BANK OF ENGLAND

Speech

Culture in financial services – a regulator's perspective

Speech given by

Andrew Bailey, Deputy Governor, Prudential Regulation and Chief Executive Officer, Prudential Regulation Authority

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It is good to be at City Week again. Also, congratulations on the welcome approach to the geography of City Week – bringing it to the Oval means that for those of us who live south of the river, we don't feel that the City always involves crossing into that other land north of the river. Whether the culture is different south of the river is for everyone to judge.

I am going to speak today on the subject of culture in financial services. For the avoidance of doubt – and in view of recent history – I want to start with what I intend as an unambiguous statement, namely that the culture of firms and the people that make them up - and of course therefore the culture of industries insofar as it can be generalised – is of the utmost importance to financial regulators. Culture matters a great deal. And this is true for both conduct and prudential regulators. Today I am speaking as the CEO of the PRA, but at the beginning of July I will become the CEO of the FCA.   One thing that this move does not require is a change of view on the importance of culture in firms.

There is a reasonable debate about what is culture, but that is not a debate about whether it is important. In my view, culture is a product of a wide range of contributory forces: the stance and effectiveness of management and governance, including that well used phrase "the tone from the top"; the structure of remuneration and the incentives it creates; the quality and effectiveness of risk management; and as important as tone from the top, the willingness of people throughout the organisation to enthusiastically adopt and adhere to that tone. Out of this comes an overall culture. It is not something that has a tangible form. As supervisors, we cannot go into a firm and say "show us your culture". But we can, and do, tackle firms on all the elements that contribute to defining culture, and from that we build a picture of the culture and its determinants.

Culture has a major influence on the outcomes that matter to us as regulators. 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. Culture has thus laid the ground for bad outcomes, for instance where management are so convinced of their rightness that they hurtle for the cliff without questioning the direction of travel. We talk often about credit risk, market risk, liquidity risk, conduct risk in it's several forms.   You can add to that, hubris risk, the risk of blinding over-confidence. If I may say so, it is a risk that can be magnified by broader social attitudes. Ten years ago there was considerable reverence towards, and little questioning of, the ability of banks and bankers to make money or of whether boards demonstrated a sufficient diversity of view and outlook to sustain challenge. How things have changed. Healthy scepticism channelled into intelligent and forceful questioning of the self-confident can be a good thing. In turn, culture matters to us as financial regulators because it can, left alone, tend to shape and encourage bad outcomes, but it doesn't have to do that.

What can we do therefore as regulators to shape and influence better outcomes on a more consistent basis? Let me start with one thing that we cannot do. As regulators, we are not able, and should not try, to determine the culture of firms. We cannot write a regulatory rule that settles culture. Rather, it is the product of many things, which regulators can influence, but much more directly which firms themselves can shape. We seek to ensure that firms have robust governance, which includes appropriate challenge from all levels of the organisation; and promote the acceptance that not all news can be good and the willingness to act on and respond promptly to bad news. We insist that remuneration is structured to ensure that individuals have skin in the game, namely that a meaningful amount of past remuneration is retained or deferred and for senior people is at risk should problems then emerge. We require that risk management and internal audit in firms are effective and act to root out poor incentives and weak controls. All of this is important and central to what we do as regulators, but let me reinforce the point that culture begins and lives, and I am afraid dies, at home, with firms.

It is not for us as regulators to prescribe culture, that would not work. Firms and their management have to want good culture. But we can have a lot of influence here. In the last few months we have taken a very important step here by introducing for banks the Senior Managers and Certification Regime, as proposed by the Parliamentary Commission on Banking Standards. It replaces the Approved Persons Regime, and in time it will be implemented across the regulated financial services sector.

There is, let me be clear, no magic bullet to change culture, but the new regime is a big step forward in my view. This is because at its heart it embeds the notion of personal responsibility for the affairs of the firm at the level of senior management. The Approved Persons Regime did not do this, and in practice it focused on a notion of culpability not responsibility. These two notions are different. I have said many times, but will keep doing so, that senior managers cannot delegate responsibility. To be fair, many have said to me over the last few years that this change does not make a difference for them as they always thought they were responsible. Good. But, set this against other conversations I have had which have doubted the enforceability of this notion of responsibility. This has concerned, but not distracted me. So, to be clear, responsibility is the central plank of the new Senior Managers Regime. We do want senior managers to feel this responsibility in all that they do and that includes a responsibility for forming and implementing a positive culture throughout the organisation. In this respect culture is no different to strategy; where are we today, where do we aspire to be tomorrow, how will we get there and what risks must we mitigate along the way.

Responsibility, as embedded in the Senior Managers Regime, is therefore an important hook to assist in firms' shaping their own culture, and also to provide regulators with the powers to conduct supervisory oversight and to act when needed. But, let me reiterate that it is not the job of regulators to enforce culture and to change culture. If we have to step in, and occasionally we do, the overriding conclusion is that management has failed.

The common theme there is that the incentives facing a firm will determine its culture and will determine its success in terms of outcomes. One of the most important elements of the regulatory changes since the crisis is that we have adopted an approach of seeking to align those incentives with our public interest objectives as well as the private interest of the firm. You can also see this in our approach to the too big or too difficult to fail problem where the actions we have taken on loss absorbency are designed to create the right oversight incentives for shareholders and bondholders by literally putting them at risk of loss. This will without doubt have an effect on culture.

I want to end with a few broader reflections on the role of culture. The basic difference between the role of the regulator and management of firms is that our objective is framed exclusively in terms of the public interest. For firms, it is important to recognise that a sustainable and viable business model is one that provides an acceptable rate of return to those who take the risk of providing the necessary loss absorbing capacity, typically its risk capital. Firms exist to service customers who make up the public interest, which of course means that service includes the notion of not exploiting customers, a value one might expect to be given in an organisation's culture. Today, the public perception of banking, and some other areas of finance, remains too much towards the exploitative "Greed is good" end of the spectrum. Major changes have occurred since the crisis which have improved behaviour in firms, but public opinion broadly does not recognise these developments and tends to think that nothing has changed. Culture is an important part of demonstrating that change.

Now, I do see evidence of that change happening, and a big challenge for all of us, regulated and regulator is to do all that we can to keep pushing that change forward. In some cases I think there should be greater clarity in terms of the outcomes that firms are seeking from the changes they make, how progress is assessed and whether there is sufficient consistency across the organisation. These are all points that I know from my discussions with them are in the sights of Colette Bowe and Alison Cottrell and their colleagues at the Banking Standards Board, and I welcome the work they are doing. It is of course very reasonable to ask what as regulators we can do to further the goal of restoring trust through strong culture. I have set out what I see as the important role of the Senior Managers Regime. Going beyond that, in the PRA from the outset we have emphasised that we are a forward-looking supervisor of firms, and at the heart of our approach is the application of judgement set against a framework of rules. We cannot write a rule to take care of every situation that may occur, and as a forward looking supervisor we are applying judgement in conditions of uncertainty about the future. How firms deal with the uncertainty of the future will also shape their culture. I firmly believe that what we can best do in this area is to provide a clear sense of direction and guidance through open communication starting with those of us at the top, in which we are clear on what we expect of firms. Open and transparent communication of this sort should then be supplemented by the clear understanding that we will all stick to the script.

Trust is important. Consumers need to be confident in the firms that they choose to use, and inevitably trust is an important part of that confidence. Likewise, as supervisors, our judgements are inevitably conditioned on whether we can trust the people with whom we deal. Good culture is a product of trust and it matters a lot for both prudential and conduct regulators. Culture is everywhere and nowhere in firms; everywhere in the sense that it is shaped and determined by all the features of the firm – its people, organisation, reward structures etc; and nowhere because culture is not a tangible thing sitting on a shelf that can be prodded and changed of itself.

A change of culture is possible and as the England Cricket team has demonstrated to our great enjoyment, a lot can be achieved in a short space of time where there is commitment.

Thank you