“Hard” Responses to Financial Crises

- At least since 1929: new laws, stricter regulations, often entirely new regulatory agencies; top-down model
- Similar pattern post-2008
- Problems identified: excessive leverage and risk-taking; interconnections between loosely-regulated and heavily-regulated banking activities; executive compensation systems that rewarded leverage and risk; growth of too-big-to-fail financial (TBTF) institutions
“Hard” Responses to Financial Crises

- *Technical solutions*, in U.S. and internationally: e.g., increasing capital requirements; requiring “living wills” from systematically important financial institutions (SIFIs); central bank stress tests; restrictions on executive compensation and dividends
- *Corporate governance solutions*: establishing risk management board committees; enhance board and senior executive oversight of firm risk-taking
- Are they likely to work? History says no
- Good thing we’re better at planes

“Soft Law”– a Cultural Solution?

- *Soft law* solutions – a/k/a new governance, collaborative regulation, etc. – have become increasingly popular in many regulatory environments
- Norms and principles versus strict requirements; bottom-up approach; the regulated collaborate with regulators in developing norms, standards, and fixes
- E.g., the *Equator Principles* for international project finance
- Potential upside: more realistic diagnoses and prescriptions, enhanced compliance
- Downside: lack of hard dis/incentives; fox in the henhouse
“Soft Law” – a Cultural Solution?

• Post-2008, many global banking authorities advocating for “ethical corporate cultures” in SIFIs as a preventive: Bank of England, US Federal Reserve, ECB, IMF, etc.
• B of E’s Mark Carney: “Fundamental change is needed to institutional culture, to compensation arrangements, and to markets”
• Already, a tentative “cultural turn in compliance” (Langevort)
• In U.S., e.g., deferred prosecution in some cases, mitigation of criminal penalties in others, where defendant company’s corporate culture included apparently robust systems for ensuring compliance with the law

“Soft Law” – a Cultural Solution?

• But these examinations of culture have occurred after the fact in assessing corporate culpability
• What’s new in reaction to the 2008 crisis – largely in Europe – is an intensive and explicit effort by regulators to shape corporate cultures prospectively
• E.g., UK’s encouragement of industry self-regulation of culture through the Fair and Effective Markets Review; EU regulators have identified “misconduct risk” as an object of financial supervision
• Despite prominence of culture – a group concept – these strategies are primarily focused on individuals and individual responsibility, through government screenings of the fitness of directors and managers of SIFIs (Fit and Proper)
By the Way: What is *Culture*? (Anthro 101)

- Ubiquitous corporate buzzword, stolen from us anthropologists – we’re not happy about that
- Anthropology’s core meaning (from 1800s): *Culture* is a set of generally shared beliefs, values, symbols, objects, technologies, and practices that characterize a particular group of people and help to define their way of life, to themselves as well as outsiders
- I.e., the things that are taken for granted by the members of a group

By the Way: What is *Culture*?

- Early anthropology emphasized its constraining, deterministic aspects – *slaves to culture*
- Contemporary anthropology’s view: Culture seen less as a set of constraining *rules* and more as a bundle of shared *resources* that members of a group draw on to organize and make sense of reality and to guide them in their daily lives
- *Resistance* to cultural norms is usual, not pathological; a significant force in the never-ending process of cultural change
- Just as culture helps to shape individual behavior, that behavior influences the abstraction we call culture
Unresolv ed Questions About Culture

- Is culture an independent reality, or is it simply a description imposed on many observed instances of individual behavior?
- How does the developing individual acquire culture (beyond the vague and unhelpful “through teaching and learning”)?
- How does the individual come to accept certain aspects of culture and reject or resist others?
- How much does culture truly constrain the individual?
- How does the individual help to shape culture?
- How, in concrete terms, does culture change?

Applying Culture to the Corporate Context

- Anthropologists have extended the study of culture from traditional societies to, e.g., corporations, financial institutions, professions, and government bureaucracies
- Culture has emerged recently as a central concept in organizational psychology and management studies – similar definition
- The basic definition works in the corporate context
- The preceding questions all apply and are equally unresolved
- But anthropology bases its analyses on long-term, patient ethnography – not a one-day retreat staged by a self-promoting consultant
- (Think we’re bitter and jealous?)
DNB Takes Banking Culture Seriously

- De Nederlandsche Bank (DNB) – the Dutch Fed, with similar mandate to supervise Dutch banking system
- Beginning in 2009, DNB initiated program for Supervision of Behaviour & Culture (B&C)
- Began with staff reviewing organizational psychology, leadership, decision-making, and corporate culture literatures to provide a “scientific basis” for B&C
- Staff members have backgrounds in psychology – \textit{not} anthro

The B&C Process
(from B&C Documents)

- (1) \textit{Context analysis}: understand the institutional environment to establish a focus for the inspection
  - “Desk research” and consultation with DNB finance supervisors; examine bank’s strategic priorities, operational issues, and governance arrangements
  - Chosen focus could involve decision-making, leadership, communication, or group dynamics
- (2) \textit{Risk identification}: self-assessments by board members, surveys, interviews, and \textit{board observations}--
The B&C Process

- At a board meeting, B&C staff observes group dynamics among board members, behaviors of those in leadership positions, and how open the communication is
- Looking for bullying, suppression of contrary views
- Do they get a staged performance?
- (3) **Risk assessment**: develop preliminary conclusions about positive or negative behavioral patterns; “peer challenge” sessions with interdisciplinary teams of other DNB staff; then recommendations finalized

The B&C Process

- (4) **Risk mitigation**: “challenging dialogue” with the bank’s board and relevant members of management, with ongoing evaluation and monitoring as necessary
- “Raising awareness of blind spots and risks and being explicit about expectations concerning effective, sustainable mitigation”
- Where findings suggest serious risk, DNB shifts to “intrusive supervision” and becomes directive about actions it expects the board to take in short order
- Finally, DNB monitors the effects over time, to see the efforts the financial institution is making and evaluate the “tangible effects of the interventions implemented”
Does it Work? — Our Project

- 25+ lengthy interviews of: DNB staff members involved in B&C supervision; executives at financial institutions supervised by DNB; members of the “consultant community,” including lawyers and other professionals, service providers, and advisors who work with the banking industry
- Follow-up qualitative analysis
- Three general topics: description of the person’s experiences with B&C supervision; an evaluation of how effective the person believes B&C supervision to be; and suggestions, if any, for future improvements
- Beyond those topics, let subject lead the interview in particular directions

What We Heard – Major Themes
What is DNB Looking For?

- Bankers ask: Does DNB have an idea of what they’re looking for? Or--
- What’s DNB’s idea of a good culture or a bad culture?
- DNB says it “has no intention of qualifying cultures as ‘good’ or ‘bad’”
- “Engaging in dialogue and holding up a mirror (which can be somewhat confrontational) are the most appropriate instruments”
- But people in banks, insurance companies, and pension funds being supervised seem reluctant to believe that DNB really doesn’t evaluate cultures as “good” or “bad,” leading to some distrust

Culture is Hard to Define – Ask Any Anthropologist

- From organizational psychology: “culture as values, culture as stories, culture as frames, culture as toolkits, and culture as categories”
- Or culture as “a pattern of shared basic assumptions that the group learned as it solved its problems of external adaption and internal integration, and that have worked well enough to be considered valid and, therefore, to be taught to new members as the correct way you perceive, think, and feel in relation to those problems”
- Unlike anthro, org psychologists ask and answers questions about cause and effect in cultural formation, continuity, and change; and the relationship between culture and the individual
DNB Has to Answer Those Hard Questions –

- When it observes CEO bullying members of board: Is it individual pathology, remedied by replacing the offender? Or evidence of a pathological culture, requiring an organization-wide remedy?
- Can new cultural norms be taught? Can they be imposed on subordinates by superiors, or must they arise from the ground up? Or could they even arise from outside forces, such as regulators or regulations?
- What motivates people to accept culture change?

DNB on Healthy v. Unhealthy Cultures

- **Healthy**: openness to others’ ideas is valued; differences of opinion are expressed and discussed; there is time for process-based reflection on how decisions are being made
- **Unhealthy**: do not value countervailing views; leaders will not listen to others’ views, or, on the contrary, are not decisive; problems are either buried or subjected to quick fixes; individual employees are blamed; very little thought is given to root causes of the problems
Bankers Say:

• “I think it’s extremely important, culture . . . But there, as it’s more of a soft thing, it must be extremely difficult to implement, but I think it’s one of the major things that can make the success of a financial institution. It’s the basis.”

• But: “If you give people who are unskilled in that, that toolbox you create a monster, if you’re not careful. I’m being a little bit dramatic but you see what I mean. I mean you can really misjudge the whole thing if you don’t know what culture is, what behavior is, what psychology is, how it works.”

DNB’s Focus on the Top

• DNB: “leaders communicate their preferences [throughout the organization] through role modelling, feedback, choices, and the use of rewards and sanctions”

• Bankers: B&C’s “main goal is to assess the role of the CEO in a meeting of the board”; “it was all CEO domination or not”

• DNB’s approach may fail to catch not only how culture trickles down, but also how it trickles up:

• “I can see that the top is changing things, from the bottom there are different types coming up, and they meet somewhere in the middle, where we have in the end who really change the culture, and that’s middle management. Middle management is the most important change agent in the bank.”
Principles Versus “Box-Ticking”

- **DNB**: “B&C supervision is — and should be — based on broad principles rather than specific attributes and behaviors.”
- **Bankers**: “It’s not about ‘trust me.’ It’s about ‘prove [to] me, show me.’ It’s about forms. It’s about reports. It’s about a tsunami of data gathering, about more I would say rules instead of principles. . . to put it bluntly, I can be an asshole, but if I report completely and timely all the forms that are in place, I’m a very good bank manager.”

Principles Versus “Box-Ticking”

- **And**: “They are struggling in, how do you measure culture? I mean at the end of the day, they have to depend on numbers and say the number of incidents and stuff that takes place.”
- **But on the third hand**: “If you turn from rule-based to principle-based, you cannot make the principle-based laws and regulations, turn them into rule-based according to your own principles. Because then you are an unreliable lawmaker and there’s no democratic control.”
“Real” Behavior Versus Mere Performance

- **DNB**: “Board observations are a controversial part of the behavior and culture inspections. . . . Of course observing one board meeting isn’t enough to draw major conclusions.”

- **Bankers**: “The board members said to each other prior to the meeting, ‘OK guys, we have to be on our best behavior because we have these two people looking at us.’ But then after five minutes it sort of falls into the background and you don’t notice anymore.”

“Real” Behavior Versus Mere Performance

- His board works through its disagreements *before* the meeting that DNB will observe, lest the supervisors misinterpret disagreement as a sign of dysfunction:
  - “We are not going to display the disagreements because they [the supervisors] might completely misinterpret our disagreements. The disagreement is good, but they cannot deal with disagreement on these topics, because they will interpret it completely the wrong way.”

- **We note**: seems odd, given that B&C supervisors (and many bankers) repeatedly told us that robust debate is a sign of a healthy culture
Is B & C Supervision “Toothless,” Or Is It Too Strong?

• Is B&C just a “talking shop,” with DNB unable or unwilling to enforce its views?
• If so, do banks fail to take it seriously?
• Or, conversely, are B & C assessments feeding sub silentio into Fit and Proper evaluations of supervisory and management board members?

Is B & C Supervision “Toothless,” Or Is It Too Strong?

• DNB: B&C’s powers are to challenge, to continue to monitor, to come back for more interviews, and to feed their risk assessments into the traditional supervisors’ ongoing reviews
• In cases of immediate threat: “intrusive supervision and boosting pressure on the financial institution”—hasn’t happened
• No Fit and Proper connection
Is B & C Supervision “Toothless,”
Or Is It Too Strong?

• Bankers: (1) “B & C is toothless”--DNB does not enforce its assessments with strong sanctions
• (2) “B&C has too much undemocratic power, because it can enforce its assessments through various means not set out in regulations” (Can you say Brexit?)
• And: “Every meeting with the DNB is part of my Fit and Proper” evaluation

Bottom Line: How Effective is B & C Supervision?

• DNB: If nothing else, B&C holds up a mirror in front of bankers and compels them to look into it
• Ultimate value lies in the depth of the external and self-assessment that it brings about
• Sometimes initial resistance to findings breaks down
Bottom Line: How Effective is B & C Supervision?

• Bankers’ judgments vary widely
• (1) B&C reaffirmed their belief that they have a well-functioning institutional culture: “They said your culture’s okay; why should we ask questions?”

Bottom Line: How Effective is B & C Supervision?

• (2) “A very fruitful and also very useful exercise to go through . . . I appreciated it, and obviously out of that came a couple of remarks that I didn’t like because they reflected my personal behavior and my personal leadership style, but nonetheless very useful to have that mirror be put in front of your face and do something with it.”
**Bottom Line: How Effective is B & C Supervision?**

- (3) DNB “is being pushed by politicians . . . their own leaders have no clue”
- B&C “something of a hobby of the field psychologists”
- And for some senior bankers, those psychologists are too young—and maybe too female
- Perhaps assessment is generational

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**Does It Work? Our View**

- The process is potentially useful (the mirror), probably harmless at worst
- It does focus attention on important non-financial issues
- The undemocratic critique reflects the EU’s most fundamental problem
- Hard (impossible?) to prove/disprove that it works—like garlic and vampires
If B&C Does Have Value, Is It Exportable?

• A distinctively Dutch “horizontal” thing?
• Mixed evidence on how B&C is being received elsewhere in EU, and even within DNB
• Dutch banking community is probably smaller than Charlotte’s—would this scale up?

If B&C Does Have Value, Is It Exportable?

• Would this deference to experts (see DNB’s Expert Centre) sell in the U.S.?
• Especially psychology experts?
• Larger concerns about soft regulation:
  • From the anti-bank side: it’s soft; fear of regulatory capture; will President [insert name] want to collaborate with banks?
  • From the other side: it’s unbounded and subjective; governance by experts is undemocratic