

A decorative graphic consisting of a grid of dots in various shades of gray and red, arranged in a pattern that suggests a world map or a network of connections.

# Reforming Bank Governance

## »Top-Down« Reform and Bank Resistance

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- The 2008 financial crisis laid bare serious issues in the governance of banks and financial firms, as regulators were confronted with widespread misconduct and a lack of effective internal risk management.
- In response, regulators focused on reforming the traditional top-down corporate governance framework operating through the board of directors, despite the shortcomings of this approach for highly leveraged institutions such as banks.
- Looking back at the failure of reforms since 2008, this paper proposes ways in which »regulation from below« by engaged and empowered bank workers can provide an alternative to a purely »top-down« approach and strengthen efforts to improve bank governance, and therefore the health of the global economy.





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## Introduction

In response to the governance issues revealed by the 2008 financial crisis, regulators moved to address the widespread misconduct and lack of effective internal risk management at banks through reform of bank corporate governance and culture. These efforts were lent further impetus by the continuing stream of scandals at large banks after the financial crisis, such as the 2012 »London Whale« scandal at J.P. Morgan and the post-crisis market manipulation uncovered at numerous major trading banks, including Bank of America and Deutsche Bank.

In pursuing these reforms, regulators focused on the traditional top-down corporate governance framework operating through the board of directors and sought to improve, enhance and expand board governance of the bank. This is in some ways appropriate given the central importance of equity owners and their board representatives in traditional corporate governance, as well as the failure of board governance during the crisis.

But this top-down approach is also flawed. It further empowers equity holders even though it is well known that the interests of equity holders can severely conflict with the public interest in governance of such highly leveraged institutions as banks. Both the board of directors and the top executive management directly responsible to them tend to be heavily predisposed to the interests of equity holders, due to both explicit fiduciary duties and equity-based compensation schemes. Thus, even as regulators seek to reform board governance to create a more responsible and public-spirited banking culture, the board may have neither the incentives nor the capacity to fulfill regulatory requirements. Not surprisingly, therefore, such efforts often fail.

This paper describes two linked post-crisis regulatory efforts at bank governance reform through »top-down« approaches—namely, the effort to increase the responsibilities and engagement of the boards of directors at major banks and the regulatory initiative to reform bank culture. A central focus is the analysis of resistance by bank lobbyists and management to these efforts and the success of this resistance in weakening or derailing top-down regulatory reform efforts. The paper then concludes by outlining some of the ways in which a »regulation from below« approach focused on engag-

ing and empowering organized bank workers could provide an alternative to a purely »top-down« approach and strengthen efforts to improve bank governance.

## Corporate Governance at Banks

Traditional corporate governance theory has focused on the need for an independent board in order to represent the interests of equity owners and to discipline management. While this theory can be questioned even for conventional corporations, it seems particularly misguided in the case of banks. To a much greater degree than other corporations, banks expose non-shareholders to major risks. This is due to both the extreme level of leverage banks can operate with due to public safety net support, and the significant externalities bank failure can create due to their central role in the financial system. As a recent study describes the issue:

*What this means for corporate governance is that not only shareholders but also depositors, other creditors, transaction counterparties, and, in most countries, also the taxpayers, are at risk from banks' activities. It follows that mechanisms should be in place to protect not just the interests of shareholders (the primary focus of much of the literature on corporate governance) but also the interests of these other constituencies.*

Becht, Bolton and Röell (2011)

Despite these differences, banks are managed much like other private corporations, with a central role for the board of directors as a representative of shareholders. Furthermore, over the past decades banks, especially in the United States, have followed the lead of other major corporations in adopting large amounts of equity-based incentive pay for senior management.

Shareholder interests can diverge very significantly from those of other stakeholders. Equity holders are in a position to take the upside from risks while imposing much of the downside on holders of debt, depositors, taxpayers or indeed society in general through the economic externalities of the failure of a large bank. These lopsided incentives become even more extreme when a bank is in danger of failing. When a highly leveraged institution such as a bank is close to insolvency, profits must be very large in order to accrue to equity share-

holders rather than creditors, so that stockholders will tend to favor large risks that can be irresponsible from the standpoint of other stakeholders. The bank's incentives to pursue shareholder interests at the expense of other stakeholders also are greatly heightened when senior management is given equity-based pay, which has the effect of aligning the incentives of key executives with those of shareholders. Such equity-based executive pay has become increasingly common in recent decades and has been demonstrated to correlate with risks of bank failure (Becht, Bolton and Röell, 2011).

*Even beyond the clash between the interests of shareholders and other stakeholders, particularly acute in the case of banks, other issues raise doubts about the appropriateness of traditional corporate governance models for large banks. Insofar as these banks are within the safety net and considered »too big to fail«, traditional capital market discipline will not be effective. The increasing involvement of large banks in high-volume, high-speed and high-risk capital markets trading also means that if risks are not carefully controlled, money center banks will be vulnerable to unexpected market shocks that could disrupt financial intermediation and create severe negative externalities for the broader economy.*

Tarullo (2014)

All of these reasons justify a strong regulatory role in ensuring that bank governance reflects the interests of a wide range of bank stakeholders, including the interests of the public as a whole. Yet in implementing regulatory controls, banks are dependent on boards and senior management who have powerful incentives to support equity owner interests over those of the public.

### The Crisis Background to Governance Reform

The failures in bank management during the 2008 crisis did not simply involve a willingness to take inappropriate risks. They also involved a large-scale failure by top management to properly measure or understand the risks that the organization did take on. As one regulatory document states:

*Many banks lacked the ability to aggregate risk exposures and identify concentrations quickly and accurately at the bank group level, across business lines*

*and between legal entities. Some banks were unable to manage their risks properly because of weak risk data aggregation capabilities and risk reporting practices. This had severe consequences to the banks themselves and to the stability of the financial system as a whole.*

Basel Committee on Banking Supervision (2013)

There are many other examples of the failure at the top executive and board level to be aware of the actual risks the banks were taking. As the Financial Crisis Inquiry Commission stated, »Our examination revealed stunning instances of governance breakdowns and irresponsibility« (The Financial Crisis Inquiry Commission, 2011). These included a seemingly complete lack of awareness of critical areas of risk at the top management and board level of major financial institutions—for example, AIG's failure to understand its derivatives exposures, or the failures at Merrill Lynch and Citibank to understand the implications of their positions in mortgage-backed securities.

Even in the post-crisis period the governance breakdowns continued despite increased regulatory scrutiny and the financial crisis failures fresh in mind. Governance breakdowns were central to J.P. Morgan's 6 billion US dollars trading loss on what were supposed to be risk-reducing hedging trades and to market manipulation of critical derivatives and foreign exchange benchmarks by mid-level traders at major banks.

In one sense, such failures in risk management may be connected to equity owners' incentive to take on excessive risk. As long as business lines were producing steady income and high share prices, the knowledge that many of the costs of long-term risks are likely to fall on taxpayers or creditors can motivate equity holders to overlook underlying risks. But another interpretation of the failures of the risk management chain is simply massive organizational incompetence—if the existence of long-term risks had been brought to the attention of the board and senior management, and the board had a competent membership that clearly understood its responsibilities, then action would probably have been taken.

The latter interpretation supports reforms within the top-down bank governance system rather than a fundamental rethinking of bank governance. Such within-the-system reforms call on boards to exercise their oversight

responsibilities more thoroughly and conscientiously, to communicate more directly with risk management staff in the bank and to cooperate with regulators in improving the bank's risk culture. The immediate post-crisis governance reforms called on bank boards of directors to greatly increase their level of activity, engagement and scrutiny of bank operations. As governance failures continued, regulators sought a more expansive reform of banking culture, but still were hampered by a top-down approach that has appeared to make limited headway in the face of resistance to change by banks.

## 1. Post-Crisis Regulatory Efforts to Reform Governance by Bank Boards of Directors

### Basel Committee on Banking Supervision

The initial framing initiative for post-crisis bank governance reforms came from the Basel Committee in 2010 (Basel Commission on Banking Supervision, 2010). The Basel guidance sets out best practices for banking organizations based on 13 different principles. Unlike national laws and regulations, these principles are not legally binding; but they serve both as direct guidance to banks and as an indicator of the broad sense of the national regulators who make up the Basel Committee concerning the practices their supervisors expect to see in a properly managed bank.

From the very first principle stated it is evident that the governance framework recommended will be a »top-down« framework. The first principle in the 2010 document charges the board of directors with the ultimate responsibility for the performance and operations of the bank, including for approving and overseeing the bank's business objectives and strategies, the governance structure and the corporate culture.

Regarding corporate culture, this principle establishes that the board should assume a leadership role in creating and promoting a culture and values that reinforce standards of responsible and ethical behavior. The guideline certifies the »tone at the top« as the key element to be strengthened in order to advance a sound corporate culture (Basel Commission on Banking Supervision, 2010, p. 16). As discussed further in the next section, this cultural element was strengthened in the 2015 rewrite of the principles.

The other principles in the document outline a comprehensive, powerful and indeed expanded role of the board of directors. The board is instructed to provide monitoring and oversight of risk strategy and internal controls, and even in some cases to ensure review of individual transactions.

Furthermore, the fiduciary duties of the board apparently are extended beyond shareholders to other stakeholders, since the board is instructed to take into account the interests of depositors and other relevant stakeholders, as well as ensuring a good relationship with supervisors themselves.

Other key elements of the governance principles include enhancing independent risk management within the bank by giving risk managers direct access to the board and requiring regular risk reporting to the board, as well as charging the board with designing and monitoring compensation systems that align senior management incentives with the long-term well-being of the bank.

The ambitious agenda laid out for the board of directors in this document demonstrates the determination of global banking regulators to rehabilitate top-down bank governance. But these efforts have met with significant resistance.

### Bank Resistance to the Basel Principles

While regulators sought to commit to a top-down reform of bank corporate culture, making boards of directors (BODs) more accountable for the performance of the organization and spurring them to be more deeply involved in setting the bank's direction, banks themselves have resisted and repeatedly told regulators their intended reforms were impractical.

This can be illustrated by looking at the industry comment letters in response to the consultative versions of the guidelines on corporate governance. For example, in its comments, The Clearing House Association (TCH) argues emphatically against the Basel Committee's repeated use of »ensure« in connection with BOD responsibilities in the document. The use of »ensure« is taken to mean that the BOD has ultimate responsibility for guaranteeing the bank's risk controls and the adoption of necessary policies, procedures, controls and personnel

necessary to achieve the objectives and goals described in the Basel guidance (The Clearing House Association, 2015, p. 6). Banks criticize this expectation as unrealistic and impractical given that the BOD does not have direct management responsibilities.

A Group of Thirty report also argued that »ensure« is too high a bar to judge effectiveness and misunderstands the role of the board« (Group of Thirty, 2013). The American Bankers Association for its part dismissed the notion that the board should ensure appropriate inputs to bank decision making as »highly inappropriate« (American Bankers Association, 2015).

Other commenters, such as BNP Paribas, joined the chorus. It does not even »support any direct reporting to the board« on key items of everyday management, and instead favors deferring to the executive body responsibilities »to select, appoint and dismiss senior management members, determine the bank’s risk tolerance/appetite, approve and monitor the operating of the bank’s business on a day-to-day basis« (BNP Paribas, 2010, p. 2). The British Bankers’ Association (BBA), which includes 80% of the banks of systemic importance for the global economy, not only claims that the board should not be responsible for the operational business activities of the bank, but also goes beyond that to suggest that the board should not take a leadership role in developing and implementing policies, procedures and strategies or in approving compliance policies—because it would not be »the best use of their time« (British Bankers’ Association 2015, p. 2). The Canadian Bankers Association argues that the Basel guidance would overload the responsibilities of the board to a point that would compromise directors’ ability to carry them out (Canadian Bankers Association, 2015).

These objections boil down to the notion that the board’s active involvement in the operations of the bank to »ensure« good results is impractical given the practical limitations of BOD governance and would inappropriately imply that regulators could find directors liable for adverse outcomes (The Clearing House Association, 2015).

In short, a recurrent theme in the comment letters from the banking industry is the notion that the Basel guidelines blur the lines between the respective roles and responsibilities of senior management and the board. This, they argue, would »compromise« and »undermine« the

board’s effectiveness by »overloading« the board with »redundant«, »undue«, »burdensome« and »overlapping« responsibilities that work to the detriment of sound corporate governance.

## The Attempt to Implement Basel Principles on Boards of Directors in the United States

The Basel principles are intended to guide the practices of national regulators and supervisors in setting expectations for bank governance and the responsibilities of boards of directors. To this end, the principles laid out in the document have affected numerous supervisory letters and directives in the United States that lay out BOD responsibilities. In this paper, we will focus on supervisory practices at the Federal Reserve Board (FRB), which especially post-Dodd-Frank is the main supervisory agency for large and complex consolidated bank holding companies.

The increased attention devoted to consolidated bank governance at the FRB began well before the issuance of the Basel principles, when the Federal Reserve issued two major supervisory letters on consolidated supervision in early October 2008 as the financial system was collapsing (Board of Governors of the Federal Reserve System, 2008). These letters (SR 08-08 and SR 08-09) laid out guidance to supervisors on the supervision of large complex banking organizations and the expectations for compliance and risk management within large banks. While the expectations in question mostly remain unstated, they reflect the realization of widespread risk management failures on the part of both supervisors and banks and the understanding that both would need to significantly enhance their capacities in order to manage the financial crisis. SR 08-08 highlights the role of BODs and accords them the central responsibility for bank leadership:

*Boards of directors are responsible for setting an appropriate culture of compliance within their organizations, for establishing clear policies regarding the management of key risks, and for ensuring that these policies are adhered to in practice.*

In 2012 the FRB laid out a new consolidated supervisory regime for large banking organizations that directly reflected the new consensus on the enhanced role of

boards of directors (Board of Governors of the Federal Reserve System, 2012). The document vests ultimate responsibility for a wide range of detailed governance elements with the BOD, with senior management being directed to »support« the board:

*In order for a firm to be sustainable under a broad range of economic, operational, legal or other stresses, its board of directors (...) should provide effective corporate governance with the support of senior management. The board is expected to establish and maintain the firm's culture, incentives, structure, and processes that promote its compliance with laws, regulations, and supervisory guidance (...) The board should set direction and oversight for revenue and profit generation, risk management and control functions, and other areas essential to sustaining the consolidated organization.*

The 2012 guidance was followed up in 2013 with directives to supervisory personnel according the BOD clear responsibility for ensuring that the bank responded to any problems and issues uncovered by supervisors. The directive states that all supervisory findings should be directly communicated to the BOD, which is »ultimately accountable« for all compliance with regulation and the safety and soundness of the banking organization. Language in supervisory findings was standardized to emphasize that the BOD was required to directly respond to supervisory issues (Board of Governors of the Federal Reserve System, 2013). In theory, this not only would place the BOD in a position of clear accountability, but would generate additional motivation for senior management to prioritize the response to supervisory findings.

This supervisory emphasis on the enhanced responsibility and centrality of the BOD met with strong resistance from banking organizations that mirrored the resistance to the Basel principles at the international level. To take a few examples, the American Association of Bank Directors issued a 2012 report denouncing »the overburdening of bank directors with responsibilities that are insignificant or better delegated to management« and demanding a lessening of the legal and regulatory burden on the BOD (Baris and Hopkins, 2012). In their comments on the overall prudential regulatory framework implemented under the Dodd-Frank Act, trade associations for large banks and broker dealers complained that

»boards and board committees will be overwhelmed with duties that impair their ability to provide independent and objective supervision to the company“, and that regulators were failing to preserve the distinction between the BOD and operational management (The Clearing House Association; The American Bankers Association; The Financial Services Forum; The Financial Services Roundtable; The Securities Industry and Financial Markets Association, 2012, p. 23).

The concerns expressed by banks led the FRB to begin an internal review of its policies toward bank boards of directors. In a speech by Federal Reserve Chair Jay Powell summarizing the results of this review, he expressed sympathy with the banks' contention that previous Federal Reserve guidance had blurred the distinction between BODs and senior management, setting expectations of boards of directors that were excessively »specific« and »granular« (Powell, 2017).

As a follow-up to the review, the FRB proposed a new guidance in 2017 changing its expectations for BODs (Board of Governors of the Federal Reserve System, 2017). While the new guidance retained substantial supervisory expectations for the board, it fundamentally reversed the approach of previous guidance by placing the board in a more secondary role to senior management (Americans for Financial Reform, 2017; Hutchens, 2018). Instead of being expected to establish and maintain culture, incentives and internal processes and set direction in all essential areas of bank management, as in the 2012 guidance, the BOD now is charged with setting a clear and consistent general direction for the firm's strategy and risk tolerance, while holding senior management accountable for implementing this strategy.

In its text, the new guidance states that the general direction set by the board should

*include sufficient detail to enable senior management to identify the firm's strategic objectives; to create an effective management structure; and to establish effective audit, compliance, and risk management and control functions.*

This implies a significant change of direction from previous guidance in that the BOD itself no longer is required to establish the management structure or incentives of



the firm. Instead, the board sets broad and general priorities for the firm and delegates the rest of the execution to senior management. The BOD also is charged with holding senior management accountable for implementation of these general priorities and supporting independent risk management. The guidance thus represents a significant narrowing in the accountability of the BOD. Senior management now is accorded the primary responsibility for establishing strategy and overall management structure, with the BOD in a reduced role, giving general guidance and holding management accountable.

To operationalize these new supervisory expectations, the FRB also announced in the same 2017 release that it would be rescinding or revising previous guidance on the roles and responsibilities of bank BODs included in 27 previous supervisory guidance letters (Federal Reserve System, 2017). It is striking that 17 of these supervisory letters date back to before the 2008 financial crisis, indicating that the change in supervisory expectations is influencing not only post-crisis reforms but also more traditional supervisory practices. The list of letters due to be revised includes SR 08-8 and SR 08-9, the two supervisory letters sent out during the worst days of the financial crisis in October 2008, in direct response to the pressing compliance and supervisory issues at failing banks. Thus it appears that the Federal Reserve is weakening even those expectations of BODs that it highlighted when directly engaged with the events of 2008.

### Further Pushback by U.S. Banks against Regulatory Supervision of the Board of Directors

With the issuance of the 2017 guidance, U.S. banks would seem to have achieved their goal of rolling back supposedly excessive regulatory supervision of bank boards of directors. But over the past year banks have mounted a political campaign to roll back supervision of BODs even further than was accomplished in the 2017 guidance.

They now have targeted the ability of supervisors to exercise authority over the board or even to engage with the board without going through senior management. This campaign is reflected in a letter from three prominent members of the House Financial Services Committee to the Federal Reserve in April 2018 blast-

ing the proposed 2017 guidance as further regulatory overreach:

*Boards of directors continue to spend far too much time on matters that do not relate to their core functions to oversee management on behalf of shareholders. Although the proposed guidance purports to distinguish between the role of the board (one of oversight and guidance) and the role of management (day-to-day functions), it continues to inappropriately blur these lines by creating numerous new requirements that a board ›ensure‹, ›establish‹, ›approve‹, ›set‹, ›develop‹ or ›detail‹ items (...) As such, these terms would impose new legal and managerial requirements that would have the board direct a bank holding company's daily business decisions (...) just because a topic may relate to a core board function, for example the oversight of strategy, it does not necessitate that the Federal Reserve regulate these areas. The Federal Reserve cannot assume the legal duties of care and loyalty from an elected board of directors.*

*This proposed guidance must not become another supervisory tool for examiners, who generally lack expertise in corporate governance, to demand additional obligations for boards. Shareholders elect a board to then appoint and oversee management to operate the business.*

Barr, Duffy and Huizenga (2018)

The repeated references to shareholders are particularly notable in this letter. It not only demands that the Federal Reserve weaken supervision of corporate directors, but it puts equity holders/shareholders firmly in the central position in board governance. As discussed previously in this paper, there is broad agreement that corporate governance of bank holding companies requires the representation of a much broader set of stakeholders than just equity owners. The letter clearly represents pushback against this idea and an attempt to block regulators from expanding board priorities beyond shareholder profits.

This political campaign was reflected in aggressive questioning of Federal Reserve Vice Chairman for Supervision Randy Quarles in a congressional hearing a few days later after this letter was sent (House Financial Services Committee, 2018). Consider the following line of ques-

tioning from House Financial Services Committee Chairman Rep. Jeb Hensarling (D-Texas):

*HENSARLING: So I've raised this issue before, and that is the whole issue of supervision versus corporate governance. A number of institutions have come to this committee to say that representatives of the Fed have insisted on attending meetings of the board of directors or committee meetings of the board of directors. So my question is, do you believe that the Fed has the legal authority to demand attendance at board meetings? And, if so, why is this a wise policy?*

*(...) this committee has heard that some Fed examiners have made recommendations to management that certain board members, if you will, be fired. Again, does the Fed have the legal authority to make those recommendations? And, if so, is that wise policy?*

*(...) Is the Fed trying to supplant itself over state corporate governance law? Where is the line to be drawn between supervision and corporate governance? Because it's getting rather murky.*

Here, Chairman Hensarling questions the general legal authority of the Federal Reserve, the key supervisory agency for large consolidated bank holding companies, to engage in even such basic elements of supervision as attending meetings of the Board of Directors, weighing in on the qualifications or performance of board members, and even taking an active role in oversight of corporate governance at all. This line of attack might be too aggressive for banks to take in their own written regulatory comments or in a lawsuit, as it likely would not be upheld by a court and would damage their relationship with regulators. But when delivered by one of the most powerful financial services legislators in the country, the chair of the House Financial Services Committee, in direct questioning of the Federal Reserve's lead supervisory executive, the message is clear.

This aggressive line of questioning was amplified later in the hearing by Rep. Bill Huizenga (R-Mich.):

*HUIZENGA: I think this really gets to what both the chairman and a number of us have—have said—is, if you have a financial institution that is not in trouble, that doesn't—hasn't tripped any of these legal wires, really, what are—what's the legal standing*

*for the Federal Reserve and its regulators to come in and be involved with board decisions, much less discussions with committees of—of that?*

In general, when members of Congress challenge regulatory authority on relatively technical supervisory issues like this, the impetus comes directly from complaints by bank lobbyists and management. This aggressive challenge from important legislators is indicative of continued strong pushback by bank lobbyists.

## 2. Governance and Culture Reform Initiative and Its Implementation

Another major effort to improve bank governance took the form of an effort by key regulators to improve internal corporate culture at banks to encourage more responsible and law-abiding behavior. The need for such efforts was clear given the major compliance failures that marked the financial crisis and the continuing scandals at major banks after the crisis ended. These continuing scandals included the London Whale trading violations in 2012 and the revelations of widespread manipulation of foreign exchange and derivatives benchmarks by trading banks.

At least in concept, the bank culture initiative appeared to represent a significant effort by regulators to expand the scope of their reforms to address what they now recognized as a significant culture problem that went beyond simply top-level inattention to risk issues. At the international level, this initiative was associated with a rewrite of the 2010 Basel Committee principles on bank corporate governance discussed in Part 1 of this paper. These rules were rewritten in 2014 and 2015 to highlight the importance of corporate culture. The new principles were in many ways structurally similar to the 2010 version, but took note of the numerous additional misconduct scandals at banks revealed during the 2010–2014 period. Concretely, the rewrite of the principles placed a greater explicit emphasis on culture change and on directing the Board of Directors to spearhead such change. For example, the 2015 version of the principles contains 38 references to «culture», as opposed to only three in the 2010 version (Basel Committee on Banking Supervision, 2015).

In the United States, these new principles were not reflected directly in new rulemakings, but instead in a

somewhat less formal initiative on bank culture change that was spearheaded by the New York Federal Reserve. Below, we review some evidence of the success of this U.S. initiative. (The discussion applies to the United States but not to some other countries such as the United Kingdom that pursued somewhat different and arguably more successful regulatory avenues to support culture change).

The U.S. initiative was announced in a major event at the New York Federal Reserve in 2014 that brought together regulators from the Federal Reserve and top executives from large Wall Street banks (Federal Reserve Bank of New York, 2014). In a speech at the event laying out the initiative, New York Federal Reserve President William Dudley described the need to improve corporate and compliance culture at banks and the need for senior leadership buy-in for this effort (Dudley, Enhancing Financial Stability by Improving Culture in the Financial Services Industry, 2014). He highlighted what he described as widespread and systemic culture failures in the banking industry, which he linked to increased risks to the financial system and to the growth of »too big to manage« firms that linked commercial banking and Wall Street trading in new ways. Like the Basel guidelines and Board of Director reforms discussed above, the culture change project took a top-down approach to institutional change. As Dudley stated in his speech:

*Correcting this problem must start with senior leadership of the firm. The »tone at the top« and the example that senior leaders set is critical to an institution's culture (...) Senior leaders must take responsibility for the solution and communicate frequently, credibly and consistently about the importance of culture. Boards of directors have a critical role to play in setting the tone and holding senior leaders accountable for delivering sustainable change.*

Even as the regulators urged senior leadership and the board of directors to take primary responsibility for generating cultural change in banking, they also laid out several specific actions that needed to be taken to support the effort. These are laid out in Dudley's 2014 speech:

- An industrywide effort to measure and benchmark the state of culture at major banks, through a comprehensive culture survey of bank employees conducted by an independent third party.
- Major changes in compensation systems at large banks to eliminate incentives for irresponsible short-term behavior, such as bonuses that give out enormous amounts of money for short-term profits with no downside risk if problems materialize later.
- Mechanisms to identify individuals who have a record of poor ethical behavior and stop these individuals from being hired and re-hired in the financial industry. Dudley suggests creating a central registry tracking reasons for firing traders and other financial services professionals, with firing for ethical lapses being a bar to further employment in banking.

The progress of the culture initiative since 2014 is more difficult to track than the progress of rulemakings, since there is no requirement under the Administrative Procedures Act for transparency in the process of implementing this initiative. Nevertheless, there is information that enables us to say something about how this initiative has advanced. A particularly informative source is a series of speeches made in mid-2018 when President Dudley stepped down from the presidency of the Federal Reserve Bank of New York.

In a March 2018 speech, then-President Dudley once again called for action on all three of the recommendations he had highlighted in his 2014 speech kicking off the culture initiative—regulatory action to make significant changes in bank compensation systems that create incentives for irresponsible short-term behavior, for a comprehensive third-party survey of bank employees to measure and benchmark culture, and for an industrywide database of bankers found complicit in misconduct (Dudley, 2018a). Strikingly, he gave no examples of any clear progress that had been made on any of these three efforts in the four years since his 2014 speech. In another speech at a June 2018 New York Federal Reserve event assessing progress on the bank culture initiative, he again called for action on all three of these changes in the United States (Dudley, 2018b). The speech again implied that little or no progress had been made in the U.S. regulatory system on any of the three initiatives Dudley had called for in 2014. Indeed, he noted that his own call for compensation reform in 2014 »seems to have fallen on deaf ears«.

While a supervisory initiative such as the culture initiative goes on to a large degree behind the scenes, the fact that four years after the initiative started, none of

the three core recommendations made at the start of the initiative appears to have been even partially implemented in the United States does not point to success. Indeed, the public documentation available at the New York Federal Reserve on the culture initiative shows little if any evidence that concrete progress has been made toward improving culture in U.S. banks. The most that can be found is statements such as the general assessment by Stuart Mackintosh, the chair of the Group of 30, at the June 2018 Federal Reserve event:

*Today, boards and senior executives in many firms have made significant strides, including beginning to measure effectiveness of reform programs. Likewise, senior leaders at many firms are setting the tone and leading by example. However, progress has been slow and inconsistent.*

Mackintosh (2018)

When combined with the evident failure to make progress on the core recommendations of the initiative, such statements do not inspire confidence.

Another reason to doubt the success of the initiative is that even while the culture initiative was getting off the ground in 2014, one of the biggest consumer banking scandals in decades was brewing at one of the nation's largest banks. In September 2016, Wells Fargo Bank was found to have created millions of fake bank, credit card and auto insurance accounts without authorization by customers in order to meet sales goals. This fraudulent behavior was driven by extreme pressure exerted on employees to meet quantitative sales goals, pressure that was not properly addressed as a systemic issue by senior management who profited from it (Independent Directors of the Board of Wells Fargo & Company, 2017). Notably, the bank fully committed to solving the problem only after it became the subject of intense negative publicity due to penalties from legal authorities.

Because the implementation of the culture initiative has taken place mostly behind the scenes, it is hard to point to the exact reasons why progress has been so slow. But there are several areas we can highlight based on public information.

The first is the excessively »top-down« nature of the initiative. As discussed above, the efforts to improve bank culture have placed a strong emphasis on the »tone at

the top« among senior leadership, with the assumption that this then would trickle down within the organization. No doubt it is difficult, if not impossible, to improve corporate culture without the necessary buy-in from top executives. Yet academic research and expert observation shows that it is easy to overemphasize the importance of apparent buy-in at the top. In comments on the 2014–15 Basel Committee rewrite of corporate governance principles, academic experts on bank risk culture criticized what they called »unrealistic expectations of tone at the top« in the principles. They stated that their research had found that the views and behavior of colleagues, team members and immediate managers generally were more important than senior leadership, and this is especially true in very large and geographically dispersed organizations such as major banks (Sheedy and Griffin, 2015).

A concrete example of this phenomenon can be seen in the Wells Fargo case. Top executives had signed their name to codes of conduct that emphasized ethical behavior and instituted training that instructed employees not to meet sales goals by opening sham accounts. Yet the unethical and illegal behavior continued due to intense sales pressure on employees who were threatened with losing their jobs unless they met unrealistic sales targets. As a *New York Times* article stated, »former Wells employees swapped grim stories about the dichotomy between their ethics training—where they were formally told not to do anything inappropriate—and the on-the-job reality of a relentless push to meet sales goals that many considered unrealistic« (Corkey and Cowley, 2016).

Of course there is a sense that senior leaders have not done the work of setting the organizational tone if they permit pressures to be brought through compensation systems and other corporate mechanisms that contradict their stated principles. But the fact remains that it is simply unrealistic to expect a small number of senior leaders to personally control the culture of an enormous, sprawling institution like a global bank. As Marvin Wheatley, the head of the UK Financial Conduct Authority, stated:

*While we've quite rightly and properly seen significant attention focused on the most senior leaders, there's been far too little debate around the many thousands of decision makers beneath them (...) It's an imperative, however, that leadership responsibility at the top isn't taken to imply a lack of respon-*

sibility for change in the middle. Bank Boards are, frankly, no more able to reform cultures on their own than star riders are able to win cycling tours without **pelotons** and **domestiques**. In fact, you could argue that those at the centre of organisational pyramids should, by basic law of averages, influence greater numbers of colleagues on a personal, day-to-day basis than a clutch of senior leaders.

Wheatley (2015)

The United Kingdom has acted on these principles by instituting an individual accountability regime designed to penetrate to line managers and employees at all significant levels of the bank (Financial Conduct Authority, 2018). However, the United States has not done so.

Those at the very top level of banking organizations themselves acknowledge the key importance of employee involvement at every level of the organization to make culture change work, and lament the difficulty of winning such engagement from their employees. At the June 2018 conference by the New York Federal Reserve on culture change, this issue was highlighted:

*Senior leaders may say that they want to hear bad news, but that doesn't mean lower-level employees are eager to share it with them. »Good news tends to travel up much more quickly« than bad news does, Elizabeth »Betsy« Duke, the board chair at Wells Fargo, said at an industry conference on bank culture hosted by the Federal Reserve Bank of New York (...) they acknowledged that one of their biggest challenges—one that strikes at the heart of the lingering worries over whether megabanks are simply too big to manage—is convincing employees to come forward and share bad news with leadership before a matter gets out of hand. »By the time an issue gets to me, it's too late«, said Michael Corbat, the CEO of Citigroup.*

Broughton (2018)

Thus, an excessive focus on »top-down« reform may backfire by ignoring the engagement necessary throughout the organization.

A second factor in the slow progress of culture change initiatives in the United States has been outright bank resistance to key elements of the project, most notably in the area of compensation. The need to change com-

penensation practices to avoid creating incentives for irresponsible short-term risk-taking has been highlighted as critical to cultural change by numerous observers and experts. As President Dudley put it in his June 2018 speech:

*(...) improving incentives is the most direct way to improve culture and conduct. Incentives drive behavior. Behaviors establish social norms. Shared social norms are the foundation of a group's culture (...) Foremost, how are employees paid? Do compensation arrangements—the mix of fixed and variable compensation, debt and equity, vested and deferred—encourage behavior that is aligned with the values of a firm as they are publicly stated?*

Dudley (2018b)

He has also made clear that regulatory action was needed and called for in this area:

*[compensation] reform may also need a push from the regulatory side. Banks may be reluctant to adopt such pay structures on their own for competitive reasons. They may perceive that there is a first-mover disadvantage in attracting and retaining talent.*

Dudley (2018a)

The Dodd-Frank Act itself contained an important provision on executive compensation that armed regulators to act on the compensation issue. Misaligned compensation incentives at major banks long have been understood as a central contributor to the 2008 financial crisis (Financial Crisis Inquiry Commission, 2011). In response, legislators required in Section 956 of the Dodd-Frank Act that regulators ban bonus practices at banks that create incentives for executives to take inappropriate risks. Yet today, eight years after the Dodd-Frank Act was passed, regulators still have not taken action in the face of fierce industry opposition.

Regulatory efforts to implement this provision began with the release of a proposed rule in 2011. Unfortunately, this rule was so weak it would have made little, if any, effective change in bank bonus practices (Americans for Financial Reform, 2014). Facing opposition from industry groups for any action in this area, and with no support from reform groups for an excessively weak proposal, regulatory action on the rule stalled. When President Obama made the completion of the rule an explicit priority late in his term, regulators finally act-



ed (Rubin, 2016). A new rule proposal on compensation was released in late 2016. While this proposal still had significant weaknesses—and was notably weaker than compensation reform proposals in countries like the United Kingdom—it still would have made real reforms by mandating a more long-term orientation for compensation through deferral of bonus compensation for a number of years and tying payout to long-term outcomes. The proposal also would have banned some of the worst incentive compensation practices, like the strict sales quotas that produced illegal behavior at Wells Fargo (Americans for Financial Reform, 2016).

The new incentive compensation proposal met with even fiercer opposition from Wall Street. A joint letter from the industry's largest trade groups blasted the proposal as »enormously overreaching«, calling for essentially every significant provision to be gutted and threatening a lawsuit on the basis that the proposal went beyond statutory authority (Board of Governors of the Federal Reserve System, 2016). The industry called for eliminating »prescriptive and onerous« elements of the proposal that would require bonus payouts to be held at risk for the long term and for striking from the proposal any limitations on bonus practices such as sales quotas that are notorious for creating pressure on employees to engage in irresponsible or illegal behavior.

In the face of ferocious industry opposition, regulators did not finalize the rule before the 2016 election and the new administration has indicated it will not take action on the rule. Thus, significant regulatory action to restrict bank bonus practices that create inappropriate incentives appears to be off the table for the foreseeable future. Yet compensation practices are critical to cultural change. Leaving in place pay incentives that run counter to a healthy risk and compliance culture by paying bonuses solely based on short-term profits undermines cultural change initiatives at a basic level. Yet without regulatory action, publicly traded banks controlled by a small number of equity holders are unlikely to limit such incentives on their own. Short-term profits benefit equity holders who take residual profits while avoiding many of the downside risks of long-term losses. Indeed, bonus compensation practices at banks frequently are based on high-powered, equity-based incentives such as stock options precisely in order to align the incentives of key executives with the incentives of equity holders, as opposed to debt holders or the public.

This is how President Dudley summarized the situation in his June 2018 speech, when speaking of proposals to defer bonus compensation ensure a long-term orientation at major banks:

*In my view, that structure would better align the interests of senior leaders with the interests of creditors and shareholders. It would also promote financial stability by reducing the incentives for excessive risk-taking (...) The concept is hardly novel. What I have proposed closely resembles the old partnership model of investment banks. What's more, a similar regime governs compensation of senior managers and material risk takers in the United Kingdom. This demonstrates that the concept can work on a broad scale. But, to the best of my knowledge, no firm in the United States has voluntarily adopted such a regime.*

Dudley (2018b)

Thus, there is good reason to doubt whether culture change efforts at U.S. banks will meet with real success without more forceful regulatory action on the issue of compensation.

### 3. »Regulation from Below« and Improving Bank Governance

The recent history of regulatory efforts to improve bank governance and culture from the top down shows the obstacles that can be created by industry opposition to changes that attempt to rebalance power between equity holders and other stakeholders of the bank. How can a »regulation from below« approach that empowers bank workers address these issues?

Our response to this question is more speculative and brief than the previous discussion of recent regulatory initiatives made possible by the extensive public discussion of those actions. However, there are two clear areas where worker empowerment clearly would aid efforts to reform bank governance. The first is that organized labor's political action can strengthen the hand of regulators in seeking to represent the interests of non-equity stakeholders and the broader public in bank oversight. The second is that stronger engagement with and participation by line workers can help achieve deeper and more far-reaching cultural change than a purely top-down approach.

*Organized Labor and Political Action:* Trade unions have a wide variety of economic interests and in some cases, such as banking-specific unions, one could conjecture that organized labor might prioritize bank interests. Yet organized labor fundamentally represents the interests of ordinary wage workers who are dependent on the health of the broader economy, as opposed to large-scale capital owners who are more insulated from labor market trends and instead are concerned with the return on capital investments. Especially given the extreme wealth inequalities in the United States and other countries, this split means that in the politics of financial regulation, organized labor should be expected to be on the side of broader public stakeholders rather than bank equity holders. In this context it also is important to note that bank profits are not even shared widely within banking organizations themselves—many line workers at large banks earn extraordinarily low wages and are extremely disempowered relative to the top executives. They clearly share interests with the broader class of employees fighting for stronger rights against holders of capital (National Employment Law Project, 2015).

Indeed, this is what has occurred in the wake of the financial crisis. Unions that represent large numbers of line workers in large banks, such as the Communications Workers of America (CWA) in the United States and UNI Global Union globally, also have been among the strongest civil society supporters of more forceful regulation of banks (Committee for Better Banks, n.d., and Communications Workers of America, n.d.). Labor confederations such as the AFL-CIO in the United States and the European Trade Union Confederation (ETUC) also have been powerful advocates for reforming and enhancing financial regulation. Labor unions and labor confederations are key members and supporters of civil society coalitions that work to support stronger and more effective regulation of the financial sector, such as Americans for Financial Reform in the United States and Finance Watch in Europe (Americans for Financial Reform, n.d., and Finance Watch, n.d.).


Financial regulation is in the final analysis a political and not simply a technical endeavor. Organized labor as a representative of the interests of the broader public can and should counterbalance the interests of the kind of narrow but highly organized and wealthy special interests that have weakened and undermined financial regulations since the crisis. At the same time, organized

labor is in a politically weakened position in many countries due to rollbacks in resources and organizing penetration, and is fighting battles on a broad range of fronts against anti-labor and austerity policies. Strengthening the overall political position of organized labor would support regulators in taking a more forceful stand on the kind of bank governance and control issues discussed in this paper, as well as restructuring the financial sector more generally.

*Deeper Worker Engagement and Changing Bank Culture:* The discussion in the previous section addressed the shortcomings of a purely top-down approach to changing bank culture. As we saw, even top executives themselves highlighted the need for deep engagement throughout their organizations to address the information problems associated with governing a large and complex financial institution. In many cases, the workers who need to be engaged will be middle managers or front-line financial professionals such as traders. In other cases, they will be line sales or administrative workers who can directly observe problems with mis-selling to consumers or other fraudulent or unethical activities. For example, line workers were central actors in bringing to light issues with sales practices at multiple banks such as Santander and Wells Fargo (Norton, 2018, and AFL-CIO and National Employment Law Project, 2017).

In order for any bank workers to be confident in speaking out and sharing information about unethical or unsound practices at banks, they need a culture that supports their voice and ensures they will not be retaliated against for sharing information that may question the decisions of their managers or even implicate their superiors in unethical or illegal activities. It is difficult to see how such a culture can be created across the industry without genuine worker empowerment at banks. In the absence of an empowered workforce, workers will be dependent on the forbearance of top management to keep their jobs if they take risks to question irresponsible practices.

There is a vast literature on the role of worker empowerment in organizational culture change that goes beyond the scope of this paper. However, large banks and their regulators may have much to learn from the rich literature on encouraging safety culture in high-risk industrial organizations, which intersects in significant ways with the issues of bank risk culture (Leaver and Reader, 2017).



Worker empowerment and labor union engagement has been an important component of improving safety culture in complex organizations.

The discussion of empowerment in the context of financial culture and bank regulation generally has been limited to the empowerment of the independent risk function to speak up against business-line managers and elevate potential issues to the attention of the Board of Directors. For example, this is highlighted in both the Basel corporate governance principles and the Federal Reserve supervisory guidance discussed in this paper. While empowering risk professionals is of course crucial, deeper engagement of front-line and business-line workers also should pay significant dividends.

In sum, a regime of bank oversight based on empowerment of workers should pay dividends politically by supporting regulators in ensuring the public interest is properly served in bank management and creating a broader base of support for strong regulatory action. It also should pay dividends in terms of management by improving information flow and positive cultural commitments across all levels of the banking organization. Certainly, it seems to be a necessary improvement to the current situation where regulators consistently struggle to implement even the top-down enhancements to bank governance and regulation they themselves have described as necessary.





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