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# Culture in financial services
Scrutiny by the regulator, in principle and in practice

CENTRE *for*
REGULATORY STRATEGY
EMEA

# Contents



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# 1. Overview

"My assessment of recent history is that there has not been a case of a major prudential or conduct failing in a firm which did not have among its root causes a failure of culture as manifested in governance, remuneration, risk management or tone from the top."

**Andrew Bailey, then Chief Executive, PRA**[1]

### Why firms need to treat culture as a key regulatory priority

The above observation is often quoted in papers on culture and rightly so: it captures eloquently how culture, alongside remuneration, risk management and individual accountability, has become a key focus for financial services regulators, both conduct and prudential, in their strategic response to the global financial crisis and a string of serious misconduct episodes. Regulators have come to a clear view that well-designed formal governance processes and controls are not, by themselves, enough to secure good regulatory outcomes: unless the right cultural mindsets and behaviours are embedded throughout an organisation at the operating level, the control environment can still be undermined. As the Financial Stability Board (FSB) has observed, a firm's culture can "defeat its formal governance".[2]

Some may argue that culture cannot or should not be regulated and that other regulatory initiatives must take greater priority. But this view takes insufficient account of the priority regulators now attach to culture and the seriousness of their concern as to the effects of poor culture on firms, customers and the market. Notably, the Financial Conduct Authority's (FCA) latest business plan describes firms' culture, along with governance, as "pivotal" to building public trust and confidence in UK financial services.[3]

While regulators do not prescribe a firm's culture, they expect boards to exert strong cultural leadership and take responsibility for establishing and overseeing the right culture. A striking example of this is the UK's Senior Managers and Certification Regime which prescribes responsibilities for the leading the development and overseeing the adoption of firm culture. Failure to exert strong cultural leadership heightens the risk of poor outcomes and hence the full range of regulatory interventions and associated reputational damage. Even if such outcomes do not materialise, any indication of poor culture can be expected to drive far more intrusive supervisory scrutiny[4] of firms day-to-day and so increase substantially the regulatory "overhead" borne by a firm.

In Deloitte's view, culture is of paramount supervisory and commercial importance because it can either reinforce or undermine firms' formal governance, risk and control processes, as well as determining customers' practical experience in all aspects of their interaction with a financial services firm.

### This paper's primary focus: how supervisors assess culture in practice

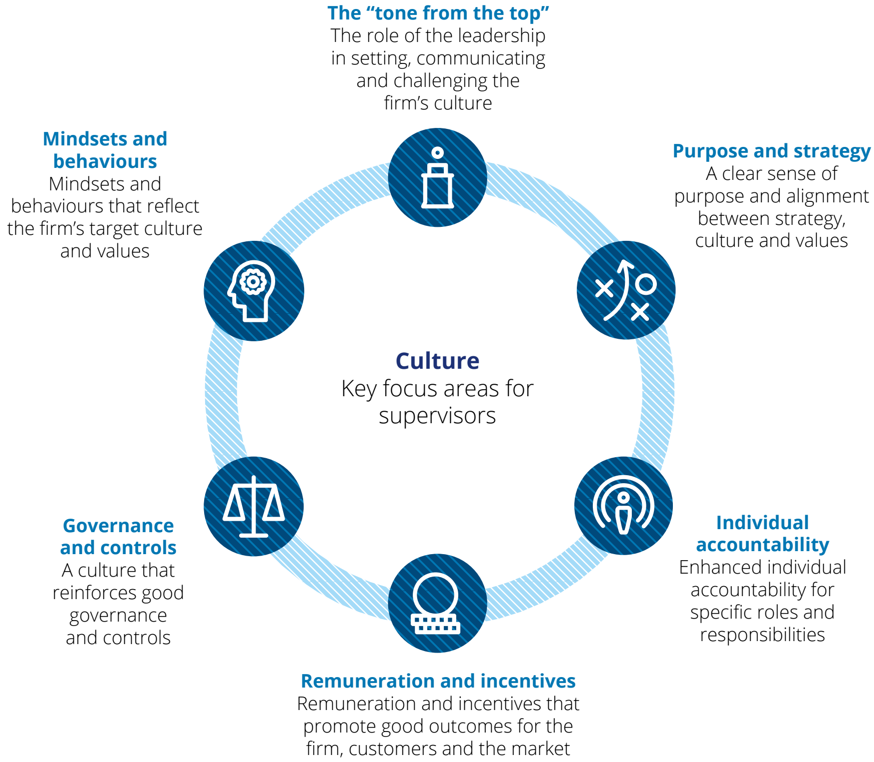
Senior regulators have emphasised, with increasing frequency, the importance of establishing the right culture; the key responsibility of the board and senior management in that regard; and the crucial underpinning role of values, accountability, incentives and strong governance and controls. **But it is much less clear how in practice front line supervisors will seek to assess the culture of a firm and reach decisions on whether any problems identified are sufficient to justify supervisory intervention**.

As well as reviewing trends in regulation and supervisory thinking on culture, this paper identifies six key areas that are, in our view, likely to attract particular scrutiny when supervisors reach judgements on a firm's culture (see Figure A). It goes on to set out positive and negative indicators that are likely to inform a supervisor's overall judgement about a firm's culture and the risks it poses, if any, to consumers, firm solvency, the market and/or the integrity of the financial system.

Andrew Bailey has acknowledged that supervisors cannot go into a firm and simply say *"show us your culture"*. However, as he goes on to say, they *"can, and do tackle firms on all the elements that contribute to defining culture, and from that...build a picture of the culture and its determinants"*. [5] **In our view, through the supervisory process, and the multiple interactions it involves at all levels in a firm, a firm's culture is always on display to its supervisors**. Even in jurisdictions where there is no overt supervisory focus on culture, supervisors will, during their day-to-day supervision of firms, build up a clear assessment of a firm's culture. This assessment will cover both the culture that is being driven by the board overall and how a firm's culture operates in discrete areas such as risk, compliance, sales and remuneration. Key areas of scrutiny will be whether:

- the firm's culture permits meaningful challenge within its board and executive governance;
- there is sufficient status and influence attached to the risk and control functions, so that they can act as an effective "check and balance";
- the approach to incentives and accountability are consistent with good regulatory outcomes; and
- the attitude and approach to the supervisory process is appropriate.

**Figure A. Culture – Supervisory areas of focus**




The judgements on culture that supervisors reach in these and other areas will strongly influence their supervisory strategy towards a firm and the level of resource they will deploy in supervising it.

The supervisory emphasis on culture is thus likely to be increasingly rigorous and wide-ranging, both in principle and in practice; it may also on occasion be judgemental and possibly intrusive in its practical operation and hence potentially sensitive for any firm. Deloitte's view is that **an in-depth understanding of supervisory perspectives and the cultural indicators that supervisors are particularly alert to will enable boards and senior management to address the increasing focus on culture** and any firm-specific challenges that supervisors raise, and demonstrate their firm's cultural alignment to the achievement of good customer, prudential, and market outcomes.

To help firms meet this complex challenge, Deloitte has developed **Culture Conscious**, a survey-driven tool that helps firms perform rapid cultural assessments, identify which different groups of employees within the firm need most attention and track performance over time. For example, across the firm's geographies, functions, business lines, grades, or "three lines of defence" governance model. Our Culture Conscious database aggregates responses allowing Deloitte to generate dynamic, sector-wide benchmarks against which results can be compared. In section four, we use Culture Conscious to provide an illustrative example of the benchmark for the insurance sector.

# 2. What is culture and what have senior regulators been saying about it most recently?

William Dudley, President and Chief Executive of the Federal Reserve Bank of New York, describes culture as *"the implicit norms that guide behaviour in the absence of regulations or compliance rules"*.[6] **Culture is often thought of as a system of values, beliefs and behaviours that influences how work gets done**. Importantly, for a supervisor, a firm's culture permeates all aspects of its business from its attitude to risk-taking (both financial and non-financial), to its treatment of its customers and the development, sale and review of its products and services.

Recent statements from senior regulators on culture have emphasised the following key themes:

### Responsibility and accountability

Whilst emphasising the need for greater accountability within firms, regulators, particularly the FCA, have drawn a distinction between culpability on the one hand and responsibility and accountability on the other.[7] Culpability concerns direct blame for an action, while responsibility and accountability are aspects of leadership at various levels within the organisation; that is, taking ownership of an area within a firm and accepting accountability or responsibility for what happens within it, even where actions are taken by other, more junior, individuals. The board and senior managers are increasingly expected, through their leadership, both to demonstrate and promulgate the culture and values of the firm.

### Changing behaviour and mindsets

Supervisors recognise the need to secure a long-term shift in the behaviour and mindset of firms to make "doing the right thing" integral to commercial decision-taking. In addition to remuneration and incentives, lessons from behavioural insights and economics are now viewed by a number of regulators as useful levers to influence behaviours and improve culture.

### Recognition of wider public interest and social outcomes

Increasingly, firms are expected to consider, as part of their commercial decision-taking, the wider public interest and outcomes such as the fair treatment of customers, financial inclusion, and, in the UK, "value for money".

This reflects a trend in some jurisdictions whereby supervisors are looking increasingly to focus their resources on groups of customers who are least able to protect their own interests. In the UK, for example, the FCA has emphasised its priority of protecting the interests of "vulnerable" and "excluded" customers, both of which the FCA has defined in wide-ranging terms.[8] In the US, the House of Representatives has recently passed legislation – The Senior Safe Act – which aims to make it easier for firms to work with regulators in order to protect older consumers from financial exploitation.

Whilst regulators acknowledge the efforts that have been made over the past ten years, their recent statements make clear that they consider more needs to be done to transform culture within firms. As William Dudley commented recently *"…have we gotten as far as we need to go? No. Have we made a lot of progress? Yes."*[9] This sentiment is shared by many international regulators and, as a result, culture remains at or near the top of the regulatory priority list.

At the same time, regulators recognise that changing culture is hard and raises many complex and challenging issues. This recognition informs the FCA's recent publication of a series of essays by market practitioners on the challenge of transforming culture in financial services.[10] Topics covered include the influence and importance of the entire "system" that surrounds individuals, and how behavioural science can be deployed in understanding and influencing culture. Importantly, the FCA has signalled, through this publication, its wish to open a dialogue on the transformation and supervision of culture; consequently, regulatory thinking on culture is almost certain to evolve further.

# 3. Supervisors' assessment of culture in practice

Regulators have, in recent years, set out a coherent and rigorous set of expectations as to the responsibilities of boards and senior management on all aspects of culture. But what has been much less clear is how, in practice, front line supervisors will assess a firm's culture and by implication the performance of the board and senior management in this area.

As the LIBOR scandal indicated, cultural failings can persist across a sub-sector of the industry and may not be restricted to a specific firm. Consequently, supervisors typically take both a "macro" and "micro" view to supervision of culture: poor outcomes detected across one or two firms may inform the focus of supervision of others in the same sector. A firm which has, or prides itself on having, a desired culture may not, necessarily, be insulated from supervisors' industry-wide cultural concerns.

Supervisors build up a picture of culture within a firm by carefully observing both informal indicators (for example, the behaviour and attitude of staff) and formal indicators (such as the appropriateness of policies and procedures). Failures in culture are also inferred from other tangible outcomes such as instances of poor treatment of customers.

To assist firms in this regard, we describe in the following sections how supervisors are likely, in our view, to approach this complicated task. **We have drawn together examples of key positive and negative indicators, across six areas, which we expect supervisors will evaluate through the supervisory process, and which we consider will strongly influence their ultimate judgement as to the culture of a firm** and hence their supervisory strategy and approach towards it.

**Figure B. Culture – Supervisory areas of focus**


### The "tone from the top"
### The role of the leadership in setting, communicating and challenging the firm's culture

The "tone from the top" almost always features in supervisory statements on culture.[11] Boards and senior management (the leadership) are considered to have a decisive influence over the culture within a firm and are expected, ultimately, to be accountable for it. Accordingly, supervisors expect the board to lead by example, role-modelling desired behaviours and demonstrating how these support the firm's culture and values. In other words, setting the tone from the top requires the leadership to demonstrate the behaviours that exemplify the target culture.

By repeatedly emphasising the importance of the tone from the top, supervisors are seeking to secure a general shift in the firm's approach to culture towards leadership taking more responsibility for setting and embedding an appropriate culture within their firms. However, as William Dudley has observed, culture does not change simply by exhortation; the leadership should *"expect and respect challenges, and in turn must challenge ideas themselves."*[12]

### Positive Indicators

The leadership is demonstrably responsible **for setting the firm's purpose and target culture** and articulating how these are reflected in the firm's strategy, values and the behaviours expected of staff at all levels.

The **championing and role-modelling** of expected behaviours by the leadership. For example, setting out "how" results are to be delivered or demonstrating how senior-level decisions align with the firm's purpose, values and target culture.

**Frequent discussion of culture**, including culture Management Information (MI), at board and executive committee meetings. Culture might be discussed as an explicit standing agenda item or be an implicit consideration in other discussions (for example, the impact of a decision on customer or market outcomes). Documentation of these discussions, and the monitoring of any follow-up actions, is essential to evidence to supervisors how culture has been considered.

Independent Non-Executive Directors (INEDs) setting aside sufficient time and resource to provide **independent oversight** of the firm's culture (and culture MI) at key committees. INEDs being able to evidence their role in driving cultural reform and challenging the business both on the substance of culture and its delivery.

A **broad mix of individuals at board level** demonstrating a range of different perspectives and **diversity of thought** on the decision-making process and recognising positive risk management behaviours and successes.

Evidence that the board **encourages and responds positively to challenge** from internal stakeholders including control functions as well as external stakeholders such as investors.

### Negative Indicators

**A lack of challenge** of, and amongst, the board increasing the risk that debate and decision-making at senior levels are dominated by commercial and competitive considerations, at the expense of other outcomes. This may include evidence of the **dominance** of key, senior individuals, whether executive or non-executive, and associated passivity and/or complacency of remaining board members. Supervisors are likely to take this as **a strong manifestation of group-think**.

Key governance fora are regarded as a **"rubber stamp"**; that is, decisions are taken outside of key committee meetings; key information is either withheld from a committee or presented during the committee itself, giving committee members insufficient time to absorb it and/or insufficient time is allocated or permitted for board discussion. "Managed" board agenda, information flows, and procedures limit non-executive involvement and challenge.

Evidence that board members do not understand the technicalities of the business, its risk profile and the regulatory framework well enough, or at a sufficiently detailed level, to provide effective **oversight and challenge to the business**.

A lack of open, transparent and constructive dialogue and interaction with supervisors, potentially indicating an **obstructive, arrogant or dismissive attitude** towards the supervisory process.

A tendency for the board to appoint like-minded individuals or evidence of **cronyism** or **non-merit appointments** resulting in a potential deficiency in diverse skillsets and a lack of challenge. The background of board members is uniform and non-diverse.

Evidence that the **size and structure of the board** or other key committees act as an impediment to their correct functioning. For example, committee structures and scopes are unclear; or the board membership is too large to facilitate coherent discussion and decision-taking.

### Purpose and strategy

**A clear sense of purpose and alignment between strategy, culture and values**

A firm's purpose, strategy and business model reveal a great deal to its supervisors about its true culture and values and whether it strikes the right balance between commercial considerations and its regulatory and social obligations.

The alignment of company purpose, strategy and values to achieve long-term success was underlined by the Financial Reporting Council's (FRC) 2016 report, *Culture and the Role of Boards*, in which it observed that companies are "recognising the value in defining and communicating a broader purpose beyond profit which generates wealth and delivers benefits to society as a whole. This can help create shared goals, motivate employees, and build trust with customers."[13]

"A firm should have a statement of its purpose and values, which sets out what it is trying to achieve (purpose) – and how it will go about achieving this (values) [...] Translating the firm's core values into business practices and governance structures is important, because it ensures there isn't a gap between the firm's desired values and actual conduct."

**Greg Medcraft, then Chair, ASIC[14]**

### Positive Indicators

A **clearly defined purpose**, linked to the firm's culture and values and accompanied by a clear articulation of **expectations and behaviours** of staff across the firm, tailored for specific areas, for example, front line staff.

Evidence that the desired culture has been **adequately communicated** to staff at all levels, with feedback mechanisms, such as a whistleblowing process, to alert senior and line management to instances where the desired culture, behaviour or values are not being upheld.

The ability of employees at all levels of the organisation to demonstrate an **understanding and articulation** of the firm's desired culture.

### Negative Indicators

A **culture of "blame" or fear**, in which staff are reluctant to "speak up" or express contrary viewpoints; or a culture where staff are **reluctant to deliver bad news** to senior management (i.e. a good news culture) giving rise to the risk that issues such as policy breaches are not reported or treated seriously.

The existence of **micro or sub-cultures** that operate against rather than in support of the overall culture and values of the firm. For example, compliance cultures that do not consider business purpose, goals and objectives or recently acquired businesses in which the management team and practices have been left in situ and entirely undisturbed.

Leadership teams that are **overly optimistic, complacent and/or unquestioning** about their firm's culture. **Hubris** has also been identified as a trait amongst the management of firms that have failed to "question the direction of travel".

## Individual accountability

**Enhanced individual accountability for specific roles and responsibilities**

Individual accountability is seen by supervisors as a key requirement to create a strong personal incentive to align the firm's culture with the achievement of good outcomes. This means that at senior levels in particular, individuals can be held accountable for failings within their area of responsibility.

Various initiatives are underway globally aimed at enhancing individual accountability within firms. Many of these seek to achieve greater clarity as to the roles and responsibilities allocated to senior individuals by requiring them to formalise and document their role. In some jurisdictions, regulators have also introduced requirements aimed at improving standards of conduct at all levels. For example, in the UK, the FCA and the Prudential Regulation Authority (PRA) have introduced conduct rules that apply to all staff within a firm.

### Positive Indicators

Evidence of **clear lines of accountability** for senior managers and other key risk takers or function holders.

**Statements of responsibility** for senior managers or, where these are not required, other documentation (for example, unambiguous job descriptions) setting out individuals' roles and areas of responsibility.

Evidence of appropriate **disciplinary action** at all levels where policies and procedures are found to have been breached.

Firm-wide communications setting out expectations on **accountability and conduct** at all levels within the firm.

### Negative Indicators

**Overlapping or unclear allocation** of responsibility obscuring who is genuinely responsible.

**Matrix structures** operating in a way that, de facto, undermines the primacy of board governance and decision-taking.

Evidence of **reluctance** amongst senior staff at any level to be accountable for their role. For example, through the inappropriate delegation of responsibility to more junior staff.

Evidence that the senior management team is unable to demonstrate the appropriate **understanding, awareness and skillset** required of their role.

### Remuneration and incentives

**Remuneration and incentives that promote good outcomes for the firm, customers and the market**

Remuneration is seen as a key lever to incentivise employees to consider the long-term risks associated with their decisions. The restructuring of remuneration packages to include greater variability and clawback is expected to produce the right incentives to deliver positive, longer-term cultural outcomes.

Other incentives, including performance management and promotion are also seen as important mechanisms for achieving good cultural outcomes. As Mark Carney, Governor of the Bank of England and Chair of the FSB has commented: *"...we must move from an excessive reliance on punitive, ex-post fines of firms to greater emphasis on more compelling ex-ante incentives for individuals, and ultimately a more solid grounding in improved firm culture."*[15]

### Positive Indicators

Reward and incentives programmes that are **transparent** and **aligned to the achievement** of the firm's culture and the desired behaviour of staff. For example, rewarding call centre staff for the good treatment of customers rather than the number of calls they take.

**Non-financial "rewards"** such as applauding and communicating to the wider firm instances where staff demonstrate desired behaviours and values.

**Evidential controls and accompanying MI** to support the team/department and the individual review process e.g. balanced scorecard including behaviours that embed the firm's culture.

Evidence that **HR acts as a key partner** in firm-wide remuneration and incentive schemes to ensure consistency of process.

Quality and risk measures form a significant proportion of overall reward and there are **clear examples where poor culture, ethics or risk management affect remuneration status** and are actively discussed in firms' remuneration committees.

### Negative Indicators

Remuneration and incentive structures **that promote excessive risk taking or poor conduct**. Remuneration and incentive structures which may be a "red flag" for supervisors include: high bonus to salary ratios, 100% variable pay and high commissions.

Evidence of excessive **pressure being placed on sales teams or customer facing teams** to meet targets at the expense of good outcomes.

Evidence that **sales targets dominate** the criteria for rewards, specifically bonuses. Second and third line staff remuneration **materially influenced** by the firm's achievement of growth and volume targets; and by the views and feedback of first line staff.

Evidence that **"star performers"**, especially in the front line, **are not penalised** for breaching policies and controls e.g. limits on lending or selling to vulnerable customers.

### Governance and controls
**A culture that reinforces good governance and controls**

Here, the supervisory starting point is that culture can either reinforce or undermine firms' governance, risk and control frameworks. Post-crisis especially, regulators have sought to elevate the internal status of control functions. The European Banking Authority's (EBA) revised guidelines on internal governance stress, for example, that "institutions should develop and maintain… a positive attitude towards risk control and compliance within the institution…"[16]

Supervisors will be especially concerned if they consider that a firm's culture is attaching insufficient status and practical influence to the risk and other control functions leading to an inadequate "check and balance" on the firm's commercial instincts. They will also treat, as a warning sign, a confrontational approach towards the supervisory process, or one that seeks unduly to constrain supervisors' involvement in the firm's business.

Supervisors will assess risk awareness at all levels and whether there is a culture that promotes open debate, the frank acknowledgement of problems and the need for improvement.[17] Staff responsible for control functions will be expected to have the technical competence and standing needed to challenge both senior management and the business first line. Whether staff are given explicit responsibility for managing risk, and encouraged to raise issues and concerns, will be a further key supervisory focus.

### Positive Indicators

An **internal governance and internal control framework** that includes a clear organisational structure and well-functioning, independent risk management, compliance and audit functions.

**Internal audit** is attuned to cultural issues and routinely includes them in its reviews, as well as conducting culture-specific reviews.

A well-defined and embedded enterprise-wide **risk management framework** including appropriate risk appetite statements, limits and controls. Risk appetite limits set at an appropriate level and designed to act as an "early warning system" by triggering before a regulatory breach occurs.

The **risk appetite framework is comprehensive** and includes all material risks including non-financial risks (such as misconduct risk).

Evidence that the board has satisfied itself that **internal governance and control arrangements are effective** both from a design and operational perspective.

Evidence of consideration, at senior levels, of the **impact of strategic decisions** on risk (including conduct risk).

Evidence that the board has **full and direct access to the heads of internal control functions** and that control functions report regularly to the board (or executive committees), for example, through the presentation of risk dashboards.

Evidence or MI to demonstrate that **policies and controls are not regularly breached or over-ridden** by undesirable behaviours.

MI is collected and root cause analysis performed on **risk-related near misses**, in addition to genuine breaches of policy, to identify potential systems and control enhancements.

**Negative Indicators**

**Inadequate resourcing** (both financial and human) of control functions such that they are not able to provide adequate oversight.

Second and third line functions **lack status** and are treated as "tick box" or "window dressing" functions.

A **lack of representation of control functions or consideration of challenge** provided by control functions at board and executive committee levels potentially indicating a weak risk culture or a lack of status.

**Inadequate, uninformative or incomplete MI** which does not capture or monitor key risks or adequately address the risks that it has been devised to monitor. For example, culture-related MI that does not provide profiling across the organisation's customer bases (such as, geography, grade, business line) to identify "hotspots" to be celebrated and "coldspots" that require focused attention.

**Inadequate documentation** of policies, procedures and control frameworks.

Evidence that issues and **problems are not escalated appropriately** or there is a **lack of adequate remedial action**. For example, the same issues recurring.

**Ignoring risk control breaches**, or the excessive tolerance of such breaches, potentially indicating a poor risk culture and lack of employee understanding regarding the alignment between risk and behaviour.

The **absence of key controls and feedback mechanisms** such as a conflicts of interest policy and internal whistleblowing procedures.

The failure to **verify capability (skills and knowledge) and risk orientation or mindset** in hiring decisions, particularly in relation to the three lines of defence.

"...financial services providers [should] engage openly with regulators, and cooperate with them when problems arise. Firms should be working towards a culture of disclosure and openness – not just about problems to resolve, but also about their business challenges and risks. Ultimately, the goal should be a culture of 'no surprises' between firms and regulators."

**James Shipton, Chair, ASIC**[18]

### Mindsets and behaviours

**Mindsets and behaviours that reflect the firm's target culture and values**

Supervisors see mindsets and behaviours as a gauge of a firm's culture and of the risk it poses of misconduct, imprudent risk-taking or consumer and market detriment.

"We define culture as the typical, habitual behaviours and mindsets that characterise a particular organisation. The behaviours are the 'way things get done around here'; they are the way that we act, speak and make decisions without thinking consciously about it. And sitting underneath these behaviours or habits are mindsets inside people's heads; the beliefs or values that people feel are important."

**Jonathan Davidson, Director of Supervision, FCA**[19]

### Positive Indicators

A clearly **defined set of positive and negative behaviours** for staff at all levels within the firm.

The **mindset required to foster the firm's desired culture** is considered as part of recruitment, retention and succession plans.

Evidence that employees have a mindset that puts **"doing the right thing"** ahead of commercial or personal interests even when it is not prescribed. For example, "going the extra mile" for customers or a willingness to challenge undesirable behaviours.

Firm-wide initiatives to **promote ethical conduct and behaviours** such as a sensitive and constructive approach to internal whistleblowing and a framework to encourage open and ethical communication.

### Negative Indicators

Evidence of a mindset in decision-making that **fails to take adequate account of customer or market outcomes**. For example, the firm has not conducted a detailed analysis of its customer base to identify potential "pockets of vulnerability"; nor of the customer impact, and/or potential detriment, of its product design and distribution approach.

The firm demonstrates a **legalistic, "tick-box" mentality** towards regulatory compliance rather than considering the intended spirit of regulation or proactively responding to regulatory guidance before it is adopted as formal rules.

### The ultimate supervisory objective: securing a lasting change in behaviour and mindset

Regulators have repeatedly emphasised the importance of moving the industry away from short-termism and a "tick-box" compliance mentality towards an approach that puts regulatory priorities and public interest objectives (such as the protection of customers) at the heart of decision-making. The role that behaviours and attitudes or mindsets play in securing this shift is seen as key. Supervisors consider that unless these change, firms will have failed to learn from the mistakes of the past.

The importance of challenge to the appropriate management of risk and achievement of better cultural outcomes in firms is also a recurring cultural theme for supervisors: if appropriate challenge is not encouraged, accepted and acted upon, even the clearest articulation of a firm's culture and values, or the best designed control frameworks, will fail to prevent excessive risk-taking and misconduct.

> "If firms don't change the mindsets then they will run a very significant risk that old habits of behaviour will repeat themselves and we will see poor outcomes for consumers, poor outcomes for firms and individuals...and poor outcomes for markets and the industry."
>
> **Jonathan Davidson, FCA**[20]

Attitudes and behaviours can, however, be slow to change. The Banking Standards Board (BSB) annual reviews of culture in banks and building societies (2016 and 2017)[21] found that while there were many examples of desired practice and positive developments across the sector, there were still examples of attitudes and behaviours detrimental to the interests of staff, customers and clients. The reviews highlighted, for example, that almost three in ten employees were worried about the negative consequences for them of raising concerns (albeit this fell slightly, from 29% to 27% between the 2016 and 2017 reviews).

Supervisors recognise this slow pace of change in securing mindset shifts. As Jonathan Davidson of the FCA has pointed out, mindsets are developed and reinforced over years and the types of people who thrive in an existing culture are usually those whose mindsets are best suited to it.[22]

Focus on mindsets almost inevitably starts with the board. Institutions such as the European Central Bank (ECB), have set out specific expectations in relation to boards and challenge – boards are expected to ensure that their composition, competence and organisation promote effective challenge. The role and make-up of the rest of the staff are also important to ensuring adequate challenge within the business – firms that lack diversity are at greater risk of group think.

Even if the board appears to be culturally in the "right place", mindset shifts may not have percolated down the organisation. Where, therefore, a poor culture has been identified by supervisors, it will remain a serious concern for them until a firm is able to demonstrate persuasively, and hence objectively, including through MI, that they have achieved a durable change in mindset and accordingly behaviours at all levels.

The role of incentives and other people-related practices – not just financial compensation – in driving the behaviour and mindset of individuals within firms has often been highlighted by supervisors. Recently, supervisors have also started looking into the benefits of an approach to culture that builds on the lessons from behavioural science. One such lesson is the effectiveness of small, frequent "nudges" to encourage staff to raise key issues and develop better cultural outcomes than traditional mandatory training regimes.[23] Another is forging a culture that builds on individuals' desires to see themselves as "good people", which may be more effective than relying solely on financial incentives or the punishment of transgressions.[24]

## Why is culture so difficult to change?

Experience of culture change programmes launched by boards has often been patchy: there is the widely perceived "permafrost" syndrome, whereby middle and lower management and operational layers remain strongly attached to certain values and outlooks that the board wishes to change and are highly resistant, albeit often covertly, to the behavioural changes the board wishes to effect. Industry norms can also slow progress by creating a perceived first-mover disadvantage in cultural reform. Mergers and acquisitions, through forcing together two businesses (or parts of a business) with separate cultural identities, can frustrate or stall progress on cultural reform within a group.

The culture of a firm is often developed and reinforced over many years. Staff learn to adapt to it and how best to succeed within it. A firm's culture can, as a result, be extremely resistant to change. The best cultural change initiatives will, therefore, not be one-off exercises but long-term programmes, incorporating realistic expectations and supported by regular assessment and committed senior management.

Supervisors expect appropriate challenge between the board and senior management as well as between senior management and the rest of the business. They therefore see a key role for feedback and escalation mechanisms (including a robust whistleblowing policy) that encourage communication, bring alternative views into the decision-making process, and allow staff to raise concerns about poor practice and behaviour.

Supervisors are acutely aware of the barriers to cultural change albeit they may greet with some scepticism claims that middle and lower management are the only barriers to cultural change. Rather, where evidence of barriers to cultural change exist, supervisors can be expected to challenge the board and senior executives rigorously on whether the board is:

- exercising sufficiently consistent, concerted, top-down leadership on culture, as opposed to placing a sporadic emphasis on it;
- articulating and asserting its desired culture, and the values underpinning it, with sufficient vigour and coherence;
- putting in place the right executive team, in terms of background, outlook and incentivisation, to deliver the desired changes;
- providing all staff with the required training, resources and incentives to embed long-term change; and
- receiving sufficiently accurate and granular MI to establish whether it is succeeding in its cultural leadership and objectives and to track progress.

The best cultural change initiatives will not be one-off exercises but long-term programmes, incorporating realistic expectations and supported by regular assessment and committed senior management.

## Principles of culture MI

A firm's culture needs to be understood, assessed and monitored. Supervisors can be expected to assess critically how well a board is doing in that regard. Specifically, supervisors will challenge the board and senior managers on how they assure themselves that the business is achieving its strategic objectives in accordance with the desired culture and values of the firm.

They will ask in particular how the board can be confident that the culture it wishes to see is operating in practice and delivering acceptable outcomes, both from a regulatory and a strategic and commercial perspective. These supervisory challenges will lead inexorably to the question of what MI the board, board committees and senior management are receiving on culture. To be able to respond to this challenge, boards and senior managers need to be able to point to insightful MI which demonstrates how they understand, monitor and manage their culture.

In order to do this effectively, the first step is to articulate what "good" behaviours look like and choose appropriate metrics and indicators to measure these behaviours. MI on culture has to be drawn from diverse sources and impartially analysed and assessed.

In large firms, or diverse groups, boards and senior management need to recognise that there may be sub-cultures present. While there may be a strong rationale for the existence of these sub-cultures, they must be identified and appropriately monitored; for example, a fast-paced trading room may have a different culture to a bank branch dealing with vulnerable customers.

MI presented to the board and senior management should include insightful analysis, highlighting key messages, trends and identifying areas of concern and recommendations for action. Clear presentation and appropriate tailoring of information for different audiences are key.

The frequency with which cultural MI needs to be collected will depend on the circumstances of the firm but any analysis and assessment of cultural MI should take into account where a firm is at on its cultural journey. MI is expected to show peaks and troughs in certain metrics depending on the stage of cultural change.

To safeguard confidence in the accuracy of the MI, there should be appropriate governance around its design, monitoring and analysis. Equally important is the competence, knowledge, independence and authority of the team responsible for collating and analysing the MI.

**Figure C. The principles of good culture MI**

We set out eight principles for collecting culture MI which will help boards and senior management to assess and manage their culture.


Further detail on the principles of MI on culture is set out in our dedicated paper on this topic: *Management Information on Culture, Connecting the Dots.*[25]

# 4. How Deloitte can help

A decade on from the start of the financial crisis, a cultural thread now runs through all aspects of the global regulatory agenda. In Deloitte's view, promoting and instilling the right culture makes commercial as well as regulatory sense. Firms that target and achieve positive cultural outcomes are likely to be more trustworthy and appealing to customers and employees alike; such firms are thus better placed to achieve long-term sustainability. Conversely, cultures that fail to consider the impact of their actions and decisions on staff, customers and the market risk the firm's long-term future as well as regulatory scrutiny and censure in the short-term.

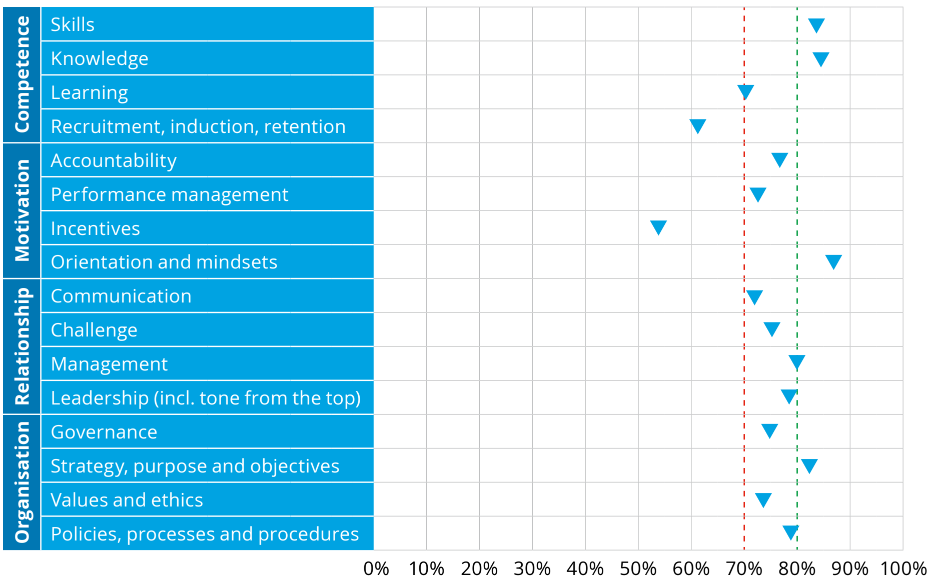
Supervisors look ultimately to boards to demonstrate that they are working to establish the right culture and have a clear, achievable strategy to disseminate it throughout the firm. Nevertheless, achieving enduring changes in culture is complex, and takes time, effort and persistence from senior leaders. Whilst supervisors will not expect to see overnight results, they will expect to see strong board engagement and responsibility, a clear link between the firm's purpose, strategy and stated values, and evidence that the right drivers are in place to secure positive outcomes.

### Culture Conscious: for rapid assessment, benchmarking and reporting on cultures

To help firms understand which influencers and/or drivers of their culture need the most attention, Deloitte has developed Culture Conscious, an automated culture database that enables rapid risk culture survey assessments with customised dashboard reporting, including benchmarking.

Culture Conscious surveys how well staff think their firm is performing against a comprehensive range of cultural indicators. It allows firms to evaluate and track their performance over time, identifying areas for improvement. The Culture Conscious database aggregates responses, allowing Deloitte to generate dynamic, sector-wide benchmarks against which results can be compared. The reporting includes Deloitte-identified thresholds, setting an independent measure of "what good looks like". For example, Figure D sets out an illustrative example from the Culture Conscious benchmark for insurers.

**Figure D. An illustrative example from the Culture Conscious benchmark**




**Deloitte thresholds:** 70% = measure of a "good" culture approach. Above 80% = measure of a "strong/desirable" culture

**Illustrative Benchmark:** % of positive responses

Source: Deloitte's Culture Conscious – illustrative example from the insurance sector benchmark

Our approach to measuring, strengthening and reporting on culture is based on Deloitte's Culture Assessment Framework for assessing the four main organisational influencers of culture across 16 key indicators. These influencers and indicators are set out in Figure E. Deloitte's framework includes human capital and risk management perspectives to give a "richer" measure of the culture across a firm.

### Figure E. Deloitte's Culture Assessment Framework

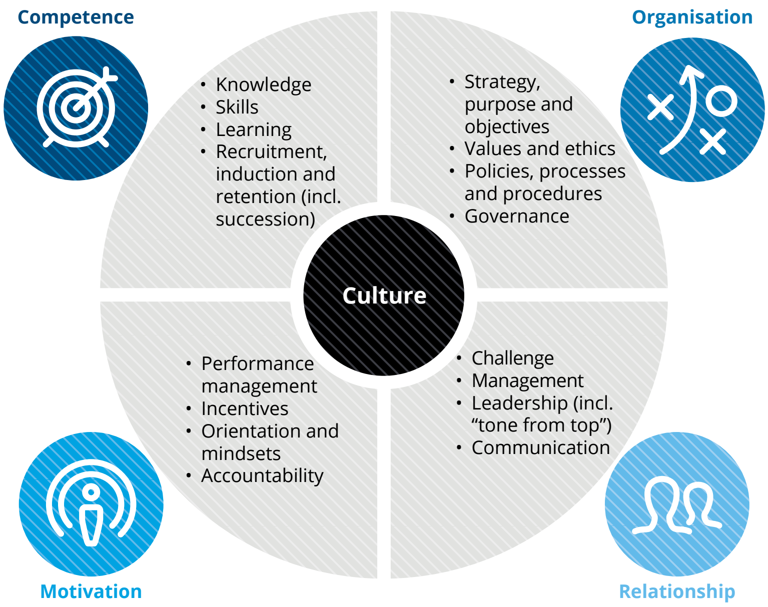
Deloitte's culture influencers

**Competence**
The collective competence of an organisation

**Organisation**
How the organisational environment is structured and valued

**Motivation**
The reasons and emotions which cause people to act the way they do

**Relationship**
How people in the organisation interact with others



# Appendix: How the regulatory focus on culture has developed since the financial crisis

The decade following the financial crisis has seen much reflection by governments, regulators, supervisors and the industry as to what went wrong and what can be done to prevent it from happening again. Informed by the conclusions of a series of reviews of individual failure cases, supervisors have become increasingly aware of the key role that poor culture played in driving excessive risk-taking and misconduct amongst some firms.

In this section we review the regulatory and supervisory response since the crisis and set out the evolving supervisory expectations in relation to culture.

### Lessons from the financial crisis

Key reports[26] into the causes of the financial crisis and subsequent misconduct scandals identified a number of common failings where cultural deficiencies played a key role:

- Failures of corporate governance and weak controls, in particular the problems of "group-think" and insufficient challenge.
- An unwillingness to be transparent in financial reporting and public disclosures as well as key product markets such as derivatives.
- Poor risk management leading some firms to act "recklessly, taking on too much risk, with too little capital, and too much dependence on short-term funding".[27]
- Misaligned incentives within a culture that normalised poor standards (e.g. the lowering of underwriting standards). Such cultures also permitted compensation schemes that all "too often rewarded the quick deal, the short-term gain–without proper consideration of long-term consequences."[28]
- Poor standards of accountability and ethics leading to the prioritisation of profit over prudential soundness, the fair treatment of customers and market integrity. Senior managers in many jurisdictions faced little prospect of serious sanction for such behaviour.

These failures (and wider market forces) contributed to the growth of cultures that, in many cases, led to poor and, in some cases, disastrous outcomes for individual firms, their customers, the market, and society as a whole. The strong emphasis that regulators and supervisors, both prudential and conduct, place on culture is a result of a wider strategic response by them to address the issues that underpinned the global financial crisis. The industry has also responded to the need to address culture. In the UK, for example, the independent BSB was set up in 2015 specifically to promote high standards of behaviour and competence across UK banks and building societies. A number of programmes have also been initiated by firms to develop and embed their target culture.

### Internal governance, risk management and remuneration

In the immediate aftermath of the financial crisis, regulators prioritised remedying the most obvious symptoms of poor culture, particularly poor internal governance, risk management and remuneration practices. In 2011, the EBA issued guidelines on internal governance which included consolidated and strengthened requirements in areas such as risk management, board oversight and internal controls.[29]

This was followed by a number governance-related reforms in EU Directives, specifically, the Capital Requirements Directive IV and, later, Markets in Financial Instruments Directive II and Solvency II. The aim was to strengthen board oversight to address imprudent risk-taking and promote a sound risk culture. Recently, the EBA strengthened its guidelines to focus the attention of the management body to risks posed by complex or opaque corporate structures and to improve transparency.[30]

The competence and skills of senior management has also gained regulatory attention. The European Securities and Markets Authority (ESMA) and EBA released guidance[31] setting out criteria to assess individual and collective knowledge and skills and experience of members of senior management.

Regulatory efforts have also been made to tackle the misalignment between the timing of risk and reward. The FSB's Principles and Standards on Sound Compensation Practices[32] focused on remuneration practices that promote the sound management of risk by aligning employees' incentives with the long-term profitability of the firm and link compensation to performance (individual and collective), as well as setting out requirements on deferral, vesting, clawback and limitations on guaranteed bonuses.

Repeated episodes of misconduct have also sharpened regulatory attention to the link between compensation and conduct. The FSB has recently issued supplementary guidance[33] to provide firms and supervisors with a framework to consider how compensation practices and tools can be used to reduce misconduct risk and address incidents of misconduct.

### Enhancing individual accountability

One reaction to the financial crisis was widespread frustration at how accountability for serious corporate failure could not, seemingly, be attributed to individuals and how few senior individuals faced regulatory sanction as a result, despite the profoundly adverse impact of the crisis on society at large.

Supervisory expectations prior to the crisis were largely focused on the board and senior management as a collective body. The focus has now shifted to individual accountability. The best known initiative is, perhaps, the UK's Senior Managers and Certification Regime. This regime prescribes specific roles to senior managers (including, for many firms, the responsibility for the leading the development of the firm's culture and overseeing the adoption of the firm's culture, which typically fall to the Chair and Chief Executive respectively) and requires that the responsibilities of senior managers are mapped comprehensively through "responsibility maps". These requirements are leading many senior managers in the UK to undertake culture assessments in order to demonstrate that they are meeting their responsibilities.

We observe a number of other international regulatory efforts to address the theme of individual accountability – Australia recently legislated to introduce a new Banking Executive Accountability Regime which requires the registration of senior executives and directors of deposit-taking institutions, as well as the development of accountability maps. In Hong Kong, the Securities and Futures Commission has introduced the Managers-in-Charge framework for all "licensed corporations" in the territory. The FSB has also produced a toolkit for firms and supervisors to use to manage misconduct risk. This includes tools to mitigate cultural drivers of misconduct, to strengthen individual responsibility and accountability, and to address the issue of "rolling bad apples" (where individuals can move firms without disclosing their history of poor conduct). [34]

### The supervisory response – a focus on indicators of desired and undesired culture

In parallel with these regulatory initiatives, supervisors have increasingly sought to identify failings in culture through their "business as usual" supervision.

Some supervisors have set out a holistic approach to addressing culture in supervision. De Nederlandsche Bank (DNB) has played a leading role in developing a culture-based approach to supervision. In the UK, the FCA has identified culture as a cross-sectoral priority and stressed the need for the financial services industry to achieve and embed cultural change. It intends to use its supervisory tools to demand high standards of conduct and ensure that firms' management maintain culture as a top priority.[35]

Others are exploring specific aspects of culture through their supervisory activities. The ECB's review of risk governance and risk appetite in the banks it directly supervises has addressed cultural aspects through, inter alia, exploring how the board makes important decisions and the quality of the debate surrounding those decisions.[36] In Ireland, the Central Bank is working with DNB and is undertaking behaviour and culture assessments at each of the five main Irish lenders, focusing on how firms identify and manage consumer risks.[37] This approach may well be extended to other sectors.

In Australia, the Australian Securities and Investments Commission (ASIC) is running two pilot projects to implement its approach to culture – in relation to the sale of direct life insurance and breach reporting practices. Both projects consider whether the firm has stated values that focus on delivering good consumer outcomes and supporting strong compliance – for example "doing the right thing" by their customers, as well as accountability, integrity, and honesty. ASIC will then consider how these values are embedded in the policies and processes of the organisation and translate in to actual behaviour "on the ground."[38]

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