Culture: the root of misconduct?

The one common thread through the myriad of regulatory and innovation challenges facing the banking sector today is that an adequate response is only possible if you have a strong and positive corporate culture. This goes well beyond legalistic conformity to detailed rules. Banks also need to ask themselves some fundamental questions about their desired culture and values, and how these are reflected across their organization – and be prepared before regulators ask them much the same questions.

It is now widely accepted that a less than desirable culture was at the root of the 2007-2008 global financial crisis and that the ‘soft stuff’, i.e. poor leadership, behavior and informal norms, can no longer be ignored. The response by global regulators and the business community largely missed the fact that a focus on ‘hard controls’ is not enough: culture plays a significant role.

Instances of misconduct, for example professional misbehavior, ethical lapses and compliance failure, have also been reported with troubling frequency, many of which have resulted in negative financial impact on customers and markets, with significant monetary and reputational costs to financial firms. The underlying reasons for this misconduct lie principally in the underestimation or ignorance of the role of culture and conduct in any given organization.

Now some banking regulators, such as the Dutch Central Bank, have responded by incorporating culture considerations into their supervisory (oversight) guidance. These developments are triggering a sea change in governance, risk management, and internal audit focus.

Increasing focus on culture

Although the UAE banking sector has not been publicly affected by scandals relating to misconduct, of late the regulators in the UAE have started to look at organizations’ culture, behavior and standards of conduct. They have been focused on how they can prevent or manage similar issues that have arisen globally. The opportunity to deliver value and improve risk management through more focused attention on culture is significant.

What is ‘culture’ and why does it matter? Culture is the intangible that is reflected in the choices and behavior of a firm’s employees.

Culture has moved rapidly up the global agenda of financial institutions in recent years, with increasing interest in the UAE. The opportunity to deliver value and improve risk management by paying more attention to culture is significant, argues Luke Ellyard.

A strong and positive culture can:

- **Reduce**: The risk of misconduct
- **Diminish**: The risk of regulatory scrutiny and the risk of related supervisory action and monetary fines, as well as diminish other potential costs, such as operating or capital charges
- **Strengthen**: Asset quality
- **Enhance**: A firm’s reputation with:
  - Customers/clients (who perceive the firm to be looking out for their interests)
  - Employees and management (who have an alliance with a positive corporate citizen)
  - Shareholders
  - Regulators (who perceive the firm to be less risky, i.e., more “safe and sound”)
- **Attract and Retain**: Highly qualified talent that similarly values a strong positive culture behavior, and reduce counter productive behavior and employee turnover
- **Protect**: The life of the brand
- **Promote**: Innovation and new product development designed to serve customers
trust, and respect for the law – carried out in the spirit of a fiduciary-type duty toward customers. That means keeping the customer’s best interest at the heart of the business model and having a social responsibility toward maintaining market integrity.

It embodies the ethics of reciprocity (treating others as you yourself would wish to be treated) at all points of interaction between a firm and its customers, and between the employees of the firm. This would foster an environment that is conducive to timely recognition, escalation, and control of emerging risks and risk-taking activities that are beyond a firm’s risk appetite. A strong and positive culture can help address some of the challenges, as shown in the diagram.

Culture is a complex but highly valuable asset for organizations operating in competitive markets such as the UAE. It is therefore important to observe, monitor and change their culture over time to support the successful realization of the organization’s vision and strategic priorities. The focus here is on the risk culture of a firm and related behavior, and not on all other aspects of corporate culture.

**Questioning culture**

Given the current industry challenges, it is the right time for UAE banks to ask themselves some fundamental questions about their desired culture and values and how these are reflected across their organization.

In order to set up the tone of culture within a financial institution, we believe that the board members and senior management, as the leadership of their organizations, are directly responsible for establishing and maintaining their firms’ culture. Regulators consider that to restore or maintain public trust it is imperative that each firm implement business strategies that place the interests of customers (retail, commercial, and wholesale) and the integrity of the markets ahead of profit maximization.

That is, they must conduct business in the ‘right’ way (right price, right allocation, right product, fair treatment followed by ongoing execution) – doing what they should rather than what they can. Beyond this directive, limited regulatory guidance has been made available and firms are largely responsible for defining their own parameters of a ‘good culture’.

Creating truly sustainable, ethical cultures may mean in some cases abandoning policies and practices that have served UAE banks well in the past. This will require some tough decisions for banking executives, as they look to create the culture of their institutions for generations to come.

Culture change will take years, perhaps a generation. Decisions made by banking executives today have the potential to shape the future success of their institutions. The banking leaders of today have a unique opportunity to create a cultural framework that will last a lifetime. Only by grasping this opportunity can banks provide the basis upon which trust can be restored and maintained in the coming years.

**“Good culture is keeping the customer’s best interest at the heart of the business model”**

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Luke leads KPMG’s financial services audit practice in the UAE. He specializes in the audits of local and international retail and corporate banks and asset management firms, including sovereign wealth funds, exchanges, private-equity houses and many DFSA regulated entities.

He has also provided specialist control and understanding input to a number of local, regional and global financial institutions and advised on UAE buy-side due-diligence exercises. Luke joined KPMG Lower Gulf in 2008, having spent nine years in KPMG London, including a three-year secondment to the Tokyo office.