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Culture and Ethics: A New Crucible for Regulator Thinking?

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Summary

- The FSA is right to recognise that a firm's culture has a powerful influence on the decisions that firms make and the behaviours that encourages. It helps explain why some companies appear not to have learnt the lessons of the recent financial crisis.
- A firm's culture is a complex web of influences and identifying the key drivers needs insight into quite deep seated issues. This makes them difficult to assess and so turns culture into a potentially unwieldy tool for a regulator.
- The FSA will find it difficult to avoid making judgements about appropriate behaviours; they may not like to talk about ethics or professionalism, but that's what it is.
- Conducting a review of their own culture would provide the FSA with insight into how effective culture could be as a regulatory tool. It would help them understand how it has influenced their successful, and less successful, moments.
- Insight into a firm's culture provides insight into what makes that firm successful; the FSA should put that message at the heart of how it moves forward with culture.
- The proportionality of a new initiative on culture will be a hard argument to carry with the Government, whose 'one-in, one-out' rule for new regulations creates a high hurdle to overcome.
- Cutting through the complexities of culture to focus instead on only a few of its attributes risks skimming over and missing what is really driving a firm's culture. It may however be the only practical way forward. If so, the FSA should use the language of those attributes, rather than talk about the much wider 'culture'.

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CII Introduction: While much of the debate about the current review of UK financial regulation has focused on the architecture and institutions, there is relatively little dialogue around the cultures which the regulation proposes to instil. In this thinkpiece, corporate responsibility and business conduct consultant Duncan Minty uses recent speeches by Hector Sants as a starting point for arguing that culture could form a part of the regulatory environment, but that it create some challenges. Duncan recommends that in order to understand how to widen the adoption of culture as part of a regulatory approach, the regulator must first assess its own culture and look at the strides being made through voluntary market led initiatives.

Public confidence in the financial markets is in short supply at the moment. As confidence in those markets has repercussions for confidence in the market's regulator, it's not surprising that some creative thinking has been taking place at the Financial Services Authority (FSA).

One new idea that has emerged is about the culture of judgements and behaviours that exist within regulated firms. The FSA's thinking has been outlined in two speeches this year by its chief executive, Hector Sants. He argues that: *"...some of the causes of the crisis were deeply rooted in behavioural or cultural issues that resulted in actions and decisions by senior management that can be seen to be at the root cause of their firm's demise."*

He goes on: *"...even after all the 'supposed' lessons learnt exercises, we are still seeing some decisions by senior management in major firms that we judge not to be prudent."*¹

There's a tinge of exasperation in Sants' speeches. The FSA clearly doesn't like it when some regulated firms simply refuse to learn what the FSA sees as obvious lessons from the financial crisis. They want to make sure that the judgements and behaviours of some senior managers really do change. Regulatory action around culture appears to be one of the sticks being sharpened to encourage that change.

Culture and Business

So what is meant by the culture of a firm? It can be summed up as 'its character': in other words, a combination of its values, traditions, customs and behaviours. It's the way in which things get done.

¹ [Can Culture be Regulated?](#) speech by Hector Sants at the Mansion House Conference on Values and Trust, 4 October 2010. See also FSA speech on 17 June 2010.

"Some of the causes of the crisis were deeply rooted in the behavioural or cultural issues that resulted in actions and decisions by senior management to be seen at the root cause of their firm's demise" (Hector Sants)

Culture exists at a number of different levels within firms. There's the observed level, made up of such things as how offices are arranged, how people dress and how you see them interacting with each other. Think of how the offices of software designers may compare with the offices of actuaries. Then there's the stated level of culture, which the firm uses to communicate its values and how its people are to behave. Think of those mission and values statements hung on office walls and how a brand is communicated. Lastly, there's the underlying level, made up of the thinking that drives the actual behaviour of the firm's people and their attitude to new situations and recruits. Think of all those hints and frowns around the coffee machine.

A firm may prefer to think in terms of having just the one culture, but there will invariably be subcultures operating within it over time. The internal audit team could pick up on and interpret some of the culture messages from its firm's leadership, in a quite different fashion to other culture messages picked up by the tele-sales team. With culture operating at different levels and in discrete pockets within firms, it is hardly surprising therefore that what you see on the surface is often a far from complete picture. Powerful undercurrents are invariably at play.

Culture and the FSA

So this is not a step that one imagines the FSA is taking lightly. Culture is a complex issue that can be difficult to assess accurately. The FSA is not starting from scratch however – their Treating Customers Fairly (TCF) initiative incorporates a culture framework that has been built around six key drivers: leadership, strategy, decision making, controls, recruitment, training/competence and reward. Each of these comes with a set of indicators of a compliant culture and a set of indicators of a non compliant culture. This is an example of one of the 'culture indicators' making up the 'reward' driver:

Indicator	Reward Driver	Contra-Indicator
The firm treats all staff fairly and understands the impact both formal and informal recognition has on staff. The firm's success measures recognise the importance of the fair treatment of customers.	Recognition	Management give formal or informal recognition to employees that excel in making profit or sales without consideration of the fair treatment of customers. These actions encourage other employees to act in the same way.

The FSA's experience of their TCF culture framework has clearly been sufficiently positive for them to contemplate making further use of culture.

And the FSA is not alone in turning to culture for regulatory purposes. In the United States, federal courts use guidelines for how sentences and fines for corporate misbehaviour are determined. In 2004, these were extended to take account of the extent to which a company had promoted "...an organisational culture that encourages ethical conduct..."² If a firm can show that it had taken steps to embed a culture of responsible judgements and behaviours, then it would hope for some leniency, for example in how big a fine it had to pay for a misdemeanour.

Culture, Ethics and Professionalism

There are different dimensions to culture within a firm: how status and rank are identified, and how its people tackle problems, are two examples of 'how things get done round here'. Sants' interest in culture is centred around what he calls 'good decision making' and how that influences managers' scope to act with integrity. The thinking is that good decision making will signal to regulators that the firm has the right ethical framework.

Rather surprisingly, Sants makes no mention of professionalism in either of his speeches, despite it being synonymous with a culture of good decision making, and judgements and behaviours taken with reference to a clear ethical framework. Leading firms in the financial markets haven't felt so constrained however, as seventeen chief executives demonstrated in a recent letter to the Financial Times: "*The recovery of a stronger sense of service through reinforcement of a culture of professionalism will both benefit the financial services industry and those who work in it as well as furthering the common good*".³ The Government is clear on this too, with a coalition agreement that carries the clear message for regulators that their focus should be on improving professional standards in high risk organisations.

If both executives and employees see culture and professionalism overlapping, then this needs to be factored into any assessments of culture that the FSA undertakes.

This may seem to give undue weight to one word, but it is something around which care needs to be taken, for any initiative on culture enters a minefield if it is not undertaken with a common language. If both executives and employees see culture and

² The guidelines are on the website of the United States Sentencing Commission: www.ussc.gov

³ [Financial leaders pledge excellence and integrity](#), letter from Marcus Argus and 16 others, *The Financial Times*, 29 September 2010.

professionalism as overlapping, then this needs to be factored into any assessments of culture that the FSA undertakes. So for example, if an individual feels the professional ethics she's working to are being compromised by her firm's inappropriate culture, then she will tune into the FSA's message more quickly if it is expressed in language she can more readily understand.

Whose Ethics Anyway?

So what does a culture of good decision making that supports 'acting with integrity' look like? Can it be expressed through a good ethical framework? Sants was quick to address this in both of his speeches, by squashing the notion that the FSA could be an arbiter of the industry's ethics. "It is right" he said, "that the FSA does not do ethics", adding a quote from one of his predecessors that it was not for "the FSA to seek to act as the conscience of the square mile".

While it is true that the FSA "does not do ethics", a quick look back in time shows that it has not been from want of trying. As early as 2003, it was actively seeking expert input to 'an ethical framework for financial services' and as recently as 2009, it was consulting on a code of ethics for investment advisers. Neither came to fruition, but they indicate that while the FSA may not like 'doing ethics', it finds it difficult to avoid.

So who should determine which types of behaviour are important for those working in financial services and what level of behaviour is satisfactory or not. In Sants' view, that's a job for society, not an unelected regulatory agency.

That's a big ask to make of society – after all, the ethical framework that this society has signed up to is set out in the law. Asking them for something more specific in relation to regulated firms in the financial markets, especially in the aftermath of an economic crisis many see as having been triggered by the reckless behaviours of financiers, would seem like a red rag to a bull.

The FSA could struggle to identify the ethical behaviours that society expects those in the financial services community to uphold. That's not to say there will be any shortage of suggestions: that is almost guaranteed. The struggle will be in sifting out from the mountain of diverse ideas a platform that represents an achievable common ground.

One idea floated by Sants is for changes to be made to the Companies Act 2006. Rather than just requiring directors to promote the success of the company for its shareholders, he suggests that it should also include an explicit obligation to society as a whole. Directors would have to show how their values and ethical behaviours have contributed to what Sants refers to as "the common good".

This is less radical than it may first appear. At one point in its drafting, the present Companies Act was to have placed just such duties on company directors, but a late intervention by the then Chancellor, Gordon Brown, resulted in the adoption of a narrower set of duties.⁴ However, even those are proving difficult, for a recent report by the Accounting Standards Board criticised UK companies for a rather lack lustre response to the non-financial reporting that was retained in the final version of the Act.⁵ That doesn't bode well for a proposal to widen the issues that directors should report upon.

On the face of it therefore, the simple model being envisaged, of society setting the ethical standards and the regulator enforcing them, has some logic to it, but is likely to be fraught with issues of interpretation and implementation. The FSA may therefore find it difficult to avoid putting some definition on what it expects on ethics from those it is regulating through culture. This was perhaps unavoidable anyway. After all, why have principles such as to 'act with integrity' been used in the Financial Services and Markets Act 2000 (FSMA), if they're not to be interpreted and applied by its expert regulator?

Unacceptable Cultures

Just as Sants is reluctant to define the ethical framework that regulated firms should adopt, he is equally reluctant to define what would constitute an acceptable culture of judgements and behaviours. This, he says, is because good cultures come in many different forms. He wants the regulator to focus instead on what an unacceptable culture looks like and the outcomes that is likely to produce. In other words, regulated firms are free to define and nurture their own cultures, so long as that doesn't result in outcomes that run contrary to the principles set out in the FSMA.

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There's again a certain logic in this. It gives the market the space to innovate and grow, while laying down 'outcome' markers beyond which firms should not stray. The danger however is that the more this notion is explored, the more the FSA seems in danger of becoming lost in a tautological mist of its own devising. For example, if the FSA wants to avoid defining an acceptable culture, how can it

⁴ [The Operating and Financial Review](#), Financial Reporting Council press release FRC PN 129, 29 November 2005. www.frc.org.uk/press

⁵ [ASB Publishes Review of Narrative Reporting noting continuing challenges for companies](#), Accounting Standards Board press release ASB PN 349, 29 October 2009. www.frc.org.uk/asb/press

then be confident of defining an unacceptable culture? Both come in many different forms and one is all too often expressed as the obverse of the other. Can one link an unacceptable outcome back to an unacceptable attribute of a firm's culture any easier than an acceptable outcome back to an acceptable attribute of a firm's culture?

Culture as a Regulatory Tool

Let's put those points aside for the moment and consider how practical a tool culture is for achieving the regulatory outcomes sought by the FSA. Sants sets out a number of management judgements that the FSA could use to assess the culture of a regulated firm, such as strategy, training, incentives and articulated vision. The danger here is that in order to tackle unacceptable outcomes, the FSA may only pick up on the **outputs** of an unacceptable culture and miss the deeper, underlying cultural **inputs** that are responsible for producing them.

Take as an example a track record of complaints about the sale of products inappropriate for certain customers. This may be down to a reward system with too great a focus on premium volume, but that reward system is still only a visible manifestation of the much deeper cultural mindset that is driving the firm forward, such as what the firm is there to achieve and right and wrong ways of going about that. Changing the reward system without addressing the deeper cultural mindset that led to its creation is likely to prove ineffective over the long term.

If effective intervention depends on addressing that deeper cultural mindset, then the FSA may need to recruit a particular type of person to carry them out. Anyone used to looking for neat, clear, scientific evidence in such situations would struggle. The influences at play are often too diverse and too deep for use in a neat, checklist approach.

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A good starting point upon which to establish the practicality of the approach set out by Sants would be for the FSA to undertake a review of its own culture and from this, determine the underlying drivers that produce the judgements and behaviours that those being regulated have to work with. There's also a well established view that to judge others' cultures, it is first necessary to have judged one's own. The insight and lessons to be learnt could be extremely valuable for the FSA and the outcomes it is seeking.

Some may question the value of such a review at a time when the tripartite regulation system under which the FSA operated is being dismantled. However others would say that such a review would

be well timed, as it could reduce the risk of replicating the problems of that old system within the new framework for financial services regulation.

A Tough Regulation to Sell

There are two further hurdles that the FSA would have to tackle. Firstly, the Government, whose coalition agreement refers to the introduction of a 'one-in, one-out' rule, whereby no new regulation can be brought in without another regulation being cut by a greater amount. With so much of the Retail Distribution Review (RDR) built around raising professional standards through attention to qualifications, ethical standards and continued professional development, and with the Treating Customers Fairly (TCF) initiative having a culture framework for assessing the impact of decision making on outcomes for customers, the FSA could find it hard to justify another layer of regulation around culture. The overlap with RDR and TCF doesn't seem insignificant. And it still leaves open the question of which regulation will be the 'one-out'. The FSA could have a tough sell on their hands.

Then there are the many thousands of regulated firms who have been devoting much time and money to aligning their businesses with the RDR and TCF. If 'good decision making' is something they feel that they've just spent the last few years building an evidence base for, the arrival of a new initiative on culture could seem to many as excessive regulatory creep.

The obvious retort of course is that if these firms have already embedded good decision making into how they work, then they've nothing to fear from an initiative like this on culture. Such logic does however sound a bit creaky when one bears in mind that the FSA regulates over 17,000 small firms, most of whom have only a handful of employees. They're unlikely to welcome more paperwork.

The Aldermanbury Declaration is all about getting the judgements and behaviours right in general insurance and is the sort of market initiative that the regulator needs to look twice at.

And many firms in the industry had already taken 'good decision making' to heart before either of Sants' speeches. For example, in March 2010, a task force of leading insurance figures set out a statement of principles known as *The Aldermanbury Declaration* to encourage the industry to voluntarily raise professional standards for staff.⁶ This initiative is all about getting the judgements and behaviours right in general insurance and is the sort of market

⁶ [The Aldermanbury Declaration: A Common Framework for Professional Standards](http://www.cii.co.uk/aldermanburydeclaration), 4 March 2010. www.cii.co.uk/aldermanburydeclaration

initiative that the regulator needs to look twice at. As of November, some 130 firms (including virtually all the leading insurers) have signed up to this declaration. A case perhaps for a regulatory dividend to reflect what many firms are already striving to achieve?

So with much already being done, and culture a complex regulatory tool to get right, the FSA needs to be offering some good reasons for companies to engage positively in this new debate. What might such reasons be?

Culture and Business Success

Let's return for a moment to the idea of the FSA conducting a review of its own culture. A valuable outcome from such a review would be a better understanding by the FSA of how its culture has influenced its own decision making. Insight into an organisation's culture can provide insight into what makes that organisation succeed.

If the FSA could put forward a strong case to regulated firms about the type of successful business outcomes that a good culture can help generate, then the market is less likely to resist the use of culture as a regulatory device or go into denial about having any problems in the first place. 'There's something in it for us' is a great motivator.

Another reason for emphasising how firms could benefit over and above compliance is that it makes firms more amenable to receiving feedback about their culture. Some firms can be uncomfortable with such feedback (and may even be shocked by it), largely because it's not something that many have given much thought to in the past. However, if such feedback is expressed in terms of how it could benefit the business (as opposed to being just another overlay of regulation), then it is more likely to be taken on board and prompt just the type of changes to how people think and work that the FSA would ultimately be looking for.

So what might a firm expect to hear from the FSA about the benefits that a look at its culture could bring? Culture is about 'how things get done round here' and so it provides a window into why your firm does some things well and some things badly. Factoring that understanding into your decision making should result in better and more certain outcomes, particularly in situations where change is taking place, such as diversification, rapid growth, mergers or new technologies. And insight into why your people are better at some things more than others is also pretty central to improving the firm's everyday performance. The benefits that the FSA could emphasise should be built around these twin themes of change and performance.

And what benefits could insight into culture provide for individual employees? It would help you make better career decisions by allowing you to align how you like to do things with how a potential employer

wants things done. It would help you adapt more easily to new situations, such as reorganisations or promotions, by helping you to read the 'how to get on' clues. It could help explain what excites or frustrates you about a particular job, team or firm. And at times of concern, it can help you understand more about the rights and wrongs of particular decisions or behaviours at work.

Conclusions

Hector Sants is right to have initiated this debate on culture: it is a powerful undercurrent to how regulated firms behave. Yet it's a complex subject that could prove to be an unwieldy tool for a regulator of financial markets to adopt in greater depth than at present. The FSA could of course cut through that complexity and focus only on certain attributes of organisational culture in order to achieve the market outcomes it is looking for. This carries the danger of turning culture into an overly loose wrapper for something too stripped down to carry that name.

This is a pity, for well researched insights into its culture can really help an organisation improve its decision making and so its performance. There's a danger that financial firms could be put off culture as a tool for better decision making if the FSA doesn't get this scaling up of culture right. One way to help avoid such a danger would be for the FSA to conduct a review of its own cultural drivers and use the insight this brings to plan its interventions in the

markets with care and attention.

The sternest test could however come from the Government, whose new 'one in, one out' rule for new regulations means the FSA could find it hard to argue for the proportionality of a new initiative on culture while at the same time implementing and enforcing the RDR and TCF. This is especially the case when initiatives like the Aldermanbury Declaration show that a key segment of the industry have already taken steps to improve the quality of their decision making.

If you have any questions or comments about this thinkpiece, and/or would like to be added to a mailing list to receive new articles by email, please contact: Laurence Baxter, CII Head of Policy & Research: thinkpiece@cii.co.uk or by telephone: +44 (0)20 7417 4783



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