Federal Reserve recently cited the ability of bad actors to move from firm to firm as one of the lingering industry obstacles to change **(Zaring 2017)**.

The policies suggested so far are for regulators to draft and for banks to implement in their own way. These policies only indirectly affect culture because regulators should not aim to interfere with precise procedures and mechanisms in banks. There are policies banks can follow to improve their culture.

Banks, in addition to the reforms mandated by the regulations outlined above, should voluntary commit to profound organizational and cultural changes to regain people's trust (see also the piece by David Trang). As Deutsche Bank asserts: "After the financial crisis, it is essential for the banking industry to restore a firm bond of trust with the communities we serve. That applies to Deutsche Bank as well as the entire industry" **(Zaring 2017)**.

To restore trust, banks wrote new ethics-based codes of conduct. A bank's code of conduct is like its Constitution. It lays out the ethical principles followed by the bank and its employees (the soul) and establishes procedural frameworks to ensure they are respected (the bones) – see for example Goldman Sachs and Morgan Stanley. Almost all banks have a code of conduct **(Zaring 2017)**. The mere existence of a code does not correspond to ethical culture. The code must be abided by and internalized by the employees to be truly transformative.

For employees to learn how to apply autonomously the code, banks should have staff revisit frequent tests and practice scenarios in which knowledge of the code is demonstrated and consolidated. Employees should also be invited to think critically about the code and provide feedback. In fact, ultimately, the culture of the bank will also be a product of the inter-subjective understanding of the code (of the tone from the top) from the bottom. **Blair & Barbiani (2019)** suggest a number of methods that banks can use in workshops to improve knowledge of the code. They mention visualization methods as well as solving together ethical dilemmas. In order to embed the code into employees' habitual behaviors and mindset, Morgan Stanley annually hosts around 1,000 mandatory "Culture Conversations", where its employees are required to reflect on the application of the code through case studies and feedback sessions **(Linklaters 2019)**.

Other important policies that banks can implement are ethical nudges, ethics-based rewards/assessments, whistleblower programs and ethical strategies.

Ethical strategies help in setting the 'tone from the top'. For example, Citigroup prohibits the purchase of firearms for its business customers and its associates who are not 21 or who have not passed a background check **(Hsu 2018)**. This gives a message to Citigroup staff about the kind of environment and ethical direction the firm endeavors to follow.

Rewarding ethical behavior in employees' *assessments and remuneration* is also key. Staff will behave ethically if what they are valued against (or recruited for) is their ethical behavior and not solely financial performance. For example, Morgan Stanley has "altered the provisions in senior banker remuneration to enable claw-backs where, inter alia, there are violations of the firm's ethical standards" **(Blair & Barbiani 2019)**.

'Ethical nudges' might involve small procedural changes that are cognitively conducing to ethical conduct. For example, pledging to respect the code of conduct beforehand reduces the risk of defection, whereas 'tick the box' posthumous declarations are not good deterrents **(Blair & Barbiani 2019)**.

Encouraging employees to give honest feedback or to report ethical misconducts re-affirms that ethical reforms should be a collective effort. Indeed, whistleblowers programs have been implemented by banks such as Barclays to encourage ethical conduct. **(Trang 2016)**.

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