NEW PERSPECTIVES

Scandals such as Libor and Forex, money laundering and ongoing cases of mis-selling have raised a multitude of questions, but quantifying corporate culture remains a particularly elusive challenge, says Professor John K. Ashton.

Long after the Libor and Forex scandals, the announcement of further indiscretions continues to raise questions about the influence of individual offenders and the role of the organisational cultures within the firms embroiled in these events. Specifically, have some financial institutions developed corrupting corporate cultures which are fostering a new generation of financial miscreants? Equally, have the actions of individual wrongdoers undermined good conduct across entire organisations?

Determining whether the culture of financial firms has been affected by individual 'bad apples', where individuals infect others with their deviant behaviours, or the firms themselves are mis-directing the actions of individuals to undertake financial crime, has become a central question facing institutions and regulators alike.

QUANTIFYING THE 'INDEFINABLE'

Whether firms are affected by 'bad apples' or malevolent corporate cultures has a wider significance for the conduct of financial regulation. It has long been understood that motivations and behaviours of financial market participants can reflect values distant from those expected by regulators, financial institutions and the public at large. Such behavioural risks have been, and continue to be, a major challenge to the prudential management of financial industries. Despite the pertinence of behavioural risks for financial regulation, the ambiguity of definition and imprecise measurement of corporate culture and behavioural concerns have long limited their adoption.

A CLOSER LOOK AT CULTURE

At the heart of the problems has been uncertainty in quantifying corporate culture and how cultural change is transmitted between individuals and within firms. The core of these concerns is focused on whether the distribution of certain behaviours within a group influences members of that group or just mirrors a collective behaviour. A cultural influence suggests a situation where an individual's behaviour varies with the behaviour of the group. Culture in this context represents internal or endogenous effects such as social norms, peer influences, neighbourhood effects and conformity, which arise across the organisation. These cultural influences can easily be misidentified as correlated effects, where individuals just tend to behave similarly as they have similar characteristics or operate in analogous environments.

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Alternatively, cultural influences could just be the aggregate actions of a group or alternatively could reflect a combination of all these factors to a differing degree. Therefore how we identify and measure such influences and distinguish their origin and direction – be this from the group to the individual or vice versa from the individual towards the group – is challenging. As a result, financial regulators have long overlooked corporate culture as an indefinable problem unable to be resolved within the current obdurate methods.

MAKING PROGRESS

At least this was the case until recently when there has been a substantial progress in the treatment and assessment of this issue by financial regulators. In the UK, we are familiar with the corporate change programmes adopted by individual banks and complemented with regulatory developments for bankers' remuneration and the increased scrutiny of industry leaders within the Senior Managers and Certification regime. We also know momentum to addressing corporate culture was arrested in the UK with the cancellation of the Financial Conduct Authority thematic review of cultural change in 2016.

Despite this halting of behavioural risk assessment, progress continues at a national level in other countries. In particular, some central bank research departments, long a bastion of economists of a more conservative demeanour, have taken the major step of embracing concepts of behavioural risk management and have engaged with academic disciplines outside their normal frame of reference. For instance, the Federal Reserve Bank of New York has initiated a research programme to aid the development of behaviour management techniques (see Lo 2016). Here the aim is to develop an empirical methodology to predict group and individual behaviours and enable forecasting and prediction of behavioural risks. This approach reflects long-standing perspectives within economics (e.g. Manski 1993) that culture can be identified as unexplained statistical endogeneity as long as information enabling the consistent identification of such influences can be developed.

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BANKING'S HIPPOCRATIC OATH?

The Netherlands central bank, De Nederlansche Bank, has moved even further. It has created the Expert Centre on Culture, Organisation, and Integrity and employed psychologists and organisational researchers. Here an entire system of behavioural management in financial supervision has been proposed with bankers and insurers even expected to undertake a professional oath to perform their duties in good faith and in the interests of the customer. This approach is founded in other social sciences with techniques relying on the multitude of survey and interview evidence already collected with the supervisory process and central to the current conduct of regulation.

These economic or social psychology approaches associated with the initiatives being developed by the Federal Reserve of New York or De Nederlansche Bank respectively, both bring advantages and drawbacks. Despite their differences, they each place the management of behavioural risks as central for effective financial regulation. While it is hoped this debate is reinvigorated in the UK, the withdrawal of the Financial Conduct Review of corporate cultures has potentially transmitted signals that this is no longer a concern for UK banking. It is conjectured that behavioural risks persist in the UK financial industries today, just as much as they did in 2015, or as they exist in New York or Amsterdam, and should remain a key area of new and policy-relevant research in banking.

John K. Ashton is Professor of Banking at Bangor University and Academic Director, Chartered Banker MBA, within Bangor Business School.