Why Regulation is not enough to enhance corporate culture

By Ron Gould, Chairman of Think Alliance Group

Over past several years, regulators have found an un-ending stream of scandals and egregious governance lapses across not only in the financial sector but also in the general corporate sector. These events drove the creation of many new rules in an effort to re-direct behaviors. This note re-examines the rationale for those regulatory initiatives and reviews, why have regulators have since spent so much effort on corporate culture. We look at the actual expectations regulators have of managements regarding culture and the implications of failure for firms, individuals and the public perception of firms.

The History

Financial scandals are not new and they are not limited to any single jurisdiction. Let's look at some of the recent ones and their impact on public confidence.

Chinese Banking Collapses - The Chinese banking system has collapsed no fewer than three times during the last 30 years, and been re-capitalised with little effect on behaviour. As long as the state was sufficiently well resourced to provide a safety net, the excesses that led to each crisis could be contained. But the root causes have been ignored - a legacy of poor lending discipline and little real governance remains today. The culture of good corporate governance has yet to fully penetrate the financial system or management behaviour.

Japanese Banking Collapse - Between 1994 and 2001, the Japanese banking industry collapsed under the weight of bad loans, poor management practices, ineffective regulation and inadequate corporate governance. Today's banking sector in Japan is far more carefully regulated and better governed. Whether the sector has fixed its historic culture and governance problems is less clear which recent involvement in Libor and FX scandals underscore.

2008 Financial Crisis

- Sub-prime lending/rating agency standards
- German Landesbanks Bailout
- Iceland
- Lehman Collapse
- UK Banking Crisis
- Etc…

The dramatic impact of the crisis on public confidence has generated a massive political and regulatory response with range of new laws and rules across many jurisdictions that raised the risks and cost of regulatory failure. But these rules changes were not enough, as subsequent LIBOR, FX and AML scandals underscored. This has led regulators to focus on changing corporate culture.

I would define the culture of a firm as " the typical behaviours and mindsets that characterise a particular organization". The behaviours are "the way we do things around here"; underneath are mindsets which drive behavior of employees. These mindsets are also influenced by the incentives inherent within each firm.

Many observers believe that a firm's culture is difficult to change as it reflects a kind of cumulative past – all the past people, systems, and programmes which created an atmosphere, a particular mindset. Behavioural experts generally agree that particular cultures tend to attract particular types of people. As a result, a firm's culture becomes highly resistant to change.

At the risk of oversimplification, I think the keys to success in shaping culture change at firms lie in four areas:-

Leadership – a firm's leaders send powerful messages across an organisation and their behavioural characteristics, not just words, helps shape culture. Those who make sure they represent real models for change by setting clear directions and follow through, are truly setting the "tone from the top". However, senior leadership is easy to ignore when more junior leaders, closer to the bulk of employees, are seen to succeed despite poor practice or conduct. The average employee soon stops believing the message from the top if say, the successful salesman who ignores all the rules is seen to be praised or gets away with poor behaviour. To be an effective change agent, leadership tone must come from people at all levels of a firm, not just the C-suite.

A second area important to the establishment of corporate culture and to its potential for change is what the firm says about itself in the form of strategies, business plans, mission statements, codes of conduct, etc. These may be more formal forms of communication but they do set a backdrop for expected behaviours such as goal setting. How a firm sets out its targets and how to achieve them will translate into what people feel they need to do to meet those goals. Goals and objectives can be very important and positive but they can also create powerful pressures on junior staff with unintended consequences that are difficult to spot. Firms will want their corporate narratives to capture imaginations, to generate excitement and enthusiasm and to become a kind of positive mantra in their own right.

The third area is the way a firm guides its employees through its polices and practice. In my view, the most important are how firms recruit, compensate and incentivise. These practices have a huge impact on an employee and their behaviours. Regulators do recognize this by seeking to limit certain kinds and amounts of incentives but often against great pushback by firms themselves. The difference that incentives can make in such areas as KYC, avoidance of mis-selling, etc should encourage firms to explore this area with a far more creative approach. The policies that a firm has give an opportunity to set expectations, clearer standards and a framework for performance assessment, all of which can impact culture in positive ways.

The last area is the hardest to define but it will likely resonate clearly with anyone thinking about this subject. It is about an organisation's ability to learn. It is about an organisation's ability to develop a new mindset and changed behaviours and to achieve this, a firm must embrace new capabilities - It must be able to grow and learn new things. Only an organisation that has a mindset in which new ideas are considered and encouraged can hope to see a fundamental and lasting change in its culture. Of course, all these four areas overlap and each relies importantly on the other. No single one will make for a successful change in corporate culture. Together however, they represent a powerful force for the kind of culture firm's aspire to achieve.