Culture Audit in Financial Services

Culture Audit in Financial Services

Reporting on behaviour to conduct regulators

Roger Miles

KoganPage

First published in Great Britain and the United States in 2021 by Kogan Page Limited

2nd Floor, 45 Gee Street
London
EC1V 3RS
United Kingdom
www.koganpage.com

122 W 27th St, 10th Floor
New York, NY 10001
USA

4737/23 Ansari Road
Daryaganj
New Delhi 110002
India

Kogan Page books are printed on paper from sustainable forests.

ISBNs

Hardback 978 1 78966 777 6
Paperback 978 1 78966 775 2
Ebook 978 1 78966 776 9

British Library Cataloguing-in-Publication Data

A CIP record for this book is available from the British Library.

Library of Congress Cataloging-in-Publication Data

[to follow]

Typeset by Integra Software Services, Pondicherry
Print production managed by Jellyfish
Printed and bound by CPI Group (UK) Ltd, Croydon, CR0 4YY

CONTENTS

ABOUT THE AUTHORS

Roger Miles researches behavioural risk, regulatory design, and why control systems fail, counselling boards on risk governance, management of uncertainty and human risk factors. He delivers bespoke small-group risk workshops for leaders in business, government, NGOs, professional firms and industry bodies.

He began his business career as a (frankly not very good) auditor with a London-headquartered big-four accounting firm. He found his business feet as a partner in a global investor relations consultancy, advising major US and EU public companies on market events and value protection. He was then invited to lead financial sector dialogues with Westminster and Brussels, later to advise HM Government on risk communications. Mid-career, he escaped all that to complete an observational research PhD on banks' rule-gaming of capital controls, in which he predicted the coming of 'the behavioural approach to regulation' as a remedy for this. After the global financial crisis in 2008, the arrival of the Conduct control regime vindicated his research prediction, leading to various invitations to re-engage with the City.

Roger leads teaching faculties for financial sector Conduct and Culture Academies in the UK, EU and Asia-Pacific. He is Conduct lead for the Finance Unlocked global learning series and a visiting lecturer on risk perception and communication at the Universities of London (Imperial College and Cass Business School), Cambridge, and UK Defence Academy where he has also been an examiner for MBA and MSc (Risk) courses. He co-edits the encyclopaedia of psychological terms for the LSE's annual *Behavioral Economics Guide* and is a long-term contributing editor at Thomson Reuters Regulatory Intelligence. His serial commentaries on risk culture and his research on behaviour in financial-sector boardrooms are published by Reuters, Risk Books, the *Financial Times*, Berkeley Research, and Board Performance (BP&E Global). Also published by Kogan Page is his popular handbook *Conduct Risk Management: A behavioural approach*.

Christopher Hodges is Professor of Justice Systems and Head of the Swiss Re Research Programme on Civil Justice Systems at the Centre for Socio-Legal Studies, Oxford; a Supernumerary Fellow of Wolfson College, Oxford; and a

Fellow of the European Law Institute. He is co-founder of the International Network for Delivery of Regulation (INDR) and advises governments, regulators and businesses on regulation and dispute resolution systems across the globe. He has been Erasmus Professor of the Fundamentals of Private Law at Erasmus University, Rotterdam and has held visiting Chairs at the China University of Political Science and Law, Beijing, Leuven University and ANU Canberra. He has chaired committees in the pharmaceutical, pharmacy, medical device, and property sectors. Before becoming an academic, he spent 25 years as a corporate lawyer based in the City of London.

Recent books include *Regulatory Delivery* (with Graham Russell, 2019); *Delivering Dispute Resolution: A Holistic Review of Models in England & Wales* (2019); *Ethical Business Practice and Regulation* (with Ruth Steinholtz); *Law and Corporate Behaviour* (2015); *Redress Schemes for Personal Injuries* (with Sonia Macleod, 2017); *Delivering Collective Redress: New technologies* (with Stefan Voet, 2018); *Consumer ADR in Europe* (with Iris Benöhr and Naomi Creutzfeldt, 2012) and *The Costs and Funding of Litigation* (with Stefan Vogenauer and Magdalena Tulibacka, 2010).

Julie Ampadu is an experienced compliance practitioner and leads the Working Group on Culture for the Association of Professional Compliance Consultants (APCC). She is owner/director of Chameleon Compliance Ltd and Business Chameleon Ltd, offering regulatory compliance support, regulatory compliance training and executive coaching for senior managers of firms authorized and regulated by the FCA, or for those seeking authorization.

She is Deputy Chair of the APCC, a former regional Chair of the Personal Finance Society and Committee member for the Chartered Insurance Institute. Julie has worked with an extensive range of clients, from sole traders to high street banks, in a wide variety of UK Financial Conduct Authority (FCA) regulatory areas and is regularly invited as an expert contributor to conferences and publications throughout the UK.

Julie's focus is supporting firms not only to understand FCA rules, but to recognize that adhering to FCA rules does not necessarily make an authorized firm compliant. Examining culture and behaviours throughout the business, she supports firms to question their own mindset of what it means to be an authorized and regulated firm in the UK today. On this basis, beyond traditional compliance support her expertise is focused on governance, culture, diversity and inclusion, as well as training and competence and the personal development of senior managers.

Elizabeth Arzadon is a psychologist and Managing Director of Kiel Advisory Group. She is a recognized global expert on the topic of cultural risk, pioneering the use of behavioural science in the auditing of culture and its impact on conduct, governance and risk management outcomes within the financial sector.

Elizabeth first started examining culture as a driver of performance in 2000 as an organizational specialist at McKinsey & Company. Following the global financial crisis in 2008, she turned her attention (along with many others) to risk and conduct. Working in corporate and advisory roles, she set her sights on solving a challenge faced by many internal audit functions: how to assess culture in an evidence-based way. Leading behavioural risk audit programmes in a range of global banks, Elizabeth developed tangible, real-world insight into the systemic drivers of behaviour within the financial sector.

This systemic lens led Elizabeth into the world of regulation. As a special adviser to the Australian Prudential Regulatory Authority (APRA) she developed and piloted the regulator's approach to evaluating culture, devising a new methodology for supervisory reviews of risk culture, and enhanced the agency's capability on the issue of culture. She worked closely with peer regulators around the world, taking a key role in drafting global regulation forum the Financial Stability Board's institutional toolkit for mitigating cultural drivers of misconduct. During this period she was also a leading member of the prudential inquiry into the Commonwealth Bank of Australia.

Elizabeth now aims to strengthen cultural drivers of sustainable performance by working across the entire system, with institutions, regulators, boards and professional bodies globally. In particular, her firm is passionate about bringing behavioural science and transparency to the challenge of culture and its impact on corporate behaviour.

Christian Hunt is the founder of Human Risk, a training and consulting firm that specializes in 'bringing behavioural science to ethics and compliance'. He works with companies and individuals to design and implement compliance programmes that are more effective as a result of being designed to operate with, rather than against, the grain of human thinking.

He began his career in the business consulting division of Arthur Andersen, qualifying as a Chartered Accountant while working on projects ranging from advising the UK gas regulator on pre-payment tariffs (the first of many forays into regulation) to the matching of dormant accounts in Swiss banks with Holocaust victims.

A move into investment banking led to him being asked to run the newly established Office of the Chairman of Deutsche Bank, London. A two-year secondment at the UK takeover regulator ended just as the 2008 global financial crisis was starting. It was hardly the best timing for a return to frontline banking, so he joined a Family Office with a focus on private equity and hedge funds.

What followed was a career-defining decision that sowed the seeds for Human Risk, which is explored in a case example on pages XXX–XXX of this book. That decision was to take up an invitation to lead supervision at one of the newly formed financial services regulators, before – perhaps inevitably – crossing the divide to become a compliance officer.

He is a regular writer, presenter and producer of online Human Risk-related content.

Hani Nabeel is the Chief Behavioural Scientist at iPsychTec, a world-leading People Analytics and behavioural science company. He is the architect and founder of CultureScope, an award-winning and groundbreaking behavioural analytics platform for scientifically measuring and embedding an organization's desired culture using predictive analytics and actionable insights. His work combines the best elements of scientific and applied research with a focus on Organizational Culture by providing groundbreaking diagnostics, delivering advanced predictive analytics and producing actionable business insights to help organizations achieve sustainable competitive advantage. In 2017, CultureScope won the Wharton People Analytics Award, the only non-US company to ever achieve this. Hani recently deployed behavioural analytics as the first line of defence against financial crime for a global bank across 71 countries.

Hani has over 20 years of experience delivering Leadership and Talent Management Consulting services as well as quantitative behavioural research. Hani also has an MSc in Occupational Psychology, an MSc in Advanced Research Methods, a BSc in Physics and holds a commercial pilot licence.

He is a regular guest at organizational culture and data analytics events such as the Wharton and Tucana People Analytics conferences. Hani is also a frequent contributor to the UK Finance Academy and Forums and has written articles on culture for the *Business Times*, *Executive Grapevine*, *Disrupt HR*, *HR Director* and *HR Zone*. Hani is a lecturer and a talent development consultant for a number of corporate universities.

Mirea Raaijmakers is Global Head of Behavioural Risk Management at ING and previously led the Dutch Central Bank (DNB)'s supervision programme for Governance, Behaviour and Culture. At DNB she was the main architect of a national and subsequently global initiative to bring financial regulation into the 'behavioural regulation' era, as lead author of the hugely influential guidance for regulators, *Supervision of Behaviour and Culture: Foundations, practice and future developments* (2015).

She was the first psychologist ever appointed by a central bank to use her specific skillset in supervision. Globally, DNB's supervision of Behaviour and Culture is perhaps the most highly regarded post-financial crisis innovation in supervision. Next to the design and development of this new type of supervision, Mirea has always been in the lead of executing behaviour and culture inspections; she understands from the inside why and how this innovation works.

Prior to DNB she worked as an organizational consultant at consultancy firms as well as the Dutch Tax and Customs Administration.

Mirea's work is deeply grounded in observational understanding and influencing the behaviour of individuals, groups and organizations, especially during complex and large-scale changes. An experienced leader, both at the highest levels in the banking industry and as a thought leader in behaviour and culture supervision, she continues to run sector-level initiatives for large-scale change, organizational development, leadership development, and behavioural change.

A graduate of Harvard Business School, Mirea also holds a MSc in Psychology and PhD in Behavioural Science from the University of Groningen.

Cosette Reczek has worked in banking for over 25 years in capital markets, divisional and Group roles at J.P. Morgan, Citibank, Deutsche Bank, RBS, PWC, Barclays, and HSBC.

At HSBC, she facilitated Group-wide evolution of the scheme of delegation and governance committee best practices. She was the inaugural Group Head of Organization Design & Human Capital Analytics and was accountable for forming and leading the Senior Manager & Certification Regime (SM&CR) management office, working with boards and staff to implement conduct, certification and senior manager requirements and guidelines.

In 2016 Cosette founded Permuto Consulting to advise on board effectiveness, organizational design, and culture and conduct including training and SM&CR.

In 2018 she was appointed Chief Executive Officer of Conduct Academy, which delivers culture and conduct training for boards, executive committees, and front-office supervisors. Continuing on the board of Conduct Academy, Cosette now maintains a portfolio career focused on governance, culture, conduct, and risk management.

Stephen J Scott is Founder and CEO at Starling, a globally recognized pioneer in the RegTech space. Starling's Predictive Behavioral Analytics platform allows firms to measure and mitigate culture- and conduct-related risks, and to identify opportunities for performance improvement across business lines and functions.

Stephen spent a 25-year career in risk management and corporate intelligence, serving clients when they were: entering new markets, ventures, or commercial relationships; conducting pre-investment due diligence or testing an investment thesis; carrying out investigations into fraud or corruption; pursuing redress through litigation, arbitration, or government inquiry; and when seeking to advance their interests before government and regulatory agencies.

He has led successful investigative inquiries in over 50 countries, and has lived and worked in New York, Washington, London, Frankfurt, Madrid and Shanghai.

Stephen holds degrees from Cornell University, the London School of Economics, the Columbia Graduate School of Business and the London Business School.

Ruth Steinholtz assists, cajoles and supports organizations creating effective ethical cultures based on values and the principles of behavioural science. She founded AretéWork in 2011 for this purpose. She uses the Barrett cultural values assessment analytics whenever possible to provide management with a realistic view of their culture(s) to enable them to use resources wisely and to the best effect.

A corporate lawyer in her first career, Ruth was General Counsel and head of Ethics and Compliance at petrochemical company Borealis AG before deciding to devote herself to values-based ethics. Her career has led her from San Francisco to Italy, Egypt, Spain, Denmark and Austria and despite her accent, London has long been her home. At Borealis she created the concept of ethics ambassadors: networks of employees who assist in nurturing values, ethical decision-making and other aspects of an organization's ethics and compliance infrastructure. Ruth's mission is to fight corruption by changing attitudes and practices relating to regulation and compliance.

Ruth is co-author with Professor Christopher Hodges of *Ethical Business Practice* and *Regulation: A behavioural and values-based approach to compliance and enforcement*. Her other publications include the Institute of Business Ethics' *Good Practice Guides to Ethics Ambassadors* (2010) and *Performance Management for an Ethical Culture* (2014). She is a member of the UNODC E4J panel of experts on Ethics and Integrity and advisor to the Anti-Corruption panel. Ruth is a certified Barrett Values Analytics consultant, a trained mediator and has an Advanced Practitioner Diploma in Executive Coaching from the UK Academy of Executive Coaching. She is a frequent speaker globally on topics related to values and ethics.

Rachel Wolcott is Senior Editor, risk and compliance for Thomson Reuters Regulatory Intelligence. With unequalled high-level direct contacts with the world's investment banking officials, investors, regulators, consultants and technical innovators, she has more than 20 years' experience covering banking and financial markets in New York and London, writing on everything from private banking and capital markets to derivatives, cybercrime, FinTech and RegTech.

Rachel's current role follows a series of distinguished editorial positions, as former European Editor of *Risk Magazine*, at *Euromoney* magazine and at *Institutional Investor*. In these roles she had a front-row seat to some of the worst banking misconduct perpetrated in the name of risk management and financial engineering.

She is a Master's graduate of New York University and holds a Bachelor of the Arts degree from Reed College in Portland, Oregon.

FOREWORD

Culture and conduct need to be taken seriously, as they are critical to successful financial firms and resilient financial systems, and hence to the success of effective regulatory systems. But we need to apply the knowledge we have properly and convert it into effective action.

Finance as a sector is a late arrival to the Conduct and Culture debate but it has spread quickly. Many other businesses, professions and regulatory systems have understood the ideas and invested greater effort in applying them. There are two major drivers to this profound change and why it has transformed some sectors more quickly than others. The first is whether the findings of behavioural science have been heard and applied. Some of the findings are challenging since they point to changes that may be difficult to make or might be seen as likely to hurt. Second, the basic desire of populations for fairness is a voice that is increasingly insistent and needs to be listened to.

The public's sense of natural justice and perception of institutional injustice have been sorely tested by two events in particular. In the aftermath of the 2008 global financial crisis, governments were seen to have used taxpayer funds to bail out failing banks; then in 2020 the stresses of the global Covid-19 outbreak exposed many institutions (government, science, healthcare, finance) to a critical public reappraisal.

On a longer-term view it is apparent that the shock waves, both from new behavioural insights and institutions failing under stress, have penetrated more quickly in some sectors than others. The most receptive areas traditionally were those where safety is key (aviation, nuclear); systems are evolving at speed (AI, online harms); where an industry is simply more open to this type of innovative thinking (some parts of food, healthcare and technology); or where public or existential pressure is effective (global sustainability, corporate governance). In contrast, some sectors have been less inclined to listen because they retain strong entrenched interests – and the levels of remuneration in financial services are certainly one barrier to change.

The financial crisis of 2008 highlighted why corporate culture matters to people 'on the street'; and the financial sector started to recognize their social concerns as valid. That is good news. However, few institutions have taken these lessons to heart and invested the time and effort to get it right.

The bad news is that there are sectors – including finance, as will be seen here in *Culture Audit* – where we have allowed too much entrenched resistance to keep us from responding effectively. There have been practical excuses for inaction: But how do we affect culture? Can we really measure culture? Isn't culture irrelevant unless we can measure it? Isn't it enough to have 'tone from the top'? Isn't it enough to have the latest governance structures? Or to have laid claim publicly to some broad social purpose? Don't all financial people behave with integrity? Isn't having a code of ethics enough? Surely we don't need to change the whole system or the way the industry works? Don't profits trickle down to alleviate poverty, so pursuit of profits is good?

The deep disconnect here is ultimately between what human beings know to be right and the way we *think* we need to do things in order to be successful. Ultimately, it's about how we behave in capitalist markets. The orthodoxy was always about maximizing individualism, profits, shareholder value, and competition. This has led to increasing inequality and people have rightly objected to the outcomes and hence questioned the way we do things. A disillusioned public now looks for evidential proof that financial firms and the people who work in them actually behave according to the values regarded as fair by most people. Not by insiders. In other words, it's about ethical behaviour, driven by positive values. All the time. Consistently.

It's not a question of whether the bank manager smiles and gives you a cup of tea. It's whether they provide supportive and objectively fair assistance that is relevant to you – not PPI or putting your small family business into rapacious intensive care. Businesses ruled by econometrics seemed to have lost the humanity of caring for others, even though a culture of humanity reaps huge dividends in the long term. As the world starts to rebuild itself in 2021, the new outlook is about interpersonal trust: values, emotion, relationships, caring and social solidarity. Far from being an abstract mystery, a healthy dialogue around purposeful culture and what's good behaviour is or should be an extension of the everyday social relationships we all have. These are the force that constantly reshapes our view of what is 'acceptable and expected' behaviour – a phrase the UK's financial conduct regulator is fond of using.

This isn't a polemical or political statement. A robust, and growing, body of behavioural science shows it to be true. The science challenges *theories* and entrenched ways of doing things. Legal theory and classical economic theory assume that imposing sanctions will affect future behaviour, through deterrence. Most of us, however, have intrinsic motivation. We come to work because we like to do good things, to contribute to society, to engage with colleagues and help others. Having enough money may be the starting point, but it is not the end. Excessive focus on financial reward itself crowds out other important things and the result is an industry that is perceived to focus exclusively on making vast sums of money for itself; meanwhile huge swathes of people on the planet have barely enough to meet their basic needs. This engenders resentment, lowers trust, and threatens the foundation of our society.

The much-trailed 'new' culture audit technique of direct observation/floor-walk, both by regulators and internal audit, is not so new at all, of course. It is a rediscovery of what any good business manager or auditor has always done: walk about and directly observe What Actually Happens. A personal anecdote: when I was a departmental manager in a City law firm in the mid-'90s, the firm paid large sums to a Harvard professor for advice on how we should manage ourselves to achieve (financial) success. The answer was simple: walk the floor, be open and nice to people, be demonstrably fair, build teams that have good social engagement, and manage out people who don't cooperate as team players, however much of a star they might be. Forget working from budgets and billings – success and profits are not objectives but follow good ethical teams. As we found, he was absolutely right (ironically enough, 'on the money').

My initial training was as a scientist and now, as an empirical socio-legal scholar, one automatically follows the evidence. It's a wonderfully liberating experience to be able to ask what the evidence is for doing what we take for granted. You can come up with some really powerful answers, even if implementing them challenges a lot of people who hate losing what they think they have in existing ways of doing things. As Dan Ariely enjoins us, we should be 'relentlessly empirical'.[1] At the macro policy level, the scientific evidence about the need to focus on ethical values is clear. At the micro-operational, managerial and regulatory levels, it is not difficult to find data that shows what sort of culture we have, such as from customer feedback and complaints, anecdotes, and weak signals from multiple frontline (and online) sources. But we have been too driven by theories and risk models, as John Kay and Paul Collier say in powerful recent books.[2] Again other sectors/times have used the 'simple culture' approach to great effect, in preference to paper-based retrospective audit. This raises another point.

The culture audit view moves firms beyond reliance on past operational risk-style controls and 'rear-view mirror' value-at-risk analysis. It looks instead to improve current situational awareness and reflexivity. Some sectors are outstandingly good at this, having learnt from their mistakes – the ways that people deliver safer outcomes in aviation, food and healthcare are inspirational. There is so much good practice to learn from. There are structured techniques such as a Barrett cultural values assessment. There are straightforward changes of habit such as making more time for Management By Wandering About, blame-free open discussions of risk and socializing of problem-solving. The second part of the story, which the financial sector has been slower to grasp, is once the true root causes of a problem are revealed, to deal with them fearlessly.

We know intuitively, as well as through behavioural science, that people may not obey norms intrinsically, but will when they see that most people do. This is where cooperation can break down: the old-fashioned way of achieving compliance and preventing free riders was to use heavy-handed enforcement. The culture approach asks a different question: 'Why would anyone make that mistake, so we can try to prevent it happening again?' That is surely a better way to inform future decisions than 'This person made a mistake and we will blame them'. Learning from root cause analysis, informed by open and fair culture, demonstrably improves performance. We should not need to coerce anyone, as a 21st-century democracy that values human integrity and respecting each other.

And yet… finance has put up a vigorous rear-guard action of arguing that its value to society means that it cannot be touched by the change: it would lose talent; it cannot be allowed to fail, goes the story. Unfortunately for the public interest, for a long time this defence succeeded in deflecting the searchlight of stark reality. It prevented the reform of attitudes to risk, the much-needed socializing of values – of people bringing their 'whole selves' to work, feeling content to raise a problem and to work with others to solve it. Ironically for an industry rooted in one form of risk analysis, its culture of risk aversion needed to be challenged; other sectors have meanwhile moved far ahead in learning from mistakes, in opening themselves up to controlled experimentation. Outside the financial sector, many organizations have a mature view of ethics, values and culture that allows people to try, then fail or succeed, but learn and improve in either event.

This is serious. It's one thing to mess up customers (especially in large numbers). It's another to mess up the viability of an institution (bank).

But it's a whole different level of threat if your collective culture undermines trust in an entire financial and economic system. What is the financial sector selling, if not trust?

Whether based inside or outside the industry, anyone with fresh insights to bring to the table – be they into behaviour, culture, cognition, or whatever field – has a public duty to add these to the call for change. We should bring the best of what we know, applying the best knowledge and wisdom currently available, to change how our institutions function. 'Organizations don't change, people do' said Richard Barrett,[3] and this means that each and every one of us working in financial services must commit to this change. This book invites everyone in the industry to find here and share – and, quite originally, to enjoy as they do so – a wider knowledge of the science, the available assessment tools, the practical issues and the obstacles. This is too important to leave to backroom people. Accordingly, it's great to see here a team of authors with such collective enthusiasm, knowledge, and commitment to share it in plain language.

Despite the work of the world's many conduct regulators, there are few practical guides as to how to assess culture in the specific context of conduct-regulated financial services. The next stage will need businesses and regulators working together to improve culture and conduct. The fact that leading regulators are focusing on culture and culture audits will in itself create improvements as people focus more on managing what they have now measured. There is more to do here, and this book is a major contribution to that effort. Whoever gets it right on the business side should do very well commercially. The lesson is to be ahead of what you are forced to do in showing that your organization Does The Right Thing.

The context has been made easier by the growing realization by all of us, and especially now by investors, that we face existential challenges (climate change, event extinction of the planet, and unpredictable pandemics) that have provoked real engagement with things that matter, such as through ESG evaluations and the need to demonstrate that our organizations' general social licence is deserved. Corporate behaviour really matters. If we don't support people, small businesses and jobs, it's going to hurt us all. This is more than a marketing attempt to use reputational claims to gain competitive advantage. The reputation needs to be deserved. It's about what we can do to deserve real trust.

This book shows the way forward in science- and evidence-based approaches to monitoring, measuring, and reporting culture. It highlights specific solutions to bridge the gap in understanding and measuring culture, not only for regulatory reporting but more importantly to help businesses grow sustainably, resilient to disruptions, and in line with rising public expectations of exemplary conduct. *Culture Audit* tells firms why and how. Now let's get to it!

Christopher Hodges
Professor of Justice Systems, University of Oxford
Co-Founder, International Network for Delivery of Regulation

Notes

1 Ariely, D (2009) *Predictably Irrational*, 2nd Edition, Harper Collins

2 Collier, P (2019) *The Future of Capitalism: Facing the new anxieties*, Harper; Collier, P and Kay, J (2020) *Greed is Dead: Politics after individualism*, Allen Lane; Kay, J (with King, M) (2020) *Radical Uncertainty: Decision-making for an unknowable future*, W W Norton

3 Barrett, R (2016) Cultural Transformation vs Change, www.slideshare.net/ValuesCentre/cultural-transformation-vs-change-richard-barrett (archived at https://perma.cc/6YZF-5M6Z)