“The role of the board of financial services firms in improving their firm’s culture”

Paper presented to the Berle XI conference on

“Law and Corporate Culture”, Seattle

16-17 May 2019

Ciaran Walker
Consultant
Eversheds Sutherland
One Earlsfort Centre
Earlsfort Terrace
Dublin 2
Ireland

The role of the board of financial services firms in improving their firm's culture
Ciaran Walker, Consultant, Eversheds Sutherland

1 INTRODUCTION

In recent years, a number of 'scandals' have come to light in the financial services industry around the world that have caused significant harm to consumers and have cost the financial services industry considerable sums, in terms of fines, redress and legal costs. It has been estimated for example that, since the financial crisis in 2007, financial services firms have paid aggregate fines in excess of $320 billion worldwide in connection with employee misconduct.[1]

More significantly, the 'scandals' and failures of governance in financial services firms have damaged trust in the financial services industry. Mark Carney, Governor of the Bank of England, for example, has stated that "*the incidence of financial sector misconduct has risen to a level that has the potential to create systemic risks by undermining trust in both financial institutions and markets*"[2].

As noted by the Dutch regulator, De Nederlandsche Bank (DNB), "*trust is the foundation on which our financial system is built*"[3]. If the financial services industry is not trusted, customers may choose to engage less e.g. by investing less in their pension, saving less or purchasing fewer financial services products; this damages both the industry and the economy, by reducing the availability of capital for productive purposes.[4]

Also, the UK Banking Standards Board, the UK financial services industry-funded body set up in 2015 that aims to promote high standards of behaviour and competence in the industry, recently stated:

> "*A successful, dynamic UK economy needs a strong, stable banking sector that serves the best interests of its customers. For the sector to contribute fully to the economy and society it needs to be trusted; not only by its customers (in the UK and globally), but also by its staff, by potential employees, by regulators and by policy makers. Trust in the sector has been damaged, and it is only the industry itself – by demonstrating honesty, reliability and competence on a consistent and collective basis – that can rebuild it*."[5]

The introduction of increasingly onerous legal and regulatory requirements on financial services firms, backed-up by more intrusive supervision by regulators and the imposition of more significant sanctions on firms and individuals who have breached legal requirements has led to improvements in the industry in recent years. It is generally recognised, however, that these developments, of themselves, do not sufficiently address the industry problems, given that the misconduct that has arisen appears to be symptomatic of a wider problem of 'culture' in the financial services industry that needs to be addressed.

As to the 'cultural nature' of the problem, the then Deputy Director of the Bank of England, Minouche Shafik, for example, described the problem as one of 'ethical drift' in the financial services industry: "*Clearly it was not the case of a few bad apples, but something*

---

[1] Gavin Finch, 'World's Biggest Banks Fined $321 Billion Since Financial Crisis'
, Bloomberg (2 March 2017); available at: https://www.bloomberg.com/news/articles/2017-03-02/world-s-biggest-banks-fined-321-billion-since-financial-crisis .
[2] Mark Carney, "Building a Resilient and Open Global Financial System to Support Sustainable Cross-Border Investment" *Financial Stability Board* (30 August 2016) 7; available at: http://www.fsb.org/wp-content/uploads/FSB-Chair's-letter-to-G20-Leaders-in-advance-of-their-meeting-in-Hangzhou-on-4-5-September..pdf .
[3] "Supervision of behaviour and culture: Foundations, practice & future developments", p.30; available at https://www.compliance-instituut.nl/wp-content/uploads/Supervision-of-Behaviour-and-Culture_tcm46-334417.pdf
[4] Sue Jaffer, Nicholas Morris, David Vines, "Why trustworthiness is important", in "Capital failure: rebuilding trust in financial services", OUP 2014, at p. 7-8.
[5] https://www.bankingstandardsboard.org.uk/what-is-the-bsb/

was rotten in the entire barrel.'[6] Also, John Williams, President and CEO of the New York Federal Reserve stated in a June 2018 speech that "*underlying these scandals is often an inadequate corporate culture, where accountability and ethical conduct have fallen by the wayside*."[7]

To address this cultural problem, regulators around the world have increasingly focused their supervisory attention and resources on firms' culture, in order to seek to address pre-emptively root causes of misconduct risks. The Dutch regulator, De Nederlandsche Bank (DNB), for example, has adopted a ground-breaking approach to supervising the behaviour and culture of firms (as described in its textbook, "Supervision of behaviour and culture: foundations, practice and future developments"[8]). Also, the New York Fed[9] and UK Financial Conduct Authority have focused efforts on culture reform in the industry.

It is very clear, however, that for regulators it is primarily for firms rather than legislators or regulators to improve culture in firms:

> "*Cultural problems are the industry's responsibility to solve. The official sector can monitor progress and deliver feedback and recommendations. In fact, many individual supervisory findings are often symptoms of deeper cultural issues at a firm. But the banks themselves must actively reform and manage their cultures*."[10]

So, who is responsible within a firm for improving its culture and what can they do about improving culture in their firm?

Regulators have typically focused their supervisory efforts, in relation to culture, on the senior executive management, rather than the board[11], as they are considered to be the key influencers of a firm's culture[12]. Board members, in particular, non-executive members, are generally considered to have less influence on the culture of a firm, given the part-time nature of their role and their very limited day-to-day engagement with management and staff of the firm.

Boards do, nevertheless, have clear legal responsibilities regarding the culture of their firm. The 2015 Basel Corporate Governance Principles for Banks[13], for example, provides that:

---

[6] Minouche Shafik, 'From 'ethical drift' to 'ethical lift': Reversing the tide of misconduct in global financial markets' (Reforming Culture and Behaviour in the Financial Services Industry conference, Federal Reserve Bank of New York, 20 October 2016); available at: <http://www.bankofengland.co.uk/publications/Pages/news/2016/078.aspx>.

[7] https://www.newyorkfed.org/newsevents/speeches/2018/wil180618

[8] 'Supervision of behaviour and culture; foundations, practice and future developments', . The DNB approach was, for example, was relied on by the Central Bank of Ireland for the purposes of its culture review of the retail banks in Ireland and July 2018 report "Behaviour and culture of the Irish retail banks", available at: https://www.centralbank.ie/news/article/consumer-focused-cultures-remain-underdeveloped-at-irish-retail-banks-24-july-2018

[9] See e.g. https://www.newyorkfed.org/newsevents/speeches/2018/sti181004

[10] Available at: https://www.newyorkfed.org/newsevents/speeches/2015/mus151123

[11] Reference to a 'board' in this paper is to a single-tier board structure (composed to some extent or wholly of non-executive directors), which is common in, for example Anglo-saxon countries. This is different to the two-tier board structure, that is common in, for example, many Continental European countries; this latter structure involves a supervisory Board (composed wholly of non-executive directors), which sits above a management Board (composed of the senior executive management).

[12] The Dutch regulator, De Nederlandschse Bank (DNB), for example, which is a globally-recognised thought-leader in the area of regulatory supervision of financial firms' culture, noted in its book "Supervision of behaviour and culture: foundations, practice & future developments (available at https://www.compliance-instituut.nl/wp-content/uploads/Supervision-of-Behaviour-and-Culture_tcm46-334417.pdf), that its supervision has focused mostly on the management board level (p.18, fn 3). See also, the Central Bank of Ireland's July 2018 report "Behaviour and culture of the Irish retail banks (https://www.centralbank.ie/news/article/consumer-focused-cultures-remain-underdeveloped-at-irish-retail-banks-24-july-2018), which states that its culture review of the 5 retail banks in Ireland, prepared in close collaboration with the DNB, focused primarily on the executive leadership team "due to the importance of its members in driving effective cultures" (p.3).

[13] Available at: https://www.bis.org/bcbs/publ/d328.htm

"*The board has overall responsibility for the bank, including approving and overseeing management's implementation of the bank's strategic objectives, governance framework and corporate culture*." (principle 1)

At EU level, these principles are reflected in the European Banking Authority (EBA) Guidelines on Internal Governance.[14]

The question then, is, what role can and should the board of a financial services firm play in improving the culture of the firm.

A difficulty is that, as noted in a November 2018 G30 report, "*Banking conduct and culture: A permanent mindset change"*[15]:

"*There is still a lack of clarity in many organizations on how the board will champion, oversee, and monitor conduct and culture issues*".[16]

In this paper, we look at the role the board is expected to play, under regulatory requirements and guidance; we then look specifically at the failings of boards in a number of the recent 'scandals'. Finally, we offer a number of suggestions on ways in which the board can have a more effective role in improving firms' culture.

In this latter regard, we specifically focus on industry (rather than firm-specific) initiatives that could enable the board to have a more effective role, particularly in light of the setting up of the Banking Standards Board in the UK and the recent setting up of the Irish Banking Culture Board[17], which is largely modelled on the UK entity.

As to the particular areas where an industry-based approach, looking specifically at the role of boards, could assist the improvement of the culture of financial services firms (and, thereby, potentially in due course, the trustworthiness of firms), we discuss further below the following, which relate to the key role of the board in identifying the firm's values and supervising how the firm deals with behaviours (at any level of the firm) that diverge from the espoused values:

- In the first place, the board needs to ensure that it is properly informed (including on the basis of sufficiently reliable information from staff and customers) of potential issues of behaviours that diverge materially from espoused values.

  As is clear from the recent 'scandals' discussed further below, in many cases boards often fail to ensure they are properly informed of these issues, which provide an early warning signal of misconduct risk issues.

  The development of industry norms and possible benchmarking in relation to this could be useful in assisting this process. In this regard, one of the potential areas of focus could usefully be in relation to customer complaints.

- Secondly, enhancing constructive challenge at board level, including through the development of industry norms and peer review of board engagement.

  Such an approach could benefit from the approach to such reviews already developed by the DNB. As discussed further below, 'groupthink' at board level and lack of effective challenge have been found to be significant contributing factors to ineffective cultures in financial services firms and the DNB has developed particular expertise in assessing such issues.

---

[14] Para. 23 of the Guidelines on Internal Governance; available at: https://eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-internal-governance-revised- ;. The EBA is mandated by Article 74 of Directive 2013/36/EU to develop guidelines in this area. Pursuant to para. 1 of these Guideline, "In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authority and financial institutions must make every effort to comply with the guidelines."
[15] "*Banking conduct and culture: A permanent mindset change", G30 report, November 2018* ; available at: http://group30.org/publications/detail/3134
[16] Ibid., at Executive Summary.
[17] See: https://www.irishbankingcultureboard.ie/

- Thirdly, boards may benefit from encouraging the industry to address more clearly the 'purpose' of a financial services firm and its wider role in society (i.e. going beyond the aim of pursuing profits, which an intended outcome of any business 'purpose').

  Under the 2018 UK Corporate Governance Code[18], for example, one of the key functions of the board is to establish the company's purpose.

  Any proper consideration of this issue would serve to tackle a core issue of public concern, that the financial services industry cannot be trusted because its mind-set is one of focusing on short-term profitability to the detriment of any stakeholders other than shareholders.

  The issue of the 'purpose' of a corporation in society is one of increasing public debate and boards of financial services firms could assist in improving trust in the industry by encouraging constructive engagement in this issue.

The particular benefit of developing industry-wide standards/bench-marking/peer-pressure around these issues is that, as noted by the DNB, "*in essence, peer pressure regulates behaviour*"[19].

2 WHAT DO WE MEAN BY A FIRM'S 'CULTURE'?

Whilst most financial services firms will likely have in place detailed values statements, codes of conduct and various processes and procedures that are intended to ensure that all employees of the firm behave in accordance with specified standards of behavior, the 'way things get done around here' will likely be more complex than can be described in written documents and can often diverge from the high-level general expectations set out in the firm's documentation.

Employees are more likely to look to their peers and 'tone from the top' than to written manuals of the firm for guidance on what behaviours are acceptable within the firm. As noted above, "in essence, peer pressure regulates behaviour"[20]. Also:

> "*For employees, organisational culture is the social glue that holds the organisation together by providing appropriate standards for the ways employees should behave. As a consequence, culture reduces employees' uncertainty and anxiety about appropriate and expected behav*iours".[21]

An important theoretical framework for identifying and assessing organisational culture has been provided by the organisational psychologist, Edgar Schein[22]. The DNB's model for assessing firms' culture is strongly based on Schein's conceptual model.[23]

---

[18] https://www.frc.org.uk/document-library/corporate-governance/2018/uk-corporate-governance-code-2018; All companies with a Premium Listing of equity shares in the UK are required under the Listing Rules to report in their annual report and accounts on how they have applied this Code. They are required to report on the basis of a 'comply or explain' approach. See also, UK Financial Reporting Council's July 2018 non-binding Guidance on Board Effectiveness; available at: https://www.frc.org.uk/document-library/corporate-governance/2018/guidance-on-board-effectiveness
[18] https://www.bankingstandardsboard.org.uk/what-is-the-bsb/
[18] https://www.frc.org.uk/document-library/corporate-governance/2018/uk-corporate-governance-code-2018; All companies with a Premium Listing of equity shares in the UK are required under the Listing Rules to report in their annual report and accounts on how they have applied this Code. They are required to report on the basis of a 'comply or explain' approach. See also, UK Financial Reporting Council's July 2018 non-binding Guidance on Board Effectiveness; available at: https://www.frc.org.uk/document-library/corporate-governance/2018/guidance-on-board-effectiveness
[19] Fn 12 above, at p.50.
[20] Fn 12 above, at p.50.
[21] Fn 12 above, at p.45.
[22] See, E. Schein, "Organisational culture and leadership", 5th ed. 2017, Wiley.
[23] Fn 12 above, at p. 46.

According to Schein, culture exists simultaneously on three levels: on the surface are artefacts, under which are espoused values and beliefs and at the core are basic assumptions. The DNB uses the metaphor of an iceberg to describe these three levels, as only the first layer is directly observable.

The first level, the artefacts of a firm, are the "visible and feelable" phenomena in a firm; the "phenomena that you would see, hear and feel when you encounter a new group with an unfamiliar culture"[24].

For present purposes, these artefacts include for example the formal governance structure of a financial services firm. its values statement, its code of conduct, its formal policies relating to e.g. financial incentives for staff, diversity. These artefacts also include observable behaviours. The DNB's supervisory approach in relation to this layer of the iceberg involves reviewing the behaviours of firms' senior leadership teams in relation to decision-making, leadership and communication.

Clearly, the board has the key role in approving many of these 'artefacts', including those relating to, for example, a firm's statement of its values and its code of conduct.

The second level of culture, espoused values and beliefs of a group/firm are the consciously understood and spoken of assumptions of the group/firm as to their values and beliefs; they are "explicitly articulated because they serve the normative or moral function of guiding members of the group as to how to deal with certain key situations as well as in training new members how to behave."[25]

For the DNB, this layer of its 'iceberg' metaphor involves assessing group dynamics, in particular at the level of the senior leaders. In its assessments of firms, the DNB looks at the 'atmosphere' of interactions within groups, in particular the senior leadership team (management board in a two-tier board structure). It looks at issues such as: is there an atmosphere where people can address unwanted or 'bad' behaviour? Is there an atmosphere of co-operation or competition, perhaps infighting? Is there a basis of mutual trust within a (management) board, between the senior management and the board or does mistrust predominate in the working relationship.[26]

Boardroom dynamics can be assessed at this level of the 'iceberg' and can have an important impact on a firm's 'tone from the top' and, hence, overall culture.

Assessing these two levels, however, may not be suffcient. The third level, relating to taken-for-granted underlying basic assumptions, is a key level. These are assumptions about behaviour, where members of a group holding these assumptions may find behaviour based on any other premise "inconceivable"[27]. The DNB has described this layer as the "mindset".

According to Schein, where a leader identifies a culture involving widespread discrepancies beween desired behaviours and observed behaviours, in order to achieve culture change the leader will need to "locate the cultural DNA and change some of that"[28] i.e. address culture issues at the level of taken-for-granted underlying basic assumptions and not merely at the level of artefacts or espoused values and beliefs.

Based on Schein, the DNB also notes that a detailed understanding of all three layers is necessary in order to understand organisational culture and to be able to target changes.[29]

Schein's model is helpful for the purposes of considering what aspects of a culture can be influenced/managed by a board. We rely on Schein's model for the purposes of our discussion of suggestions on this issue in section F below – in particular, the issue of considering the purpose of a firm.

---

[24] Schein, fn 22 above, p.17.
[25] Schein, fn 22 above, p. 20.
[26] Fn 12 above, at p..50.
[27] Schein, fn 22 above, p. 22.
[28] Ibid., at p. 27.
[29] Fn 12 above, at p. 52.

3 REGULATORY REQUIREMENTS AND EXPECTATIONS ON BOARDS TO APPROVE AND OVERSEE CORPORATE CULTURE

As noted above, the 2015 Basel Corporate Governance Principles for Banks provide that the board of a bank has the overall responsibility for the bank, including approving and overseeing corporate culture. These Principles note that "a fundamental component of good governance is a corporate culture of reinforcing appropriate norms for responsible and ethical behaviour" and state that, in order to promote a sound corporate culture, the board should reinforce the "tone from the top" by:

- "setting and adhering to corporate values that create expectations that all business should be conducted in a legal and ethical manner, and overseeing the adherence to such values by senior management and other employees;

- promoting risk awareness within a strong risk culture, conveying the board's expectation that it does not support excessive risk-taking and that all employees are responsible for helping the bank operate within the established risk appetite and risk limits;

- confirming that appropriate steps have been or are being taken to communicate throughout the bank the corporate values, professional standards or codes of conduct it sets, together with supporting policies; and

- confirming that employees, including senior management, are aware that appropriate disciplinary or other actions will follow unacceptable behaviours and transgressions."[30]

The Basel Corporate Governance Principles also provide that an appropriate code of conduct should be put in place and that Boards should have oversight of the whistleblowing policy mechanism and ensuring that senior management addresses legitimate issues that are raised. Also, the board should oversee and approve how and by whom legitimate material concerns shall be investigated and addressed by an objective independent internal or external body, senior management and/or the board itself.[31] At EU level, these principles are reflected in the European Banking Authority (EBA) Guidelines on Internal Governance.[32]

More recently, the 2018 UK Corporate Governance Code[33], which came into force in January 2019, provides that:

> "*The board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned. All directors must act with integrity, lead by example and promote the desired culture*."

Also:

> "*The board should assess and monitor culture. Where it is not satisfied that policy, practices or behaviour throughout the business are aligned with the company's purpose, values and strategy, it should seek assurance that management has taken corrective action. The annual report should explain the board's activities and any action taken*."

---

[30] Para. 29-30; available at: https://www.bis.org/bcbs/publ/d328.htm.
[31] Ibid., at p. 9-10.
[32] https://eba.europa.eu/regulation-and-policy/internal-governance/guidelines-on-internal-governance-revised- ; para. 23. The EBA is mandated by Article 74 of Directive 2013/36/EU to develop guidelines in this area. Pursuant to para. 1 of these Guideline, "In accordance with Article 16(3) of Regulation (EU) No 1093/2010, competent authority and financial institutions must make every effort to comply with the guidelines."
[33] https://www.frc.org.uk/document-library/corporate-governance/2018/uk-corporate-governance-code-2018; All companies with a Premium Listing of equity shares in the UK are required under the Listing Rules to report in their annual report and accounts on how they have applied this Code. They are required to report on the basis of a 'comply or explain' approach. See also, UK Financial Reporting Council's July 2018 non-binding Guidance on Board Effectiveness; available at: https://www.frc.org.uk/document-library/corporate-governance/2018/guidance-on-board-effectiveness

Whilst the legal responsibility on boards to approve and oversee an appropriate culture is clear, the practical difficulties faced by boards must also be recognised. As noted in an important 2015 G30 report setting out recommendations for culture change in the industry:

> "*Most Boards struggle in addressing culture. Difficulty defining the underlying concepts, a lack of clear metrics, diffuse responsibilities across the Executive team, a lack of sufficient time to consider cultural issues properly, and lack of visibility on key cultural issues are cited as challenges to improving the Board's oversight and engagement on conduct and values*."[34]

4 HIGH-PROFILE RECENT EXAMPLES OF BOARD FAILURES

A number of reports into the failings of the banks in the run-up to the financial crisis in 2007-8 highlighted failures of the boards, in particular in terms of failures to challenge the executive effectively. The 2009 Walker Review, which reported at the behest of the UK Prime Minister on corporate governance in the UK banking industry and made recommendations for reform, emphasised that:

> "*The most critical need is for an environment in which effective challenge of the executive is expected and achieved in the boardroom before decisions are taken on major risk and strategic issues*." [35]

More generally, as noted in the above-mentioned 2015 G30 report:

> "*In the lead-up to the 2008–2009 financial crisis, Boards in certain banks allowed their management to take decisions and actions that ultimately led to poor outcomes for the firms' employees, customers, shareholders, and the wider economy. Boards had neither sufficient expertise nor the ability to effectively challenge management strategies. And Board decisions suffered from self-reinforcing groupthink and herd behavior*."[36]

The April 2013 Salz review[37] of the business practices of Barclays Plc prior to the financial crisis also provides useful insights into the governance and culture problems that gave rise to excessive risk-taking and ethical issues. With regard specifically to the role of the board, the report notes:

> "*The board sets the tone from the top of the organisation, and must carry ultimate responsibility for its values, culture and business practices. With the benefit of hindsight, we believe that the Barclays Board did not give sufficient attention to this area. We also believe the Board found it difficult at times to penetrate into what was a large, complex organisation. It was significantly stretched in coping with the many issues that arose in the financial crisis – the Board met on 30 occasions in 2008 (at times by conference call) and 27 times in 2009 – and many of the events that have raised questions about culture and business practices only clearly emerged after the beginning of the financial crisis.*
>
> *One of the principal roles of the Board is to provide challenge to management. Whether it is successful is influenced by a number of factors, including the composition of the Board, the skills of the Chairman, Board members' understanding of the Group's businesses, the time they have to give, the openness*

[34] "Banking conduct and culture: A call for sustained and comprehensive reform; p. 31.. Available at: http://group30.org/images/uploads/publications/G30_BankingConductandCulture.pdf

[35] "A review of corporate governance in UK banks and other financial industry entities: Final recommendations; p.12. Available at: https://www.google.ie/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&cad=rja&uact=8&ved=2ahUKEwjXgJWZ35zfAhUKYlAKHRVrAX4QFjAAegQICRAC&url=https%3A%2F%2Fwebarchive.nationalarchives.gov.uk%2F%2B%2Fhttp%3A%2Fwww.hm-treasury.gov.uk%2Fd%2Fwalker_review_261109.pdf&usg=AOvVaw2F5lGTtCvDxq4mo8gsOBmO

[36] Fn 34 above, at p.19.

[37] Salz review: An independent review of Barclays' business practices"; available at: https://www.euromoney.com/downloads/2013/Barclays-Salz-review.pdf

of the executive directors and the information available to the Board. Barclays has made progress in improving the specialist financial experience on the Board, as well as its diversity, but there is more to be done.[38]

The findings of the UK Parliamentary Commission into banking standards (set up to consider and report on professional standards and culture of the UK banking sector), in its June 2013 report "Changing banking for good"[39] were more stark:

> *"Banks whose board-level governance arrangements could be described on paper as approximating to best practice have run into serious governance problems. There were frequently several common elements to bank governance failures. Some CEOs were overly dominant, which the Board as a whole failed to control. Chairmen proved weak; often they were too close to, and became cheerleaders for, the CEO. NEDs provided insufficient scrutiny of, or challenge to, the executive, and were too often advocates for expansion rather than cautioning of the risks involved. There was insufficient wider banking experience among NEDs and the resources available to them were inadequate. Central functions, including risk and control, had insufficient capability and status to perform their functions and were often regarded as an impediment to the business, rather than essential to its long-term success."*[40]

The UK Parliamentary Commission also identified the importance of individual accountability at the highest levels:

> "*Too many bankers, especially at the most senior levels, have operated in an environment with insufficient personal responsibility. Top bankers dodged accountability for failings on their watch by claiming ignorance or hiding behind collective decision-making. They then faced little realistic prospect of financial penalties or more serious sanctions commensurate with the severity of the failures with which they were associated. Individual incentives have not been consistent with high collective standards, often the opposite*."[41]

In Ireland, the 2011 Nyberg Commission of Investigation into the Banking sector in Ireland[42] noted, with regard to the responsibilities of the Board:

> "*Banks' management and boards embraced a lending sales culture at the expense of prudence and risk management. This view then spread down through the ranks, partly through the effects of volume targets and bonus systems and partly through indoctrination, causing the massive run-up in risky assets*."[43]

More recently, in a July 2018 report on the culture of the five retail banks in Ireland[44], the Central Bank of Ireland (CBI) noted that the Irish banks have a way to go to develop a customer-focused culture; as to the role of boards, the CBI noted that more needs to be done to improve the effectiveness of challenge at board level[45].

Also, in Australia, the April 2018 report[46] by the Australian Prudential Regulation Authority (APRA) into the Commonwealth Bank of Australia (CBA), the largest financial institution in Australia, following a number of misconduct issues at the bank, provides some interesting

---

[38] Ibid., para. 2.22, 2.23.
[39] https://www.parliament.uk/business/committees/committees-a-z/joint-select/professional-standards-in-the-banking-industry/news/changing-banking-for-good-report/
[40] Ibid. para. 120.
[41] Ibid. p.8.
[42] "Misjudging risk: causes of the systemic banking crisis in Ireland. Report of the Commission of Investigation into the banking sector in Ireland; available at: http://www.bankinginquiry.gov.ie/Documents/Misjuding%20Risk%20-%20Causes%20of%20the%20Systemic%20Banking%20Crisis%20in%20Ireland.pdf
[43] Ibid., at para. 5.4.8.
[44] "Behaviour and culture of the Irish retail banks", July 2018; available at: https://www.centralbank.ie/docs/default-source/publications/corporate-reports/behaviour-and-culture-of-the-irish-retail-banks.pdf?sfvrsn=2
[45] Ibid., p. 30.
[46] "Prudential inquiry into the Commonwealth Bank of Australia", APRA, April 2018; available at: https://www.apra.gov.au/sites/default/files/CBA-Prudential-Inquiry_Final-Report_30042018.pdf

insights into the role of the board and board failings. This report found that there were significant shortcomings in governance and management of non-financial risk. It found that the board "*did not demonstrate rigour of oversight and challenge to CBA management*" or "*have the right balance of both summarised and detailed reporting*" in relation to non-financial risks[47]. Also, with regard to customers, CBA's board focused on aggregate customer satisfaction survey results (such as Net Promoter Scores, discussed further below) and alarm bells from treatment of aggrieved customers "*did not sound loudly*"[48]:

> "*Although CBA has drawn comfort from strong customer satisfaction metrics, which reflect an aggregated view of customer sentiment, it has missed the tail where customer issues reside*."[49]

More recently, in February 2019, the Australian Royal Commission report[50] into misconduct in the Australian financial services industry was published. This report was highly critical of the extent of misconduct in the financial services industry in Australia and noted that primary responsibility lies with the entities and "*those who managed and controlled those entities: their boards and senior management*."[51]

Board 'blind spots': Wells Fargo

The recent Wells Fargo scandal is an example of a board 'blind spot', in that the commercial success of a particular business model blinded it to the underlying conduct risks of the model. Specifically, the board failed to consider/look for information on whether the successful business model was in line with the stated values of the firm.

Essentially, the Community Bank business of Wells Fargo in the US incentivised/pressurised its staff to cross-sell products to existing clients, in particular to open new bank accounts and take on new services (the then Wells Fargo Chairman and CEO, John Strumpf, regularly used the infamous mantra "8 is great", to motivate staff to get customers to take 8 of the company's products). The pressures on sales staff to meet overly-ambitious sales targets resulted in them taking short cuts or engaging in fraudulent activity to meet their sales targets.

As noted in an October 2018 settlement agreement between Wells Fargo and the Attorney General for the State of New York, under which Wells Fargo was fined $65 million:

> "*As a result of its cross-sell driven sales culture, certain Wells Fargo employees engaged in the following misconduct without customer knowledge or consent: opened deposit accounts; transferred funds from customers' authorized accounts in order to temporarily fund unauthorized accounts; used email addresses not belonging to customers to enroll customers in on-line banking services; requested debit cards and created personal identification numbers (PINs) in order to activate them; and submitted applications for and obtained credit cards*"[52]

The misselling affected approximately 3.5 million customer accounts.[53] In July 2017, Wells Fargo announced that, following a review, it would provide a total of $2.8 million in refunds and credits due to customers on top of $3.3 million previously refunded.[54]

In 2016, Wells Fargo was fined $185 million by US regulators for these activities.[55] In June 2018, Wells Fargo settled a class action lawsuit in California relating to these practices for

---

47 Ibid., p.11.
48 Ibid.
49 Ibid., p.92.
50 "The Royal Commission into misconduct in the banking, superannuation and financial services industry"; available at; https://financialservices.royalcommission.gov.au/Pages/default.aspx
51 Ibid., at p.4.
52 https://ag.ny.gov/press-release/ag-underwood-announces-65-million-settlement-wells-fargo-misleading-investors
53 https://stories.wf.com/wells-fargo-remediation-plans/
54 Ibid.
55 https://www.consumerfinance.gov/policy-compliance/enforcement/actions/wells-fargo-bank-2016/

$142 million[56]. Wells Fargo has also been forced to pay compensation to former employees of the firm who lost their jobs as a result of whistleblowing about the sales practices (in one case the compensation amounted to $5.4 million[57]).

In testimony to the US Senate Banking Committee, John Strumpf, the Chairman and CEO of Wells Fargo during the period in question, famously stated that what had happened at the bank went against "our values, ethics and culture and runs counter to our business strategy"[58]. In October 2016, he resigned from Wells Fargo.

On 2 February 2018, the US Federal Reserve issued a letter[59] to him, in his capacity as then Chair of the Board of Wells Fargo, noting that Wells Fargo pursued sales strategies that "motivated compliance violations and improper practices" and that Mr Strumpf was aware of sales practices issues, but failed to investigate them or inform the board about them in a timely manner. The letter concluded "*your performance in addressing these problems is an example of ineffective oversight that is not consistent with the Federal Reserve's expectations for a firm of [Wells Fargo's] size and scope of operations*."

In April 2017, Wells Fargo published a report[60] on the misselling scandal, which was commissioned by independent directors of the Board of Wells Fargo. This report gives some useful insights into the background of the misselling. The principal findings of this report included:

> "*The root cause of sales practice failures was the distortion of the Community Bank's sales culture and performance management system, which, when combined with aggressive sales management, created pressure on employees to sell unwanted or unneeded products to customers and, in some cases, to open unauthorized accounts. Wells Fargo's decentralized corporate structure gave too much autonomy to the Community Bank's senior leadership, who were unwilling to change the sales model or even recognize it as the root cause of the problem.*
> *Community Bank leadership resisted and impeded outside scrutiny or oversight and, when forced to report, minimized the scale and nature of the problem*."
> (Overview section of the report)"

The report found that sales practice violations were identified as far back as 2002 (when the Community Bank took steps to address it, including through the creation of a sales integrity task force). The volume of sale practice violations steadily increased over time. Carrie Tolstedt took over as CEO of Community Bank in 2007. Her aggressive sales approach was fully supported by Wells Fargo CEO, John Strumpf, who considered her to be the "best banker in America"[61].

It appears that, at least prior to the October 2013 and December 2013 Articles in the Los Angeles times about the sales practices, they were not considered to be a material issue within Wells Fargo. This was despite the facts that: between 2011 and 2016, over 5,300 Wells Fargo emplyees were fired for sales practice violations – indeed, Mr Strumpf concluded as late as May 2015 that the fact that around 1,000 employees per year were fired because of sales practive violations meant "*this is not systemic*"[62]. Also, as far back as 2004, an Internal Investigations report that went to the Chief Auditor of Wells Fargo found that staff "*feel they cannot make sales goals without gaming the system. The incentive to cheat is based on the fear of losing their jobs for not meeting performance*

[56] https://www.housingwire.com/articles/43698-court-finally-approves-wells-fargos-142-million-fake-account-class-action-settlement
[57] https://www.osha.gov/news/newsreleases/region9/07212017
https://www.osha.gov/news/newsreleases/national/04032017
[58] See e.g. https://money.cnn.com/2016/09/20/news/companies/wells-fargo-ceo-apology/index.html?iid=hp-stack-dom
[59] https://www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a4.pdf
[60] Independent Directors of the Board of Wells Fargo & Company Sales Practices Investigation Report April 10, 2017; available at: https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf
[61] Ibid. p.56.
[62] Ibid., p.56

expectations" and that this gave rise to ethical issues and reputational risks for Wells Fargo[63].

Importantly, "*the Community Bank identified itself as a sales organization, like a department or retail stores, rather than a service-oriented financial institution. This provided justification for a relentless focus on sales, abbreviated training and high employee turnover*"[64]. Indeed, from 2011 to 2015, average annual staff turnover was 30%, reaching 41% for the year to October 2012.[65]

Also, the April 2017 report of the independent directors found that:

> *"This underreaction to sales practice issues resulted in part from the incorrect belief, extending well into 2015, that improper practices did not cause any "customer harm"; and "customer harm" itself was narrowly construed to mean only financial harm such as fees and penalties. This flawed perspective made it easy to undervalue the risk to Wells Fargo's brand and reputation arising from the misuse of customer information and the breaches of trust occasioned by improper sales practices."*[66]

More generally, an important factor was that CEO John Strumpf was Wells Fargo's principal proponent of the cross-sell and general sales culture; also, he "was not perceived within Wells Fargo as someone who wanted to hear bad news or deal with conflict."[67]

As to the role of the Board, the report found that the Board's actions could have been improved in three respects: first, it should have centralised the risk function sooner than it actually did (in 2016); second, from 2014, when it was informed of the sales practices as a noteworthy risk, it should have insisted on more detailed and concrete plans from the various reporting functions; third, the Board should have been more forceful in pushing Mr Strumpf to remove Carrie Tolstedt as CEO of the Community Bank, at least by October 2015[68].

The report was widely criticised in the press when it was published[69]. The report appears to be overly-generous to the Wells Fargo board.

In particular, the report notes that "*there was a growing conflict over time in the Community Bank between Wells Fargo's Vision & Values and the Community Bank's emphasis on sales goals*"[70] – but the report fails to consider this central question in any meaningful way and the board's responsibility for addressing it. This growing conflict was evident from whistleblower reports that could and should have been considered by the Wells Fargo board (for example, an April 2017 report by the Office of the Comptroler of the Currency[71] noted that by 2010, there had been about 700 whistleblower complaints of gaming of the incentive plans – this volume of whistleblower complaints alone should have been a 'red flag' to the board).

Also, the Wells Fargo board was, at best, remarkably incurious about the high volume of staff turnover in the Community Bank, along with the nature and volume of firings for sale practice violations and the reasons for these firings.

Ultimately, the board failed to attach adequate importance to ensuring that the culture of Wells Fargo lived up to the espoused values of the firm.

---

63 Ibid., p.89.
64 Ibid. p.7.
65 Ibid., p.27.
66 Ibid., p.14.
67 Ibid., p.53-54.
68 Ibid., p.16-17.
69 http://fortune.com/2017/04/14/wells-fargo-fake-accounts-2/
70 Ibid., p.4
71 http://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-wells-fargo-supervision-lessons-learned-41917.pdf

Board 'blind spots': UK Payment protection insurance (PPI)

The UK PPI issue provides a useful example of a board 'blind spot' of focusing on the commercial benefits of the high profitability of a product, whilst ignoring the potential conduct risks inherent in such high profitability.

PPI policies are intended to assist borrowers to repay their loans where they are otherwise unable to do so because of a specified event (e.g. loss of job, illness). In the UK, they were typically offered by banks and other credit providers when providing credit to consumers (e.g. for a mortgage; unsecured loan).

PPI was a very lucrative business for the banks in the UK. For Barclays Bank, for example, PPI comprised between 32% and 42% of its UK retail and business bank pre-tax profit between 2001 and 2005, when almost 70% of borrowers taking some loan products also bought a policy; also, between 2002 and 2012, Barclays' total revenues from PPI, net of claims and provisions for alleged mis-selling, amounted to an estimated £940 million[72].

A 2005 Citizens Advice report described the PPI business in the UK (with its estimated 20 million policies in force and annual gross premiums in excess of £5 billion) as a 'protection racket'[73]. Indeed, concerns about misselling of PPI had been in the public domain in the UK since at least 1998.[74] The mis-selling involved various practices, such as selling PPI to customers who were not eligible to claim on the policy; high-pressure sales tactics, giving people the impression that they had to take out PPI in order to get a loan; various exclusions which significantly limited the scope of the potential benefits, sales to peole with no incomes to protect. In 2009, the UK Financial Services Authority estimated that PPI mis-selling may have affected around three million people in the UK since the 1990s[75].

The PPI market was investigated by the UK Competition Commission[76]. Its 2009 inquiry report noted hat there was considerable customer confusion about the features and benefits of PPI[77]; there was evidence of consumers being under the impression that their credit application was more likely to be successful if they also bought PPI[78]. Also, PPI customers were more likely to be earning below the national average wage or come from the socio-economic groups C and D[79]. The Competition Commission's 2011 market investigation order imposed various restrictions on future selling of PPI[80].

To date, financial services firms in the UK have refunded over £33 billion to customers affected by the PPI mis-selling in the UK[81]

As to the role of the boards of firms involved in the PPI scandal, it appears from the Competition Commission investigation report that PPI was discusssed at board level, but the focus of discussion was on its profitability. The Salz review found that Barclay Bank Group Executive Committee reviewed PPI in 2005; it found that PPI was "highly profitable" and was aware that:

[72] Salz review; fn 37 above, at para. 6.18.
[73] https://www.citizensadvice.org.uk/about-us/policy/policy-research-topics/debt-and-money-policy-research/protection-racket/ ; also, https://www.theguardian.com/business/2011/may/05/how-ppi-scandal-unfolded
[74] https://www.telegraph.co.uk/finance/personalfinance/insurance/incomeprotection/8681344/Timeline-how-the-PPI-scandal-unfolded.html .
[75] Salz review; fn 37 above, at para. 6.16-6.17.
[76] https://webarchive.nationalarchives.gov.uk/20140402202346/http://www.competition-commission.org.uk/our-work/directory-of-all-inquiries/ppi-market-investigation-and-remittal/final-report-and-appendices-glossary
[77] Ibid., para. 5.41.
[78] Ibid., para. 2.66.
[79] Ibid., para. 11.
[80] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/330608/ppi_order.pdf
[81] As at November 2018: https://www.fca.org.uk/data/monthly-ppi-refunds-and-compensation .

> "*there were potential concerns relating to the fairness of single premium policies, policies sold where customers could not make claims and sales practices that were "not customer friendly" or "high pressure."*[82]

The Salz review cricicised Barclays Bank, stating that:

> "*the high profitability of PPI should have raised questions as to whether this was consistent with Barclays' obligations to customers*", it was "*slow to address control failures*" and "*the culture of the bank had developed into one which at times valued meeting financial targets more than meeting customer needs*"[83].

These are all issues that could and should have been addressed at an early stage at board level. It is likely that the conclusions of Salz review regarding PPI mis-selling could equally apply to the other UK banks and other financial institutions that mis-sold PPI in the UK.

Board 'blind spots': Danske Bank

The recent Danske Bank scandal is an example of a board 'blind spot' of uncritical acceptance of indications from a second line of defence function (compliance), in this case that outstanding potential conduct risk issues were being effectively addressed.

Danske Bank, the largest financial institution in Denmark, established a presence in Estonia when its acquired Sampo Bank, together with its Estonian branch, in 2007.

The Estonian branch had a specific 'Non-resident Portfolio' of non-resident clients; from 2007 to 2015 (when the non-resident accounts were closed), there had been around 10,000 non-resident customers in this Portfolio, many from Russia, Azerbijan and Ukraine. During the period 2007-2015, there was a flow of funds amounting to approximately 200 billion euro from external parties to these non-resident bank accounts and on to external third parties.

Concerns about the possible use of these non-resident accounts for money laundering emerged from 2007. As stated in the report on this scandal, prepared by a Danish law firm for the Danske Bank board in September 2018, some time after the issue became the subject of significant public comment (EU Commissioner Vestager referred to it as a '*giga scandal*'[84]):

> "*In 2007, shortly after completing the acquisition of Sampo Bank, Danske Bank had a real opportunity to conclude that the Non-Resident Portfolio involved suspicious activity not caught by AML procedures at Sampo Pank in Estonia. In 2007, the Estonian FSA came out with a critical inspection report, and at the same time Danske Bank at Group level received specific information from the Russian Central Bank, through the Danish FSA. This information pointed to possible "tax and custom payments evasion" and "criminal activity in its pure form, including money laundering", estimated at "billions of rubles monthly". However, Danske Bank missed this first real opportunity.*"[85]

In 2007, the above letter from the Russian Central Bank was on the agenda of a Danske Bank board meeting and information was given to the effect that the matter would be investigated internally. Also, a 2009 anti-money laundering inspection by the Estonian regulator found that the Estonian branch of Danske Bank did not fully comply with relevant legal requirements.

A further red flag that should have been considered by the board of Danske Bank at the time was that, whereas the Estonian branch's share of total assets of the Danske Bank

[82] Salz review; fn 37 above, at para. 6.20.
[83] Salz review; fn 37 above, at para. 6.24.
[84] https://www.independent.ie/business/world/danske-bank-money-laundering-giga-scandal-spreads-to-britain-37340762.html
[85] "Report on the Non-Resident Portfolio at Danske Bank's Estonian branch", 19 September 2018, p.8; available at: https://danskebank.com/news-and-insights/news-archive/press-releases/2018/pr19092018 :

group was minuscule, at 0.5%, at its height (in 2011) it represented almost 11% of the whole group's profits.

The issue became a matter of public concern following the publication of news reports, in March 2017 of a 'Russian Laundromat' money laundering operation in which the Danske Bank entity featured prominently (news stories about an 'Azerbaijani Laundromat' emerged subsequently in 2017).

The above-mentioned report to the Danske Bank board concluded that neither the Danske Bank group CEO nor board had breached their respective legal obligations:

> "*it is clear that problems were reported to the Board of Directors and the Audit Committee, and it is equally clear that such reporting was accompanied by assurances that problems were being dealt with and mitigation was ongoing. This information came from within the bank where the severity of the situation and the risks facing the bank had not been comprehended, and this affected the reporting. In hindsight, the question may be raised whether the Board of Directors or the Audit Committee could reasonably have done more. This, however, would not, in our view, form sufficient basis for legal criticism when taking into account the information available combined with the nature and extent of the responsibilities of the Board of Directors*."[86]

As with the above-mentioned report commissioned by the board of Wells Fargo, the conclusions of this report, which was commissioned by the board of Danske Bank, seem somewhat narrowly-focused and generous to the board and CEO in light of the above information that was available to it.

In any event, shortly after the publication of this report, the then CEO resigned and the chairman was removed, at the behest of the bank's largest shareholder, in order to "*strengthen the bank's ability to address its culture, compliance program and engagement with regulators*"[87].

Various national investigations into the issues are on-going.

5 ENHANCING BOARD EFFECTIVENESS IN ITS ROLE OF OVERSEEING A FIRM'S CULTURE – ISSUES TO BE ADDRESSED

Quite apart from board failures in addressing key structural issues giving rise to conduct risk issues, such as lack of diversity and distorted financial incentives (having the effect of incentivising staff not to take adequate account of customer interests), the recent reports and high-profile cases outlined in the previous section have highlighted significant further failings of boards. In particular:

(i) Boards have often failed to attach sufficient importance to ensuring that they receive sufficiently useful and adequate data that would give them an insight into whether there is a material divergence between the firm's espoused values and how it actually behaves in practice. Such data would provide potentially important early-warning signals to the board of possible issues around, for example, excessive risk-taking and unethical/illegal conduct.

This was one of the areas where the recent Australian Royal Commission report was particularly critical of financial institutions, noting that "*too often, boards did not get the right information about emerging non-financial risks; did not do enough to seek further or better information where what they had was clearly deficient; and did not do enough with the information they had to oversee and challenge management's approach to these risks*"[88]. The Royal Commission report emphasised that boards must have the right information in order to discharge their functions:

[86] Ibid., at p. 81.
[87] https://www.irishtimes.com/business/financial-services/maersk-family-ousts-danske-bank-chairman-after-scandal-1.3688352
[88] "The Royal Commission into misconduct in the banking, superannuation and financial services industry", at p.400; available at; https://financialservices.royalcommission.gov.au/Pages/default.aspx

"*When I refer to boards having the right information, I am not referring to boards having more information. As I noted earlier, it is the quality, not the quantity, of information that must increase. Often, improving the quality of information given to boards will require giving directors less material and more information.*

I do not pretend to be able to offer any single answer to how boards can ensure that they receive the right information. But boards and management must keep considering how to present information about the right issues, in the right way."[89]

Similarly, as noted in a recent US report an corporate governnance:

"If the board relies solely on management reports, the risk is that information may be incomplete, filtered or edited, even in good-faith ways. The general name for this problem is 'asymmetric information', and this imbalance can weaken the board's ability to oversee the corporation properly."[90]

In this regard, whilst a Board might for example take some comfort from knowing that adequate processes and procedures are in place to enable and facilitate speaking-up within the firm, this is of relatively little use in practice if staff within the firm do not actually feel comfortable speaking up about sentitive matters, so the board remaims ill-informed about potential issues.

Also, when assessing customer-related data, boards can often focus on data that will not give them a sufficient insight into customer outcomes. Often, boards rely on data relating for example to complaints made by customers - although many poor customer outcomes may not give rise to customers complaints until long after the customer harm has arisen, if at all. Also, a customer-related metric commonly used by boards is the Net Promoter Score. As noted in a recent report by the New Zealand financial services regulator:

"Many banks used a survey tool known as 'Net Promoter Score', which gauges customer loyalty. These surveys are typically done immediately after the customer interacts with the bank. However, the harm caused by poor product design or inappropriate sales or advice may not manifest for years. We do not consider Net Promoter Score or other similar surveys sufficient to measure customer outcomes."[91]

It must be recognised, however, that this is a complex issue. As noted in a recent G30 report:

"Banks are searching for metrics to assist in monitoring and understanding cultural progress over time, and while a broad range of metrics has been adopted, most banks are still experimenting and have neither found a definitive set of indicators nor concluded what those metrics should be." (p.33)

(ii) Boards have failed to challenge executive management adequately and effectively.

It may be difficult for boards to perform effectively this essential task of supervision of executive management in circumstances where they have not been provided by the executive management with adequate data to enable them to do so. This can arise where, for example, the executive management has a conscious or unconscious bias against providing data to the board that may raise an issue with the performance of the executive management. This is a matter for the board to resolve.

---

[89] Ibid.

[90] "Bridging board gaps". Report of the Study Group on Corporate Boards, 2011, Columbia Business School, Weinberg Centre for Corporate Governance University of Delaware; available at: https://www.google.ie/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=2ahUKEwjC_rTbvNnhAhXHDGMBHXAVAGgQFjAAegQIABAC&url=https%3A%2F%2Fwww0.gsb.columbia.edu%2Ffaculty%2Fghubbard%2FStudyGroup_3%252025.pdf&usg=AOvVaw3yND8GbnxAp8vlfapoQiOt

[91] "Bank conduct and culture", Findings from an FMA and RBNZ review of conduct and culture in New Zealand retail banks", November 2018, at p.15; available at: https://fma.govt.nz/assets/Reports/_versions/11883/Bank-Conduct-and-Culture-Review.1.pdf

Lack of effective challenge can also arise where there are issues of 'groupthink' at board level, where the board chooses (again, consciously or unconsciously) not to dig too deeply and challenge generally accepted approaches within the firm.

A group, such as a board, is particularly vulnerable to 'groupthink', when its members are similar in background, the group is insulated from outside opinions and there are no clear rules for decision-making.[92] Also:

> "*One of the root causes of Groupthink is cultural cohesiveness. In a cohesive group, members avoid speaking out against decisions, avoiding arguing with others and work towards maintaining friendly relations in the group. If cohesiveness gets to such a high level that there are no longer disagreements between members, the group is ripe for Groupthink*."[93]

In light of this potential problem of groupthink, regulators internationally have increasingly focused attention on ensuring increased diversity at Board level, including gender diversity, given that "*a lack of diversity at senior management and board level is a leading indicator of heightened behaviour and culture risks*"[94].

(iii) Boards have focused on short-term profitability, to the detriment of longer-term sustainability or to an adequate consideration of stakeholders other than shareholders. This shareholder value 'mindset' has resulted in decisions being taken at board level (or issues not being adequately considered at board level) that have eventually proven to be very costly to the financial services firms, as well as their customers and wider society.

In the sections below, we consider how boards could improve their effectiveness in relation to each of these three issues, in particular in the context of an industry-wide approach that could facilitate, first, the development of improved norms of behaviour across the industry (i.e. greater clarity around what 'good' performance looks like for boards, as opposed to mere minimum legal requirements); second, benchmarked assessments that could enable boards to gain a better insight into how they are progressing, in particular by reference to the industry as a whole; third, peer pressure to improve performance.

6 THE BENEFITS OF INDUSTRY-WIDE INITIATIVES TO ADDRESSING THESE BOARD EFFECTIVENESS ISSUES

In the first place, in our view, certain types of industry initiatives have the potential to improve firms' culture, as they can address the "co-ordination failure" problem, identified by the New York Fed. As noted in a December 2017 New York Fed white paper on "Misconduct risk, culture and supervision"[95], which identifies a number of market failures to explain why firms do not invest adequately in 'cultural capital', the reasons include "co-ordination failures", reflecting the inability of private actors to reach a common objective that is in the collective best interest – this is because short-term competitive pressures make it difficult to invest in longer-term cultural capital. The New York Fed White Paper recognises that:

> "*the Group of Thirty efforts around standard-setting and convening the industry and the UK's Banking Standards Board should help solve coordination failures and drive industry solutions*." [96]

The UK Banking Standards Board (and the setting up in Ireland of an equivalent industry-funded body, the Irish Banking Culture Board) provides a particularly interesting forum for industry initiatives to improve banking culture.

---

[92] Y. Valine, "Why cultures fail: the power and risk of Groupthink", 2019 (volume 11 part 4), Journal of risk management in financial institutions", p.301, at p. 302.
[93] Ibid.
[94] Ed Sibley, Deputy Governor Central Bank of Ireland, "Culture, diversity and the way forward", speech, 25 October 2018; available at: https://www.centralbank.ie/news/article/culture-diversity-and-the-way-forward---deputy-governor-ed-sibley.
[95] Available at: https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/2017-whitepaper.pdf
[96] Ibid., p.15-16.

In this regard, the UK Banking Standards Board states that its role is to:

> *"provide challenge, support and scrutiny for firms committed to rebuilding the sector's reputation, and it will provide impartial and objective assessments of the industry's progress*."[97]

A second (related) benefit of industry initiatives in this area is that enables firms to combine and focus resouces on complex multi-disiplinary issues relating to behaviours that firms may have practical difficulties in addressing on their own (or may be unprepared to invest internally or provide the resources to invest in external experts to address these issues).

Third, it must be recognised that, in terms of addressing complex behavioural issues within firms, only so much can be achieved by the imposition of increasingly onerous regulatory requirement, greater regulatory scrutiny and increased sanctions on firms and individuals. For example, a 2016 UK Financial Coduct Authority paper found:

> "*The evidence that we have suggests that there are limitations on the extent to which greater compliance can be achieved by increasing fines and the probability of detection. For example, there is a tendency of certain firms to carry on breaking rules in spite of continuing to accrue large fines*."[98]

More generally, relying wholly on increased regulation and enforcement can actionally be counter-productive in terms of improving behaviours. As argued by Hodges and Steinholtz in a recent book on "Ethical business practice and regulation":

> "An increase in monitoring, reporting and compliance in general can inadvertantly *increase* unethical behaviour, as people feel they are not trusted. Companies can spend large amounts of energy on compliance and have little left over for ethics. Focusing on rules crowds out objective thought on whether behaviour is ethical. Focusing on compliance can engender cynicism and disengagement, as the implicit message is 'we are only doing this because it is the law' and 'we don't trust you'. Disengagement clearly feeds unethical behaviour directly and indirectly as disengaged employees are less likely to speak up and report issues"[99].

Fourth, whilst the approach of the Dutch regulator, the DNB, to the supervision of behaviour and culture in firms is very significant, it does have some potential limitations in terms of achieving the desired outcome of improved behaviour and culture.

The DNB approach has the potential to significantly improve the level of self-reflection at board level of behavioural issues, including in relation to constructive challenge and addressing risks of groupthink, to lead to improvements in the industry. The DNB has a highly-experienced team of experts in organisational behaviour, which assesses firms' organisational behaviours (including by way of attending at board meetings) and makes suggestions, if appropriate, to firms for improvement.

The DNB approach is significant and influential, in terms of providing the expertise and constructive challenge to firms regarding the behaviours that is expected of firms, including board members[100] (although the DNB methodology specifically focuses on the executive/management board, rather than the supervisory board or main board in a unitary board structure[101]).

---

[97] https://www.bankingstandardsboard.org.uk/what-is-the-bsb/

[98] *Behaviour and Compliance in Organisations*, UK Financial Conduct Authority Occasional Paper No 24, December 2016; available at: <https://www.fca.org.uk/publications/occasional-papers/no-24-behaviour-compliance-organisations>.

[99] C. Hodges, R. Steinholtz, "Ethical business practice and regulation: A behavioural and values-based approach to compliance and enforcement", Hart, 2017, at p. xxv.

[100] For a detailed review of the Dutch regulator's approach, see, e.g. "Can soft regulation prevent financial crises? The Dutch Central Bank's supervision of behaviour and culture", J. Conley, L. Smeehuijzen, C. Williams, D. Rupp; available at https://ssrn.com/abstract=3277678

[101] Fn 12 above, at p.18, fn 3.

There are, however, some potential limitations to this DNB approach:

- It is a 'top down' regulatory approach which has the potential to give rise to moral licensing (all behaviours that are not specifically criticised by the regulator may be considered by the firm to be perfectly acceptable). Some firms/board members might also take a minimalist regulatory compliance-based approach and not to look beyond what they may deem to be regulatory 'impositions' in terms of standards of behaviour to be adopted by them. In other words, the DNB methodology might possibly "have the unintended effect of crowding out firms' intrinsic motivations to think seriously about cultural risks"[102].

- The approach depends, to an important extent, on sufficient mutual trust as between the regulator and the senior individuals in the firm that open conversations can be had between them to enable a fuller mutual understanding of behaviours and culture, on the basis of which constructive engagement on potential changes can be held. If senior individuals in the firm are concerned, however, that information/views they provide to their regulator may subsequently be used by the regulator against them or colleagues (for example, in the context of a fitness and probity review of an individual) or in a formal sanctions proceeding against the firm, it may be very difficult to establish the necessary level of mutual trust to achieve sufficiently meaningful reforms[103].

Fifth, peer pressure is a key influencer of behaviours and can be used to complement regulation to improve behaviours (if appropriately harnessed). As noted by the DNB, "*in essence, peer pressure regulates behaviour*"[104].

Also, the 2013 UK Parliamentary Commission on Banking Standards report, which recommended the creation of an industry standards body in the UK, stated that:

> "*We believe that the influence of a professional body for banking could assist the development of the culture within the industry by introducing non-financial incentives, which nonetheless have financial implications, such as peer pressure and the potential to shame and discipline miscreants. Such a body could, by its very existence, be a major force for cultural change.*[105]

Such a peer-based approach can serve to identify best practice internationally (in relation to matters such as constructive challenge at board meetings, to address 'groupthink' concerns) and facilitate the 'normalisation' of such practices and their 'internalisation', so that executives and board members more readily accept these norms as the appropriate way to behave rather than merely a form of regulatory requirement or expectation to be tolerated, at best.

As to whether there are sufficient incentives for industry to engage meaningfully in such initiatives, certainly at least in Ireland there is significant political pressure on banks to improve their culture, in particular in light of the recent tracker mortgage scandal in Ireland[106]

Also, businesses are becoming increasingly aware of the positive impact on their business success and profitability of a good ethical culture[107]. This may become an increasingly significant factor in particular in those areas of the financial services industry that are, as a result of technological innovation and regulatory change, opening up to competitors who are not traditional financial services operators.

---

[102] See e.g. fn 100 above, at p.54.
[103] See e.g. fn 100 above, at p.54-55.
[104] Fn 12 above, at p.50.
[105] Changing banking for good, Report of the Parliamentary Commission on Banking Standards, para. 138; available at https://www.parliament.uk/documents/banking-commission/Banking-final-report-volume-i.pdf
[106] See, e.g. http://paschaldonohoe.ie/minister-donohoe-welcomes-banking-initiative-that-aims-to-rebuild-trust-in-the-industry/ . As for the background to the tracker mortgage scandal in Ireland, see, e.g. https://www.rte.ie/news/business/2017/1025/915149-explainer-the-tracker-mortgage-scandal/
[107] See, e.g. C. Hodges, R. Steinholtz, fn 99 above, at pp.104-107, section entitled "The financial rewards of ethical culture".

Furthermore, there is also the potential benefit of lower compliance costs in the longer term, as improved culture leads to fewer breaches of regulatory requirements (for example, where an improved culture of speaking up leads to potential regulatory issues being identified and addressed at a much earlier stage than they might otherwise be) and a more constructive relationship with the regulator.

There is, of course, the risk that industry initiatives may be more inclined to serve the interests of industry firms rather than consumers. As Adam Smith famously stated, "*People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices*."[108] Such a risk is significantly mitigated, in the case of the Irish Banking Culture Board, by virtue of the fact that the board of this organisation is chaired by a former Court of Appeal Judge and a majority of the board is composed of individuals who are not from the banking industry (they include representatives of consumer groups).

7 SUGGESTIONS FOR INDUSTRY-WIDE APPROACHES TO IMPROVE BOARD EFFECTIVENESS

(i) Enhancing the quality of data available to the Board to enable it to assess more effectively the alignment of the firm's behaviours with espoused values

As noted above, it is important for a board not to have as its sole source of information the information provided to it by its senior management team. In this regard, as stated in a US report on corporate governance, boards should:

> "*Encourage direct dialogue with the entire organization by having routine contact with employees beyond the senior management team*."[109]

A useful development in this direction is the UK Banking Standards Board's comprehensive benchmarked annual assessment process for all of its member banks and building societies. The high-level results of the first annual assessment were published by the BSB in 2016. It's third annual assessment was published in April 2019[110].

The assessment involves an employee survey (over 72,000 took part in the latest survey), firm-specific focus groups with employees, written submissions from boards and interviews with non-executive directors and executives. The survey results are provided through an online dashboard that allows the firm to cut and analyse the data in multiple ways, subject always to constraints imposed to protect respondents' anonymity[111].

Such an industry-wide assessment approach is particularly useful as:

- It provides a common language to describe relevant culture factors and metrics for assessing them across the industry. This makes it easier for boards and other stakeholders to engage in an effective discussion of culture within their firm, on the basis of a language and a set of metrics derived from industry best practice.

  The UK Banking Standards Board is clear that it does not seek to assess firms against a template of what a 'good' culture looks like. Rather, it assesses firms against nine identified characteristics: honesty, respect, openness, accountability, competence,

[108] Adam Smith, "The wealth of nations", 1776, Book IV Chapter VIII, p. 145.
[109] "Bridging board gaps". Report of the Study Group on Corporate Boards, 2011, Columbia Business School, Weinberg Centre for Corporate Governance University of Delaware, at p.13; available at: https://www.google.ie/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=2ahUKEwjC_rTbvNnhAhXHDGMBHXAVAGgQFjAAegQIABAC&url=https%3A%2F%2Fwww0.gsb.columbia.edu%2Ffaculty%2Fghubbard%2FStudyGroup_3%252025.pdf&usg=AOvVaw3yND8GbnxAp8vlfapoQiOt
[110] Available at: https://www.bankingstandardsboard.org.uk/annual-review-2018-2019/
[111] See, further, A. Cottrell (CEO of the BSB), "The UK Banking Standards Board: An outcome-based approach to assessing organisational culture", 2018 (vol.11(1)) Journal of Risk Management in financial istitutions", 47-56. Also, BSB Submission to Australian Royal Commission, October 2018; available at: https://www.bankingstandardsboard.org.uk/bsb-written-evidence-for-the-australian-royal-commission-into-misconduct-in-the-banking-superannuation-and-financial-services-industry/

reliability, responsiveness, personal and organisational resilience, and shared purpose. According to the Banking Standards Board:

> "*We do not, …, set out to measure or rank culture directly. Rather, we ask how far each of our nine characteristics is demonstrated by the firm and relative to other firms. We would expect a firm that strongly exhibited our nine characteristics to be better equipped and more likely to service its customers, members and clients well, than one in which these elements were lacking*."[112]

These nine characterists are very similar (although not identical) to the nine common attributes of a healthy culture, identified in the UK Financial Reporting Council's July 2018 non-binding Guidance on Board Effectiveness (which accompanies the 2018 UK Corporate Governance Code).[113]

- The UK Banking Standards Board assessment is in-depth and provides a rich source of data, including firm-specific data, that enables boards of financial services firms to gain an indepth understanding of the culture of their firm. The assessment methodology was, for example, relied on by the Irish Banking Culture Board in its survey of its five retail bank members; the survey findings, which were published in April 2019, included:

    - Only 59% of respondents believed that senior leaders in their organisation meant what they said;
    - 49% of respondents stated that they see instances where unethical behaviour is rewarded;
    - 47% of respondents believed that if they raised concerns about the way they work, they would be worried about the negative consequences for them[114]

  The Banking Standards Board provides firm-specific data to the board of each participating firm and discusses it with the firm (but publishes only high-level aggregated data). The Banking Standards Board is clear that participation in the assessment "*demands a readiness on the part of board members and the executives to be self-critical and to ask questions of themselves and their employees that may elicit unexpected and unwelcome answer*."[115]

- Firms receive benchmarked data, so that they can assess their performance in the context of the norms of the wider industry. The relevant comparison data include a range and quartile against the equivalent category across all relevant firms.

- The published results are likely to create a form of peer pressure for boards to address any identified issues of concern.

- The results also enable the Banking Standards Board to carry out further work on industry standards of good practice, where issues of concern have been identified.

The customer perspective

For a board properly to assess whether its firm's behaviours are aligned with its espoused values, another key data set it will also need relates to the perspective of its customers.

This is particularly important, given the opportunities for financial services firms to take advantage of customers, particularly retail customers.

In the first place, such opportunities for taking advantage of customers can arise as a result of market power[116]. This market power can derive in particular in retail markets from, for example, customer inertia and their lack of financial literacy.

---

[112] https://www.bankingstandardsboard.org.uk/assessment-results-2017/
[113] available at: https://www.frc.org.uk/document-library/corporate-governance/2018/guidance-on-board-effectiveness. The nine characteristics identified are: honesty, openness, respect, adaptability, recognition, acceptance of challenge, accountability and shared purpose (p.6).
[114] Survey report available at: https://www.irishbankingcultureboard.ie/reports/
[115] https://www.bankingstandardsboard.org.uk/assessment-results-2017/
[116] As noted by the UK competition authority:

As stated in a recent UK Competition and Markets Authority (CMA) retail banking market investigation report:

> '*The behaviour of customers can play a central role in providing competitive constraints on providers. This happens if customers are engaged and willing to search for and implicitly threaten to switch to another provider, which offers them a better deal. Conversely, a lack of customer engagement in the market reduces banks' incentives to compete*.'[117]

Customer inertia and limited financial literacy appear to be particular issues of concern in retail financial services markets.

With regard to customer inertia, for example, a November 2017 bulletin from the CBI noted that the number of bank current accounts held by personal consumers in Ireland in H1 2017 was just over 5.28 million and that during this period the number of switches of current accounts was 2,715 i.e., a switching rate of 0.05%.[118] This rate of switching is considerably lower than the 3% annual rate noted by the UK Competition and Markets Authority for personal consumer accounts in its study of the UK market, which rate the UK Competition and Markets Authority considered to be 'very low' and was a factor resulting in the imposition of regulatory remedies on the retail banks in the UK to address competition concerns.[119]

As for retail customer financial literacy, as noted by Governor of the Central Bank of Ireland, Philip Lane in a February 2017 speech:

> '*A vast empirical literature shows that consumers tend to make poor financial choices, taking on too much debt, misunderstanding investment risk and choosing financial products that do not match their needs*.'[120]

Even in competitive markets, customers risk being taken advantage of, as demonstrated in the 2015 book by the Nobel Laureates George Akerlof and Robert Schiller, "Phishing for Phools: The economics of manipulation and deception". In this book, the authors argue that even in competitive markets sellers systematically exploit our psychological weaknesses and our ignorance through manipulation and deception.

An interesting recent example of such 'phishing' arose in the March 2019 fine imposed by the UK Financial Conduct Authority on The Carphone Warehouse for misleading customers in the sale of mobile phone insurance products over a 7-year period (during which period policies worth almost £450 milion were sold – although the Financial Conduct Authority

---

"Market power can be thought of as the ability profitably to sustain prices above competitive levels or restrict output or quality below competitive levels. An undertaking with market power might also have the ability and incentive to harm the process of competition in other ways; for example, by weakening existing competition, raising entry barriers or slowing innovation"; CMA/OFT "Assessment of market power", para. 1.4; available at https://www.gov.uk/government/publications/assessment-of-market-power

[117] CMA, *Retail Banking Market Investigation, Final Report* (9 August 2016) para 74, available at: <https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf>.

[118] CBI, 'Consumer Protection Bulletin – Current Accounts and Switching' (November 2017), available at: <http://www.centralbank.ie/docs/default-source/Regulation/consumer-protection/compliance-monitoring/reviews-and-research/consumer-protection-bulletin---current-accounts-and-switching---november-2017.pdf>. The Irish government has also launched a "Switch Your Bank Campaign". See, Pascal Donoghue, 'Minister Donohoe Launches Phase Two of Switch Your Bank Campaign' (22 January 2018), available at: <http://paschaldonohoe.ie/minister-donohoe-launches-phase-two-of-switch-your-bank-campaign/>. It noted, "The Department of Finance is running this campaign as part of a range of competition measures agreed with the European Commission to raise awareness and promote customer switching in the retail financial product area. This was agreed in the context of the restructuring plans for AIB and PTSB. The campaign is being funded entirely by the two banks."

[119] CMA, *Retail Banking Market Investigation, Final Report* (9 August 2016) para 11.3, available at: <https://assets.publishing.service.gov.uk/media/57ac9667e5274a0f6c00007a/retail-banking-market-investigation-full-final-report.pdf>.

[120] Speech by Governor Lane, 23 February 2017; available at: <https://www.centralbank.ie/news/article/financial-regulation-protecting-consumers-governor-lane>.

found that in many cases the product had little or no value to customers or was unsuitable for them). The firm was fined just over £29 million[121].

In light of these issues, the on-going work of the UK Banking Standards Board to develop a Consumer Framework, is interesting and potentially useful. In November 2017, the Banking Standards Board published a consultation document, entitled "*What do good banking outcomes look like to consumers*?"[122]. This document sets out outcomes-focused criteria for assessing what good consumer outcomes are. The criteria they have identified are: access, choice, clarity and transparency, safety and security, redress and being listened to, value for money, fairness.

The development of these industry-agreed criteria for assessing customer outcomes will likely be helpful in providing an industry-agreed language for assessing the consumer perspective (i.e. going beyond a minimalist approach of focusing on issues such as volume of complaints received).

More generally, in our view, there may be a benefit in an industry approach/benchmarking to develop best practice in the area of dealing with customer complaints and to ensure that there is sufficiently useful board-level engagement on this issue, to enable boards to assess effectively whether the behaviours of the firm are in line with espoused values (and to mitigate agaist the risk of board 'blind spots' in relation to this):

- Customer complaints provide a potentially significant counterveiling influence on firms, that will assist boards to identify and possibly address issues in which the firm takes unfair advantage of its customers (whether intentionally or otherwise). As stated by Dr Ken Henry, Chairman of national Australian bank (and former Australian Treasury Secretary) in evidence to the Australian Royal Commission into misconduct in the Australian financial services industry:

  > "So how do you measure customer outcomes?---Mainly – mainly through complaints from customers, to be honest"[123].

- Financial services firms are subject to regulatory requirements in relation to complaints management[124]. The requirements, however, broadly tend to be procedural in nature[125]. There would be a benefit in industry considering this issue not simply from a regulatory/procedural perspective but increasingly from the perspective of the board's role in assessing whether the actual practices of their firm diverges from its stated values.

- Any such articulation of industry best practices/potential benchmarking would serve to address the risk of complacency of firms regarding the adequacy of their complaint management systems, by subjecting the systems to constructive peer appraisal; in the words of Onora O' Neill, commenting on the role of the UK Banking Standards Board, "it is like someone else holding a mirror at an unfamiliar angle to give a view that in-house exercises may not provide."[126]

---

[121] https://www.fca.org.uk/fca-fines-the-carphone-warehouse-over-29-million-for-insurance-misselling

[122] https://www.bankingstandardsboard.org.uk/bsb-consultation-what-do-good-banking-outcomes-look-like-to-consumers/ . In September 2017, the BSB published a summary of responses it received to the consultation; available at: https://www.bankingstandardsboard.org.uk/the-banking-standards-board-publishes-summary-of-responses-to-consumer-consultation/

[123] Transcript: https://financialservices.royalcommission.gov.au/public-hearings/Documents/transcripts-2018/transcript-26-November-2018.pdf , at p. 7117.

[124] In Ireland, for example, the relevant requirements relating to complaints management include the provisions set out in section 10 of the Consumer Protection Code 2012: https://www.centralbank.ie/docs/default-source/regulation/consumer-protection/other-codes-of-conduct/4-gns-4-2-7-cp-code-2012.pdf?sfvrsn=6 .

[125] Under the CBI's Consumer Protection Risk Assesment Model, however, firms are expected to have effective complaints management systems in place, including systems to address "Root cause analysis of complaints, appeals, issues or other matters escalated in relation to Consumer Protection Risk and evidence that this analysis was used to mitigate future similar risks"; CBI Guide to Consumer Protection Risk Assessment https://www.centralbank.ie/docs/default-source/regulation/consumer-protection/170328-cpra-guide-28-march-2017.pdf?sfvrsn=0 , at p. 17.

[126] https://www.bankingstandardsboard.org.uk/remarks-by-baroness-onora-oneill/

- There is currently a major problem of lack of public trust in the financial services industry. The trustworthiness of the financial services industry may improve, and trust in this industry may thereby increase, if the industry further improved its standards in relation to the handling of customer complaints.

- It may be that customers may be more likely to complain to their financial institution if they consider that the chances of their complaint being effectively considered increased - interestingly, the Australian Royal Commission received over 10,000 customer complaints during the course of its deliberations[127]. This has the benefit for firms of providing useful indicators of potential misconduct risk. Indeed, whilst individual customer complaints may appear to be relatively trivial to boards, trend data including qualitative information on the trends can provide useful indicators of potential misconduct risk[128] (and would likely have proven useful to the boards of Wells Fargo and the UK banks dealing with PPI, described above, had they paid sufficiently close attention to such information that could and should have been available to them).

(ii) Effective constructive challenge by boards of executive team

Each individual director on a board is individually responsible for engaging in effective constructive challenge of the executive team, to ensure that the strategy and cultural values set by the Board is being properly implemented by the executive team. Thus, for example, Art 91(8) CRD IV[129] states:

> *"Each member of the management body [board] shall act with honesty, integrity and independence of mind to effectively assess and challenge the decisions of the senior management where necessary and to effectively oversee and monitor management decision-making."*

The ability of each prospective member of a board to carry out this essential function of effective challenge can be and is assessed by the regulator when the prospective board member applies for regulatory approval under the applicable fitness & probity regime in Ireland. With regard to the criterion of "independence of mind", the joint European Securities and Markets Authority/European Banking Authority Guidelines provide that, when assessing an individual's "independence of mind", the assessing regulator should consider whether the individual has:

> "*a. the necessary behavioural skills, including:*
>> *i. courage, conviction and strength to effectively assess and challenge the proposed decisions of other members of the management body;*
>> *ii. being able to ask questions to the members of the management body in its management function; and*
>> *iii. being able to resist 'group-think'.*"[130]

---

[127] Fn 50 above, at p.xxxv.

[128] In Ireland, under the Consumer Protection Code 2012:

> "A *regulated entity* must undertake an appropriate analysis of the patterns of *complaints* from *consumers* on a regular basis including investigating whether *complaints* indicate an isolated issue or a more widespread issue for *consumers*. This analysis of *consumer complaints* must be escalated to the *regulated entity*'s compliance/risk function and senior management." (Para. 10.12)

[129] Directive 2013/36/EU of the European Parliament and of the Council on access to the activity of credit institutions and the prudential supervision of credit institutions; available at:
https://www.google.ie/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=2ahUKEwi82_Pv2IjgAhUiUBUIHWxNBboQFjAAegQIBhAC&url=https%3A%2F%2Feur-lex.europa.eu%2FLexUriServ%2FLexUriServ.do%3Furi%3DOJ%3AL%3A2013%3A176%3A0338%3A0436%3AEN%3APDF&usg=AOvVaw0RxJAneppbRLk6tBgN88OD

[130] https://eba.europa.eu/documents/10180/1972984/Joint+ESMA+and+EBA+Guidelines+on+the+asses

Apart from this individual assessment in the context of a fitness and probity application process, boards are also required to carry out regular reviews of their effectiveness[131].

These review processes, together with on-going supervision, provide regulators with some insights into the effectiveness of boards and individual members of boards. There is a limit, however, to how useful an insight can be gained from process-driven regulatory engagements (e.g. reviews of board minutes are unlikely to give particularly useful insights into the dynamics of board meetings and the effectiveness of board-level challenge of the executive team).

Accordingly, as outlined above, we consider that there is merit in industry initiatives to identify, 'normalise' and potentially benchmark best practice in relation to how board members can best engage in constructive challenge whilst maintaining the effectiveness of the board as a whole.

Given that groupthink has been identified as as issue of concern by regulators (according to e.g. Andy Haldane, The Bank of England's Chief Economist, "*groupthink was the reason most banks (as well as many regulators, central banks and academics) failed in 2008*"[132]), an industry culture/standards body could, for example, using inter-disciplinary approaches, usefully identify international best practice to address this problem and the issue of effective constructive challenge at board level.

In this regard, it is interesting to note that the UK Banking Standards Board has created a new unit, called 'BSB Insights', that will draw on insights from behavioural economics and organisational psychology to identify cultural or behavioural factors that enable, promote or inhibit high standards in banking, understand their causes and help to test the effectiveness of interventions.[133]

Any such guidance on best practice could also look at a core related behavioural problem of lack of speaking up within financial services firms and the approach of the board/board members to this. Whilst boards may well have approved appropriate processes and procedures in place to enable and facilitate speaking up, this is of limited use if, in practice, there is a culture that does not encourage speaking up. As noted by the UK Banking Standards Board:

> *"Encouraging people to speak out and challenge — something that is central to a good risk culture — requires effort on the part of those leading an organisation to address all of the many factors that will reinforce conformity; to make, in other words, challenge and continuous improvement so acceptable that they become the norm. This requires not just talking about what's expected, but acting it out: demonstrating constructive challenge, for example; inviting and visibly responding to feedback; or sharing personal examples about speaking out, being challenged or making and learning from mistakes.*

---

sment+of+suitability+of+members+of+the+management+body+and+key+function+holders+%28EBA-GL-2017-12%29.pdf/43592777-a543-4a42-8d39-530dd4401832 para. 82.

131 Art 88(2)(b) CRD IV.

132 "The diversity project", speech delivered by Andy Haldane on 8 November 2016; available at: https://www.bankofengland.co.uk/speech/2016/the-diversity-project . Also, for example, one of the findings of the recent Central Bank of Ireland review of culture in the main retail banks in Ireland (see, fn 48) was that:

> "*we found the banks have much more work to do in terms of ensuring their organisations are sufficiently diverse and inclusive, particularly at senior level, to prevent group-think, guard against over-confidence, and promote internal challenge" (p.5)*

> *"Group-think has been identified as a contributing factor to the financial crisis. Research suggests that diversity at senior levels can help to reduce the likelihood of group-think, improve decision-making, increase the level of challenge, and improve risk management*." (p.29)

133 https://www.bankingstandardsboard.org.uk/bsb-written-evidence-for-the-australian-royal-commission-into-misconduct-in-the-banking-superannuation-and-financial-services-industry/

To have credibility and carry weight, especially on an issue as difficult as speaking up, leaders need not just to tell stories about what is expected; they need to be in the stories that other people are telling. One interesting aspect of the assessment focus group discussions, in this context, is the extent to which participants talking about values or behaviours refer to the example set by their leaders or managers, or whether the latter are notable by their absence."[134]

(iii) Clarifying the purpose of the firm

The role of a corporation in society is becoming a topic of increasing public discussion[135]. A bank's role in wider society and its "social licence to operate" is also an issue of concern to financial services regulators globally. As stated in a 2015 speech by a vice President of the New York Fed:

"*Banks receive operating benefits unavailable to other industries because they provide important services to the public. For example, financial intermediation is enhanced through deposit insurance and access to the discount window. Public benefits, though, are not a gift. They are part of a* quid pro quo*. In exchange for receiving valuable operating benefits, a bank's implicit codes of conduct—that is, its culture—must reflect the public dimension of the services that banks provide*."[136]

Also, in October 2018, commenting on the proposed new legislation to introduce a UK-style individual accountability regime in Ireland, Minister for Finance Paschal Donohoe stated:

"*My objective in legislating for expanded Central Bank powers, is to cultivate a sustainable financial services industry, with rewards reaped over the long-term for customers, staff, and shareholders, and where consideration of the impact on individuals, the economy and society as a whole is firmly embedded in organisational culture*."[137]

Notably, in the UK, the 2018 revised UK Corporate Governance Code 2018 provides, as one of its core principles, that the role of the board of a company is to:

"*promote the long-term sustainable success of the company, generating value for shareholders and contributing to wider society*."[138]

This goes beyond the shareholder-value focus of companies in recent decades. Also, in Australia, a proposed revised edition of the Australian Corporate Governance Principles and Recommendations proposes to introduce a new principle regarding listed entities' social licence to operate: "*A listed entity should instil and continually reinforce a culture across the organisation of acting lawfully, ethically and in a socially responsible manner*"[139]. Further, in the US, Senator Elizabeth Warren has proposed a legislative bill that would require certain-sized corporations in the US to take account of a range of stakeholders, going beyond shareholders.[140]

---

[134] https://www.bankingstandardsboard.org.uk/the-uk-banking-standards-board-an-outcome-based-approach-to-assessing-organisational-culture/

[135] See, e.g. David Brooks, "The remoralisation of the market", New York times, 11 January 2019; available at: https://www.nytimes.com/2019/01/10/opinion/market-morality.html?action=click&module=Opinion&pgtype=Homepage

[136] "Why focus on culture?", speech by Albert Musalem, Executive Vice-President New York Fed, 23 November 2015; available at https://www.newyorkfed.org/newsevents/speeches/2015/mus151123

[137] Speech by Minister Paschal Donohoe at Central Bank of Ireland/Trinity College Dublin Conference on "Culture, Diversity & the Way Forward for Corporate Governance in Ireland"; available at: http://paschaldonohoe.ie/central-banktcd-conference-culture-diversity-the-way-forward-for-corporate-governance-in-ireland/

[138] Fn 18 above.

[139] "Consultation on Fourth Edition of Corporate Governance Principles and Recommendations"; p.25 of the consultation draft "Corporate Governance Principles and Recommendations; available at: https://www.asx.com.au/regulation/corporate-governance-council/review-and-submissions.htm

[140] Elizabeth Warren, "Companies shouldn't be accountable only to shareholders; my new bill would require corporations to answer to employees and other stakeholders as well", Wall Street Journal, 14

Interestingly, in the UK, the British Academy is currently engaged on a major research project on the future of the corporation[141]. The programme aims to "*contribute to redefining business in the 21st century and building trust between business and society*."[142] In December 2018, it published its initial research conclusions[143], pointing to the need to develop a new framework for the corporation around three interconnected principles: well-defined and aligned purposes; a commitment to trustworthiness; embedding an enabling culture. Also, according to the initial research conclusions, this shift would require co-ordinated action on a new approach to the use of five identified levers, relating to: ownership, corporate governance, regulation, taxation and investment.

The next phase of this major research project is continuing in 2019, looking at precise business practice and policy implications of the proposed framework; in particular, it will consider the laws and regulation, ownership and governance, and measurement and management required by the proposed new framework.

As to the issue of a proposed shift from the current 'shareholder value' paradigm of corporations to a future paradigm in which corporations take greater account of a wider social purpose, the research paper notes the development of the Friedman Doctrine, essentially equating corporate purpose with shareholder profits. Whilst this doctrine may have addressed the problem of the lack of sufficient accountability of managers of a firm:

> "*It is at this point that our research suggests the nature of the corporation erred. While it was right to be concerned about the lack of accountability of management, it was wrong to see its resolution in control by one party to the firm. The reason why this happened was that the rights of shareholders were equated with the property rights of owners. Shareholders bore the risks and rewards of the success and failure of business and so had corresponding rights to control it.*
>
> *But shareholders are not in many cases owners in any meaningful sense of the word and do not aspire to act as owners. This misconception and preoccupation with one single party to the firm rather than a wider constituency has been the cause of mounting environmental concerns, social tensions and political backlash.*
>
> *These have become particularly acute since the 2007–8 Financial Crisis, as many of the defects of the conventional wisdom were laid bare*".[144]

In our view, addressing this issue of corporate purpose will be a key element in improving trust in the financial services industry over time. For many consumers, their distrust of the financial services industry derives to a significant extent from evidence that this industry has focused on short-term profit maximising at the expense of consumer interest. This consumer perception derives in part from an understanding that the 'mindset' of the financial services industry is based on the above Friedman doctrine which, in extremis, suggests that firms can go to any lengths to profit maximise, unless specifically prohibited by law or the regulator i.e. consumers cannot rely on financial firms to look after their interests, unless specifically required to do so by law or the regulator (and, even then, any reliance placed by customers on financial institutions complying with the law can be misplaced).

This problem is compounded by a range of issues that arise in the financial services industry, described earlier in this paper, including: (i) information asymmetries between the financial services provider and the customer (reinforced by generally low levels of

---

August 2018. Available at: https://www.wsj.com/articles/companies-shouldnt-be-accountable-only-to-shareholders-1534287687

[141] "The future of the corporation phase 1: developing a new framework for business"; available at https://www.thebritishacademy.ac.uk/programmes/future-corporation-phase1-developing-new-framework

[142] Ibid., at p.3.

[143] "Reforming business for the 21st century: a framework for the future of the corporation"; available at https://www.thebritishacademy.ac.uk/publications/reforming-business-21st-century-framework-future-corporation

[144] "Reforming business for the 21st century: A framework for the future of the corporation", p.14. Available at: https://www.thebritishacademy.ac.uk/publications/reforming-business-21st-century-framework-future-corporation

financial literacy of retail consumers); (ii) conflicts of interest in financial services firms; (iii) market power of firms, particularly arising from lack of customer engagement/willingness to switch provider; (iv) the relatively high rewards for the staff of financial services firms in successfully contributing to short-term profits of the firm, sometimes with little if any down-side for doing so at the expense of the customer interest (other than compliance with clear minimum legal requirements).

As outlined above, in accordance with the framework for assessing culture set out by Edgar Schein, where the culture of a firm involves widespread discrepancies beween desired behaviours and observed behaviours, as is the case in the financial services industry, leaders need to "*locate the cultural DNA and change some of that*"[145] i.e. address culture issues at the level of taken-for-granted underlying basic assumptions and not merely at the level of artefacts or espoused values and beliefs.

It our view, therefore, key to improving culture in the financial services industry in the longer term will be addressing the need to tackle the 'Friedman doctrine' mindset in the industry (and in corporations more widely) and recognising the need for firms' purposes to encompass wider purposes than 'shareholder value'.

There is a limited amount that firms can do individually to address this industry-wide 'mind-set' issue, given for example the 'co-ordination failures' problem identified by the New York Fed as discussed above.

Accordingly, bodies such as the UK Banking Standards Board and Irish Banking Culture Board would be particularly well-placed to build on the above-described on-going work of the British Academy to consider how financial services firms can embed in their firms a 'mindset' regarding the purpose of the firm that takes sufficient account of the interests of a wider range of stakeholders than merely those of shareholders.

8 CONCLUSIONS

Boards of financial services firms have a clear and critical role in establishing the values of the firm and monitoring whether the behaviours of the firm are aligned with these values.

Quite apart from ensuring that appropriate structures and governance are in place, increasingly more is expected of boards in terms of ensuring that they (i) have available to them the best and most reliable information in order to enable them to perform this function effectively – and to proactively seek out further information/explanations where there are indications available to the board that actual behaviours within the firm do not align with stated values; and (ii) constructively challenge executive management.

In our view, given that, as noted above by the DNB, "in essence, peer pressure regulates behaviour", there is merit in improving the standard of board performance in these particular areas on the basis of industry-wide initiatives, as suggested in this paper. Any such initiatives would, of course, be in addition to minimum standards of behaviour as established by law and regulatory requirements and expectations.

Furthermore, there is also merit, in our view, for the same reason, in industry-wide engagement in the evolving public debate, to address the issue of the 'mind-set' within the industry, which is arguably based on the 'shareholder value'/Friedman doctrine and whether and how this can evolve to a wider conception of the purpose of a financial services organisation in society.

[145] Fn 22 above, at p. 27.