GOVERNANCE AND CULTURE REFORM
FEDERAL RESERVE BANK *of* NEW YORK

BUILDING CULTURAL CAPITAL IN THE FINANCIAL SERVICES INDUSTRY
Emerging Practices, Risks and Opportunities

The Federal Reserve Bank of New York ("New York Fed") held its fifth conference on culture and behavior in the financial services industry on June 4, 2019. This year's conference featured TED-style presentations from academics, regulators, and other thought leaders, roundtable discussions based on case studies, and a video interview with former Federal Reserve Chairman Paul Volcker.

Key themes included:

- Organizational culture is not the sole province of just CEOs or boards of directors. Instead, an optimal approach is both "bottom-up" *and* "top-down" and must involve influencing the social dynamics within a workplace.

- Human beings often behave based on subjective perceptions, personal motivations, and blindness to objective consequences. One recurring "blind spot" is the failure to consider the ethical dimensions of decisions. These oversights may have more to do with automatic responses than morality—reactions rather than choices. Organizations need to take account of behavioral phenomena when creating systems to generate reliable outcomes.

- New technologies, especially social media, contribute to a workforce with different ethical values and experiences, as well as new ethical challenges. While technology can potentially be useful in ascertaining misconduct, organizations must avoid overreliance on technology as a convenient way to avoid questions of ethics.

Opening Remarks

John Williams, President and Chief Executive Officer of the New York Fed, delivered the opening remarks. He described culture as a long-term, evolving, mission-critical project, and likened culture to cybercrime and data protection—issues that defy short-term, clear solutions. Williams observed a lack of urgency about culture, despite its apparent contributions to misconduct scandals.

He called for a shift in mindset for firms when dealing with matters of culture. He also challenged the audience to be as proactive about culture as it would for managing these other mission-critical risks. He also suggested the audience should seek out diverse points of view.

Williams said that the aim of the New York Fed's culture conferences is to promote serious discussion about culture within the industry and among regulators. He posited that fines had proven insufficient to create lasting behavioral change, and criticized the often-heard "bad apple" theory of misconduct. He urged regulators to consider culture when holding the industry accountable. Williams recommended that industry leaders take responsibility for how their decisions affect culture, for better or worse.

President Williams then summarized the New York Fed's approach to culture in three principles: connect, convene, and catalyze:

- *Connect*: The New York Fed recently launched the Education and Industry Forum on Financial Services Culture ("EIF"). The EIF will publish case studies for students and financial professionals to learn to recognize ethical dilemmas and to practice how to approach difficult decisions. He also pointed the audience to the New York Fed's online research hub, which collects materials about culture from the official sector and the industry.

- *Convene*: It is important to bring together stakeholders and experts from outside the industry to learn from each other. In addition to its annual culture conference, the New York Fed hosts a Supervisors Roundtable. This forum draws supervisors from many agencies and countries to develop shared resources and tools related to the supervision of governance, culture, and behavior.

- *Catalyze*: Finally, the New York Fed must lead by example. Williams announced that this year the New York Fed is taking the Banking Standards Board ("BSB") assessment, which uses a survey, focus groups, and interviews to evaluate organizational culture. The BSB, whose work has been featured in previous conferences, is a private, industry-funded organization based in London. It aims improve standards in the financial services industry. Williams encouraged other firms to follow the lead of the New York Fed in taking this type of assessment.

Session One: Ireland and Australia – Supervisory and Industry Responses

Moderator: **Richard Lyons**
Former Dean, Haas School of Business, Berkeley, California

Panelists: **Gráinne McEvoy**
Director of Consumer Protection
Central Bank of Ireland ("CBI")

Stuart Bingham
General Manager, Governance, Operational & Insurance Risk
Australian Prudential Regulation Authority ("APRA")

Main Points:

- Culture cannot be improved with a few easy fixes or checklists.
- Change must be "bottom-up" as well as "top-down." Changing culture does not belong solely to the CEO or board.
- Government organizations have presented actionable items to banks in both Australia and Ireland, and have monitored implementation of their recommendations.
- There is still a long way to go before true cultural reform can occur throughout financial institutions.

Richard Lyons began with a confession: Economists are not trained to think about culture. Although fluent in the language of incentives, behavioral norms—the essence of culture—are often a foreign tongue. Lyons suggested to the audience, many of whom have a background in economics, to consider a few core questions: What is a norm? Who sets a norm? He suggested a simple answer to the first question. Norms are "the way things are done around here." He urged the audience to focus on the second question, and to avoid the assumption that senior leaders have a monopoly on setting norms. In most organizations, there will be many employees who "own" an organization's culture. We all know who they are in our own organizations: respected colleagues of varying seniority who serve as role models and from whom we seek advice.

Lyons advised that the cost of misconduct is only partially evident on a balance sheet. Regulatory fines may cause short-term consequences for the balance sheet and perhaps a slight decline in market value. More lasting and significant harm can come from long-tenured, dedicated staff who no longer feel proud of where they work. That damage is not directly reflected in public metrics, but can have a profound effect on employee productivity and misconduct risk.

Lyons also encouraged the audience to consider the role of "norm entrepreneurs"—employees who change "the way things are done." What if, he suggested, employees decided on a norm that

encourages the sharing of information, so that information that *can* flow within an organization (legally and ethically) actually *does* flow? How many business problems based on hoarding information could be avoided in an organization whose employees choose to share what they know with colleagues? A better exchange of information and ideas may be difficult to achieve through incentives and other traditional management tools. The route may lie instead through changing group norms.

Gráinne McEvoy's presentation featured the Central Bank of Ireland (CBI)'s supervision of culture in the financial services industry. The impetus for the project was the "tracker mortgage scandal." Multiple Irish banks overcharged customers who were eligible for mortgages with favorable borrowing rates (a fixed margin above a European Central Bank benchmark rate). In the end, the banks had to review approximately two million mortgages in a country of five million people. And, despite public outcry, banks resisted calls to compensate customers.

The tracker mortgage scandal further undermined confidence in Irish retail banks, which was already damaged after the industry received a bailout in 2010 that was the equivalent of 40 percent of Ireland's GDP. This led Ireland's minister of finance to call on CEOs of the major retail banks to improve their culture. Additionally, the CBI examined group behaviors at five leading retail banks. It adopted a model pioneered by the Dutch central bank, which embeds experts in behavioral science with bank supervisors.

The CBI published a summary of its examination last year. It concluded, among other things, that there was no shared understanding in the industry of what it meant to have a "customer-oriented" culture. Actual behaviors within firms displayed features of a "fire-fighting" and "command-and-control" styles—reactive (not proactive) and hierarchical (not collaborative). Leaders also exhibited optimism about improvements, without having well-developed plans for achieving cultural change. Remediation efforts have had mixed success. Only one of the five banks put forward an acceptable plan; the other plans were notably underdeveloped. For example, one plan lacked board involvement and limited the ownership of culture to Human Resources. Several plans underestimated the time and commitment to improve culture, and evidenced a preference for quick fixes over a serious inquiry of root causes.

On the positive side, banks have shown modest improvements in diversity at senior levels. In addition, the retail banks that the CBI examined recently formed the Irish Banking Culture Board, based on the model of the BSB. The Culture Board's work is still preliminary, and the results of its initial survey are consistent with many findings in the CBI's examination. McEvoy highlighted two statistics. First, one out of five employees reported a conflict between the firm's stated values and its norms. Second, one out of five employees believed career progression was not possible without being "ethically flexible." Invoking the Irish poet Seamus Heaney, McEvoy concluded

with advice to keep at it. Improving culture is a long-term project. It requires a conviction that there is good worth working for.[1]

Stuart Bingham observed that culture is evidenced through behavior, not rhetoric. For airlines, safety is a lodestone. Bingham would like to see a similar approach for banks and other financial firms, and suggested that a first step is recognizing that culture affects outcomes. The message that "culture matters" featured prominently in work by Australia's Royal Commission into Misconduct in Banking and Financial Services. Its final report was published earlier this year. Bingham's presentation noted two culture recommendations in that report: (i) that financial institutions assess their own culture, and (ii) that APRA build a supervisory program to assess culture.

APRA has undertaken two programs of work in response to recent conduct failings. First, it launched a prudential inquiry into the Commonwealth Bank of Australia (CBA), the country's largest financial institution. In the public report that followed, APRA found four aspects of CBA's culture that contributed to numerous scandals: (i) complacency prompted by its much celebrated financial success, (ii) a reactive (rather than proactive) approach to non-financial risk, (iii) insularity, which led to a failure to learn from mistakes, and (iv) an overly collegial environment in which employees did not constructively challenge each other.

Second, APRA wrote to boards of other supervised firms asking them to conduct a self-assessment against the findings of the CBA Inquiry and provide that assessment to APRA. After reviewing the responses, APRA concluded that many of the same issues seen at CBA were evident across the industry. In general, banks needed to improve non-financial risk management, make accountability clear, and think creatively about the unintended consequences of their cultures. On that last point, Bingham noted that banks rely almost entirely on employee engagement surveys as the means to assess their cultures. APRA, by contrast, encourages multiple methods of measurement. Moreover, responses to culture surveys tend to focus on fixing problems. An understanding of the root causes of individual or group behavior is often lacking.

In the discussion that followed these presentations, both McEvoy and Bingham highlighted the importance of escalating issues and in distinguishing what is permissible from what is ethical ("can we" versus "should we"). They also suggested that firms assess their value statements against actual practice by seeking out the views of junior employees. This is a bottom-up approach to understanding organizational culture. Asked what other techniques work in assessing culture, Bingham stated that a variety of inputs can help. These may include a comparison of internal and external audits, and one-on-one interviews to develop anecdotal evidence that helps turn survey statistics into meaningful lessons.

[1] *See* Seamus Heaney, *Finders Keepers: Selected Prose 1971-2001*, 47 (2002) ("Hope, according to [Vaclav] Havel, is different form optimism. It is a state of soul rather than a response to the evidence. It is not the expectation that things will turn out successfully but the conviction that something is worth working for, however it turns out.").

One audience member asked what "good conduct" looks like, and recommended that supervisors focus more effort on showcasing decisions made the right way. The panelists offered two responses. First, it was helpful for senior leaders to visit branch offices and speak directly to employees about culture. Second, the panelists complimented firms that communicated openly with supervisors about problems, even before they may have solutions. Both cautioned away from emphasizing any single value too much. For example, an overly collegial atmosphere may encourage "getting along" to a degree that stifles dissent. Any strength in excess, Bingham cautioned, can become a weakness.

Bingham and McEvoy acknowledged that resource constraints at supervisory agencies require careful prioritization and tradeoffs. "Deep dives" into the culture of supervised firms are resource-heavy and cannot be sustained year-over-year. Supervisors will have to choose which firms require more active inquiry, and which may need only passive monitoring—or perhaps more targeted follow-up on particular issues.

Session Two: Persistent Misconduct – Beyond Traditional Approaches

Moderator: **Richard Lyons**
Former Dean,
Haas School of Business, Berkeley, California

Panelists: **Ann Tenbrunsel**
David E. Gallo Professor of Business Ethics
University of Notre Dame

Celia Moore
Associate Professor,
Department of Management and Technology, Boccioni University

Todd Haugh
Assistant Professor of Business Law and Ethics
Kelley School of Business, Indiana University

Main Points:

- Individual misconduct is guided by ordinary human behaviors and biases. Part of reforming culture will likely involve safeguards counteract these behaviors.

- Some management techniques may have unintended, harmful consequences. Organizations need to be aware of the effects of well-intentioned practices.

- Organizations should bear individual motivations in mind when designing compliance programs and incentives.

Ann Tenbrunsel explained her work on ethical "blind spots"—a type of cognitive bias based on gaps in our understanding of systems and choices that lead to unintended behaviors. Her presentation covered four main blind spots.

- *Ethical illusions*: an overstated assessment of our own ethicality. Most people think their ethics or honesty are above-average, which cannot be true. Even expert ethicists can fall victim to this bias. Tenbrunsel presented a study on stolen books from university libraries. Across campuses, ethics books oriented toward graduate-level readership were stolen at a higher rate than books on other subjects. Tenbrunsel posited that the bias has roots in a breakdown of the three phases of decision-making: (i) prediction, (ii) action, and (iii) recollection. In the first phase, we tend to predict that we will act according to our professed values. In the second phase, however, we act based in part on near-term self-interest. In the third phase, unable to match our action with our expectation, we justify the action in retrospect so that our behavior and values align. We might excuse some dishonesty with the comfort that everyone cheats a *little* bit, *some* of the time. Or perhaps we may criticize a lack of enforcement, which can signal that breaking a rule is acceptable. Tenbrunsel called this "revisionary ethics." She illustrated the problem with a powerful experiment about forecasting errors involving sexual harassment. In a survey, subjects predicted they would report sexual harassment. In reality, they largely failed to file a report when confronted with harassment in a mock interview.

- *Ethical fading*: framing decisions in a way that ignores the ethical dimensions of choices. We sometimes justify ethical fading through euphemisms. An unethical decision may be termed a "judgment call." We also engage in ethical fading through compartmentalization. That is, we might label some decisions a "business" or "legal" matter, rather than an "ethical" one. As an example, Tenbrunsel cited the Challenger explosion. Prior to launch, engineers had expressed safety concerns. The chief engineer, however, was encouraged to "take off his engineering hat and put on his management hat." This signaled that the launch decision should not be made on the basis of safety, but rather on considerations of morale, public relations, and politics. Ethical fading may also explain the results of studies that show lower rates of compliance with rules when fines are imposed. Fines may encourage some people to assess adherence from a cost-benefit perspective, rather than from principles of right and wrong.

- *Reward systems*: organizational contributions to unethical behavior. Tenbrunsel posited that roughly 30 percent of incentive compensation plans encourage unethical behavior by conditioning financial gain on performance metrics rather than on principled choices.

- *Motivated blindness*: seeing past the unethical behavior of others because of our own personal convenience or gain. Bernard Madoff's implausible returns are a prime example. Tenbrunsel also summarized studies of auditors, who report accounting errors more frequently when asked to serve as "independent" auditors than as auditors to a particular company.

Celia Moore framed her presentation around a central question: "How do leaders of organizations create culture (and therefore influence behavior)?" She offered three methods.

- *Pointing*: Goals exert a powerful influence on decisions, so much that they can, at times, distort broader objectives and obscure the consequences of our choices. The Ford Pinto provides a cautionary tale. Ford wanted a cost-effective and fuel-efficient car to compete with Japanese manufacturers. It set goals for its engineers to produce a car that weighed less than 2000 lbs and cost less than $2000. The result of strict adherence to these goals was to compromise safety. Tragically, safety improvements would have exceeded the weight and price goals only slightly, likely without much effect on sales. Moore argued that, in her experience, goals expressed in numbers have a particular tendency to obscure original objectives. We focus on a proxy and lose sight of the core purpose. Goals expressed qualitatively or conceptually offer less distraction—a "good education" versus a "top 10 school."

- *Social motivation*: Praise and peer pressure—influences often associated with adolescence—shape culture and behavior in any group setting. When it comes to ethics, human beings tend to behave in ways that they deem appropriate within specific contexts. This is especially true if the behavior is also personally advantageous. Studies show that people will cheat if there is no chance of being caught, but usually just enough to maintain their self-image. Moore also cited an example of a trader who exceeded his risk limits without authorization, but earned a handsome profit. His manager praised the profit publicly, but addressed the breach of risk limits only in private. This sent a strong message that profits were more important than compliance. Praise and money activate the same brain chemistry, Moore explained.

- *Market mentality*: Finally, Moore posited that our ethical judgment may be weaker in a market setting, where we default to norms of "arm's length" dealing and "buyer beware." Moreover, market environments tend to prompt decisions based on near-term gain, regardless of personal principles. This tied into Tenbrunsel's ideas of ethical fading and

> motivated blindness. We may categorize a decision as a "market" decision, rather than an ethical one, or be willing to overlook ethical shortcomings if peers—especially competitors—do the same.

Todd Haugh argued that effective compliance programs need to take account of lessons from behavioral science, including many of the points raised by Tenbrunsel and Moore. Other fields—in particular, criminology and network theory—also offer valuable and overlooked insight. In particular, academic research may help compliance officers and regulators answer the perennial question, "Why do good people do bad things?"

Bad decisions may be attributable, in part, to the way human beings think. Haugh referred to Daniel Kahneman's popular book, *Thinking Fast, Thinking Slow*, which divides decision-making into two systems. "System 1" uses associative memory to make snap judgments. These fast decisions are necessary given the number of choices we face in any situation. "System 2," by contrast, is deductive, technical, and methodical. It is how we reason through new situations. Haugh posited that most people regard their decisions as the result of "System 2" deliberation, but in truth we all rely on "System 1" much more often than we may admit or believe. The implication for ethical decision-making is that individuals often default to self-interest and observed behavior as their decision calculus, which is "System 1" reasoning. Retrospective rationalization for unethical decisions may give the illusion of more deliberate thought. This process may later provide a vocabulary that helps motivate future bad choices. For example, cheating can be rationalized as "helping the company," making it easier to "help the company" again in the future. Compliance officers can learn from behavioral research about how group dynamics affect behavior.

The questions to the three presenters focused on practical advice for translating theoretical concepts into workable programs. The answers repeated a theme: There is no single solution for a culture in need of improvement. Each organization is different and, even within organizations, different approaches may work better for different sub-groups. The panelists recommended that targeting smaller groups could prove more fruitful than attempting large-scale change. In addition, Tenbrunsel suggested looking at how language is used to excuse unethical behavior, and how reward structures may yield unintended consequences.

All three panelists cautioned against seeking a "gold standard" for culture. Programs need to be tailored to the circumstances. One effective way to do this is to have frank conversations about mistakes, emphasizing root causes of employee conduct. Another is to have discussions among employees about which corporate values are easy to live by, which are harder to follow, and why.

The three presenters agreed that even the noblest goals need to be tempered with reason. For example, if an organization over-emphasizes a goal of "zero safety incidents," there is a risk that accidents will not be reported. Other specific recommendations included: (i) focus groups of new

employees, who may have an "insider/outsider" view of a group's culture, (ii) keeping current with management literature, (iii) sharing examples of decisions made the right way, (iv) examples from senior leaders of ethical dilemmas that they wish they had resolved differently, (iv) rotations among compliance and business lines, and (v) paying attention to euphemisms used in the organization.

Case Studies

Before lunch, conference participants were assigned to tables of eight to 10 people, with representatives from different organizations, to discuss two short case studies prepared for the conference. The case studies highlighted two ethical dilemmas that arose in the context of a hypothetical merger: misselling to retail customers and internal reporting about suspected breaches of an anti-money laundering program.

Conference participants observed how well-intentioned messages from senior leaders can become distorted as they move down through an organization's hierarchy. Some emphasized the need to understand the reasons for over-performance, despite the temptation not to look a gift horse in the mouth. Others recommended that case studies include interactions with compliance and risk management professionals. One participant cited research by Sean Martin, a professor at the University of Virginia's Darden School of Business, on the power of stories within organizations. Unfortunately, the stories that are shared tend to be about high-profile leaders doing the right thing and low-level employees doing the wrong thing. The stories could be more powerful if they recounted good decisions by junior employees and poor decisions by senior employees.

Session Three: Impact of New Technologies and the 21st Century Workforce on Culture

Moderator:

Jonathan Haidt
Professor of Ethical Leadership
Stern School of Business, New York University
Founder, Ethical Systems

Panelists:

Damon Horowitz
Philosophy Professor
Columbia University

Vanessa Colella
Chief Innovation Officer and Head of Citi Ventures
Citigroup

Stephen Scott
Founder and CEO
Starling Trust Services

Main Points:

- Changing technologies provide firms with a number of new challenges. Examples include a workforce with distinct motivations, preferred methods and styles of communication, and different ethical propensities.

- Technology can have useful applications to culture, including in its ability to monitor conduct and help predict misconduct.

- Organizations will have to design new ethical frameworks to account for new technologies, including ways to avoid overreliance on algorithms and mechanical processes as substitutes for moral judgment.

- Organizations should draw from disciplines like philosophy and behavioral science when designing programs of ethics for the future.

Jonathan Haidt served as both the session moderator and a presenter. His presentation covered three emerging challenges for corporate culture: (i) political polarization; (ii) Generation Z and anxiety; and (iii) "callout culture."

Politics, according to annual surveys from the Pew Research Center, is far more polarizing than ever before. It is also significantly more divisive than differences in other belief systems, like religion. Haidt attributed an increase in polarization to virtual echo chambers created by social media. These divisions facilitate validation of our personal worldviews because we choose to only hear feedback from like-minded individuals. Our "friends" and "likes" can close out views that may challenge our assumptions and conclusions. Political polarization is a challenge for cultures that thrive on cooperation, like modern businesses.

Second, members of "Generation Z" who attend elite universities—where financial institutions recruit—have demonstrated expectations significantly different from previous generations. For example, students sometimes demand "trigger warnings"—advisories that material may be personally upsetting. Controversial speakers have been shouted down. There are demands for "safe spaces"—classrooms in which personal points of view are not challenged. Additionally, rates of anxiety, depression, and suicide are higher on elite college campuses than ever before. Haidt posited that vastly overprotective parents and, again, social media may be responsible for the

change. Generation Z comprises students who arrived on college campuses in 2013 and 2014. They began to enter the workforce in May 2018. According to Haidt, financial employers will face a corresponding increase in mental health problems among young employees.

Haidt's third challenge to culture is what he termed "call-out" culture, a hypersensitivity to opposing views. Haidt observed that, increasingly, disagreements on campus are deemed personally offensive. It is one thing to protest unequal treatment of minorities and women. It is another to "call out" perceived aggressions that do not threaten diversity, inclusion, or fundamental fairness. Employers will need to inculcate graduates of elite universities into a culture of cooperation, in which employees work together toward a common goal. A "speak-up" culture, he noted, is not a "call-out" culture. A willingness to cooperate with colleagues may have been a given in previous generations, but should no longer be assumed. Haidt also recommended programs that emphasize moral humility and giving others the benefit of the doubt—the foundations of getting along. Finally, he recommended that employers resist calls to "bring your whole self to work." They should instead focus on developing a workplace ethos based on respect for others and professionalism.

Damon Horowitz followed Haidt's presentation with a telling anecdote. In a recent survey of freshmen entering Stanford University, 80 percent expressed an interest in political activism, but had not yet identified an issue requiring action. He commented that many of the phenomena observed by Haidt—including an increase in mental illness and a tendency to shut out opposing views—are reactions to uncertainty. In Horowitz's view, it is a human impulse to make sense of a messy, scary world. Religion, philosophy, and politics are all ways to confront uncertainty. Technology is a way to give structure to limitless information. The process of applying technology, though, involves choices on which data to use, and which to exclude. These choices need to be made carefully because the processes by which we analyze data produce outcomes on which we rely. It is not sufficient to defer judgment to an algorithm. Human beings have to make choices, and bear responsibility for outcomes. Ethics may help the process of technology by challenging how we select inputs and outputs. This is the "burden of reckoning."

Our contemporary emphasis on data also poses philosophical challenges. In Horowitz's view, we risk treating people as metrics, rather than as beings of inherent worth, and thereby entitled to basic dignity. Ethics provides reminders that intrinsic good is distinct from instrumental good. Horowitz argued that the choices we make about what data to collect about people necessarily limit our view of them. Our data are accurate, but our assessment is incomplete. It is likely impossible that data can ever tell us everything there is to know about a person. We are unique individuals because of our love of family members, powerful memories, regrets, dreams, and other elements of our psyches. We look, instead, for only what we need to know from the data and, as explained in the previous session, sometimes our understanding of what we need may be biased. In the words of

Immanuel Kant, "Out of such crooked timber as men are made, nothing perfectly straight was ever built."[2] Our data and our technology are no better than the people who collect and design them.

Vanessa Colella presented some views on technology from the perspective of an insider/outsider. She is a senior executive at Citi, but spent most of her career in Silicon Valley. If a theme of the morning was "thinking fast, thinking slow," her message was that change can also come fast or slow. Indeed, it is often more slowly than you may expect. Not knowing in advance what the pace of change implies, it is often difficult to know when to change in response.

Colella presented three categories of change that confront employers: (i) evolving technology, (ii) individual behavior, and (iii) industry structure. Her core observation was that change is not always easy to spot until it is right in front of you. But, assuming that one can recognize change, the more important question is how to respond. When is it appropriate to "move fast and break things?" How can financial services firms experiment, when their customers demand predictability and repeatability?

Colella gave three examples from her work at Citi on how to confront technological change. The first was the D10X program, which aimed to identify technological improvements that could make game-changing improvements to customer service. Second, Citi has tried to integrate control functions into new product development. ("Brakes were put on cars not to slow them down, but so they could go faster.") The third example was a program called CUPID, which placed 1,400 interns into innovation projects. The interns gained experience in working in a financial services office setting; Citi reaped insight on how younger generations approach problem solving.

Stephen Scott began with an observation based on 25 years of investigating fraud: culture eats compliance for breakfast. What is more, employers admit this, but do not know what to do about it. Culture is messy compared with traditional economic models and management concepts, like incentive compensation. Behavioral scientists, primatologists, network theorists, and other academics can help. Scott's presentation highlighted several observations from the academy that have practical application.

Scott agreed with the expression "culture drives conduct." But, he asserted that a more precise expression of the idea is that "culture drives constraint." Cultural norms prohibit us from engaging in some behaviors, or from failing to engage in others. Behavior that communicates reprimand and exclusion is the most powerful coercive force shaping behavior by members of a group. Citing work by Robin Dunbar, an eminent evolutionary anthropologist, Scott argued that the closer the emotional distance of a group, the greater coercive effect of group feedback. The further the emotional distance, the lesser the effect. Applying this concept to organizations, it made sense to pay attention to how small groups of trusted peers influence behavior predictably.

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Scott also cited a Stanford study that involved an analysis of over ten million emails and mapping distinct "encultration trajectories" within an organization. The study found that certain communication patterns could predict future success or failure at an organization. If behavior is contagious, anticipating behaviors through technological analysis can permit proactive mitigation of organizational misconduct. According to Scott, buried in data are signals that correlate with predictive reliability to specific conduct. For example, firms can identify employees who are ambivalent or disengaged, and may be likely to leave a firm. Network science can also help firms track the spread of contagious behavior.

The discussion that followed began with reflections on wisdom. Haidt observed that the more we are told what is best—by algorithms or by authorities—the less opportunity we have to become wise. Wisdom, like ethics, is a habit. It needs to be practiced. Horowitz noted that liberal arts education had moved away from its traditional approach based on a critical discussion of the Western canon. This was, in part, a response to campus protests about "dead white male" curricula. A more productive approach, in his mind, was to supplement the canon with additional, marginalized voices. He and Haidt argued that workplaces must be vigilant in hiring individuals willing to listen to others and accept responsibility for their actions. Colella advised that financial firms can do a lot to promote collaboration, respectful disagreement, humility, and responsibility among their employees. Leaders play an important role in modeling these behaviors.

The discussion also covered an analysis by the United Kingdom's Financial Conduct Authority ("FCA"), which reported that firms exhibiting greater gender diversity had less risk of misconduct. The FCA views diversity and inclusion issues within firms as a proxy for broader cultural problems. The presenters debated whether a lack of gender diversity was a cause of misconduct or a correlated symptom. They argued that the most potent forms of diversity cover thought, perspective, and experience, not just population demographics. More viewpoints need not beget chaos, if norms of professionalism and cooperation coexist with norms of deliberation and challenge.

Fireside Chat

Paul Volcker, Former Chairman of the Federal Reserve
interviewed by **Jack Gutt**, Executive Vice President, Federal Reserve Bank of New York

Before introducing a video interview with Paul Volcker, President Williams offered three reflections on the day's presentations. First, he emphasized the value of seeking out a wide range of views on the subject of culture. Second, he recommended that discussions of culture not become

mired in semantic distinctions between "risk culture," "ethical culture," "compliance culture," or some other variation. These are just aspects of a group's culture. Third, culture cannot change without open and honest conversation, which will occur if groups become more inclusive and diverse.

The video of Chairman Volcker began with a discussion about the purpose of banking. He stated that banks are vital intermediaries between borrowers and savers, and remain necessary for economic growth. Their importance to the economy has led, over time, to heavy regulation and to supervision, which are appropriate because of the public service that banks provide. Chairman Volcker worried that non-banks had become significant intermediaries without significant oversight. He attributed the financial crisis, in part, to the rise of "shadow banking."

While recognizing the importance of banking, Chairman Volcker described his own views as "cynical" about some of the services that Wall Street provides. He told a story about a conference on derivatives, in which firms were urged to consider opportunities in "financial engineering." Chairman Volcker asked how much financial engineering contributed to a country's production and economic well-being. "Nothing" was the response. Derivatives and other financial engineering tools only moved rents within the financial system.[3] In retrospect, Chairman Volcker observed that the increase in so-called "financial contribution" portion of the GDP has risen in parallel with income inequality. He suggested that the people who reap the benefits of that financial contribution are an elite, and that the financial engineering they specialize in is not a social good.

Turning to the root causes of misconduct, Chairman Volcker summarized many of them as near-termism. In many financial institutions, this is encouraged through incentive compensation systems that link variable compensation to short-term performance. The overall volume of compensation was another ill. The amount of money at stake for bankers leads them, understandably, to focus their efforts on profit maximization, which may not align with the best interest of customers. Separately, he wondered whether banks remain too big to manage. The directors of banks are distinguished people, but they are only human. They are simply unable know or understand what occurs in the vast "belly of the bank." They therefore cannot make informed decisions about risk management. He also criticized the idea that "maximizing shareholder value" should excuse a diminished regard for other stakeholders, especially customers.

Finally, Chairman Volcker discussed the importance of public service. In his view, the public sector faces a perennial and sharpening disadvantage in recruiting because it pays less than private firms. Universities need to reinvest in schools of public administration to attract motivated undergraduate and graduate students. Universities must also train students in the analytical skills that will make them more effective public servants. Chairman Volcker recently founded The Volcker Alliance. The group seeks to improve connections between the federal government and

[3] *See* Paul Volcker, *Keeping At It: The Quest For Sound Money and Good Government*, 205-06 (2018).

universities, and to promote investment in schools of public administration. The interview concluded with a quote from Alexander Hamilton: “The true test of a good government is its aptitude and tendency to produce a good administration.”

Closing Remarks

Michael Strine, the New York Fed’s First Vice President and Chief Operating Officer, delivered closing remarks. He praised the conference’s interdisciplinary approach and focus on future challenges. He stated that the New York Fed remains committed to its culture initiative because culture is critical to the long-term stability of the financial system. Like President Williams, Strine highlighted the Education and Industry Forum as an example of work that aims to improve industry norms over the long term. Finally, he praised Chairman Volcker as an example of the inspirational power of leadership.