SPEECH

Transcript of Banking Culture - Still Room for Improvement? Panel Discussion at Thomson Reuters, New York City: February 7, 2018

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William C. Dudley, President and Chief Executive Officer

Moderator: Rob Cox, Global Editor, Reuters Breakingviews

James Rosener:

Distinguished guests, colleagues, ladies and gentlemen: good morning. My name is James Rosener. I'm President of the European American Chamber of Commerce, and managing partner of the New York Office of Pepper Hamilton. First, let me thank Thomson Reuters for hosting this event and our own partnership with them together.

On behalf of the European American Chamber of Commerce, it's a great pleasure to welcome you today to a program on "Banking Culture: Room for Improvement?", which brings together three of the foremost thinkers on the subject. Here with us today are William Dudley, President of the New York Federal Reserve Bank; William Rhodes, President and CEO of WR Rhodes Global Advisors, and author of *Banker to the World*; and Ellen Alemany, Chairwoman and CEO of CIT Group, who also brings us a European perspective from her tenure in London.

Among our esteemed guests, we also have Stuart Mackintosh, Executive Director of the Group of Thirty. And moderating today's panel is Rob Cox, editor of Breakingiews, of Reuters News.

This panel discussion is particularly important as many consumers are still with the process of rebuilding wealth and financial services firms continue to struggle with consumer mistrust as well as regulatory compliance issues.

We all remember the crisis of 2007 and 2008, and how it shook the foundations of the exciting economic system. People all over the world became increasingly angry, cynical, and distrustful. Stock markets plummeted, companies collapsed, individuals watched their savings evaporate, and unemployment rose to levels unseen in decades.

In the aftermath of the global crisis, regulators introduced a wide range of measures and began implementing stricter micro- and macroprudential policies intending to strengthen the resilience and stability of the economic system.

Although in the years since the financial crisis, authorities have increased investigative and enforcement capabilities, punished business for misconduct, and addressed violations, we've learned from a number of scandals and corporate abuses regularly making the headlines that malfeasance, reckless business practices and behavior are a common and widespread phenomenon across business sectors worldwide.

Almost every active observer acknowledges that the state of affairs represents a bigger problem and calls for drastic change in culture—how employees and management interact and handle business affairs.

Just last Friday, the Fed made it clear to the entire banking system that it will hold boards of directors responsible for conduct and impose limitations on growth where financial institutions have not shown sufficient progress in implementing the kind of risk management that is expected.

At the same time, we're hearing from the administration about increased deregulation. Thankfully, there's growing and spirited debate on culture and conduct. A majority of banks and institutions are active participants in the debate. They employ consultants, host workshops and conferences, and adopt culture-oriented mission statements. Everyone agrees there's plenty of room for improvement. Creating a virtuous business culture is not an easy task and presents some serious challenges.

We hope this discussion will shed some light on how banks and financial institutions can benefit from corporate governance best practices—specifically culture change—and overcome the widespread negative perceptions that continue to rattle the sector.

I encourage all participants to engage in the discussions. Do not hesitate to ask questions, not only of our panelists but to one another, and make this a truly interactive event. Thank you for your attention, and I hope you enjoy this important discussion.

With that, I'll handle it over to Rob Cox.

Rob Cox:

Thanks Jim. Good morning everybody. Thank you for braving the incipient snow and getting yourselves away from your screens, showing us reds and greens in the stock market. It's hard to believe it's only Wednesday. But I can only surmise from your participation here that you also see a link between culture, banking culture, and the global economy, as I think these panelists that we have up here do, and have done quite a bit to champion our thinking in that regard.

They don't need any introduction. You've got their bios. Their reputations precede them. I thought I'd just start with you, Bill D. I'm going to go with Bill D, it could be your hip-hop name when you retire next year. But we have two Bills here.

So, four years ago, you kicked off this conversation with a conference on banking culture, and forming banking culture. It's gone global. Are you happy with the progress that's been made up to now? What's the state of affairs in our understanding of good bank culture?

President Dudley:

Well, I guess I would say I'm pleased that there's been substantial progress, but I'm not satisfied with the progress. In other words, there could be even more progress. I think in the United States, for example, we could do more in terms of having an industry-wide survey that actually allows firms to benchmark their results versus one another—we have that in the U.K.

We could probably do more to address the so-called "rolling bad apple problem." This is where someone leaves a firm after bad behavior, and then gets hired by another firm that's completely unaware of why that person was let go.

So we proposed—the Federal Reserve Bank of New York has proposed a banking registry, where you could actually keep track of why people actually were dismissed.

There is something similar to that in the U.K., so I think they've actually made a bit more progress than we have. The good news, though, is I think bankers are taking this a lot more seriously. A number of bank leaders have endorsed working on culture. A number of boards of directors have set up committees on culture. So, I think—have we gotten as far as we need to go? No. Have we made a lot of progress? Yes.

Rob Cox:

You're speaking as the New York Fed President, but what is your sense of other folks around the world, whether it's the Bank of England who are starting the Financial Conduct Authority, or whoever it might be in the U.K. and Europe.

President Dudley:

I think there's a pretty broad acceptance of the notion that regulation and compliance only takes you so far, and that bad conduct really does undermine the effectiveness of the financial system, because it basically reduces trust.

We saw in the middle of the financial crisis that it was the breakdown of confidence in the system that really led to the severity of the Great Recession. And I'm not sure how much conduct played into that, but I think it probably played a role.

Rob Cox:

Bill R, a question for you. Maybe stepping back, what are we talking about when we talk about culture? It's not yogurt, right? As someone who has been a banker for many years, and now has spent a lot of time looking at this issue from the vantage point of the G30, how do you characterize culture?

Bill Rhodes:

I think culture is really made up of the history, tradition, and values of a given institution. Each institution is different, and it must look to those three elements, and it can't be imposed by the supervisors and regulators, which they understand. I mean, this isn't something like capital, where you can say—or liquidity—

Rob Cox:

Which is a number?

Bill Rhodes:

Exactly. At the end of the day, though, it's the most important element of all, because if you don't have a good culture and you don't enact it in the sense of conduct, you're going to ruin your reputation. And once an institution, particularly a financial institution, loses its reputation, then it is a very, very difficult road to slog back.

And this is why the Group of Thirty decided to get into this area in the first place. We've been working on it for five years. We are now finalizing with our third report, and as we go around the world in all areas of the world, we are finding that financial institutions, mainly banks, understand the importance of this thing. And if we needed to have a reminder, it was the Great Recession, and what occurred there.

Rob Cox:

One of the things that's come out of this discussion, I think it was Baroness O'Neill in the U.K., her argument was that you have to ask yourself as an institution, what are you for?

And I think that's a pretty interesting—I think any company, it doesn't have to be a bank, but certainly a bank—there are certain other social imperatives to make sure that you know what you are for. How would you, Ellen, describe what CIT is for?

Ellen Alemany:

Sure, actually CIT has a very long history, but it's a 110-year-old company that started out as a commercial finance company in St. Louis, as Commercial Credit and Investment Trust, which then became Commercial and Investment Trust, CIT.

It had a lot of different owners. It was unregulated, and what happened was it took TARP money during the crisis, filed bankruptcy, and then reemerged, and then acquired OneWest Bank.

So when I took over the company, it definitely had "who are we?" And I think one of the first things we had to do with employees was really come up with a specific "this is our strategy," which is to give loans and leasing to small and middle-market companies on a national basis, funded by deposits. And a very clear statement.

We also—because of all the different ownerships, and unregulated/regulated et cetera—really didn't have a value set at the company. And so another exercise I did with the team was we did a cultural survey, and it was really telling what came out of the cultural survey, but as a result of that, we said "what are the top behaviors that we want for the company going forward?"

And we came up with six behaviors. The first was straight talk. In the institution, we found that people were just really afraid to be open and to talk about bad news. And so straight talk was the first.

The second was collaboration. Everybody just wanted to be left alone. That was one thing that came out loud and clear in the survey, it was just "leave me alone." They felt if they were doing their piece of the project, that was enough. No one was looking at the enterprise-wide or the full picture.

Accountability was another one. When 15 people sign a credit memo, who's really accountable?

And then we also came up with customer-focused, risk-disciplined, and high-performing. And so these are our six values. And we have to constantly reinforce these values in the company.

Rob Cox:

You had to do a fair amount of pruning and pairing back of some of the businesses. You had an international business, aircraft leasing. Does that tell us anything about the difficulty of actually imparting culture across borders, or was it just too difficult to pull all those things together?

Ellen Alemany:

No, I mean we put a strategy in place that we wanted to be a leading small and middle-market domestic lender, and we did a strategic review of the company, and we saw that we were in many countries. These businesses were underperforming. There was no connectivity with any of the other businesses.

We also felt that an aircraft leasing company shouldn't be in a bank because of the capital requirements on the forward order book. So, this was all part of a clear, crisp strategy for the employees, for our shareholders, and then executing against it.

Rob Cox:

Bill Rhodes, you were at Citigroup for many, many years. It in many ways it defines sort of the international banking culture. Just thinking about that culture—not necessarily Citigroup—but when do you think it lost its way a bit? That American banking culture, the global culture of banking?

Bill Rhodes:

Well, when I started out in banking, which was obviously a long time ago, we had embedded in us three things. First of all, the reputation of the bank. That was number one. But also along with that was the need to look after your customer, and also work with the community.

These were the three basic values that were embedded in us. Along the way, unfortunately, I think it shifted to short-term profitability, and those early, let's say "commandments" tended to be forgotten. And what was the result of this? The financial institutions—again, we're talking banks here—lost the trust of the public, the shareholders, and even of their own staff. And we can see this in some of the more recent cases like Wells Fargo. All three of them are there.

The other point which people tend to forget, and this is just basic business logic for success, is that if you have a good culture and you act in the proper way, conduct-wise, you are going to do better in your business. It's something that Mario Draghi always says, and he's correct. It's that good business practices, in the sense of culture and conduct, makes your customer feel better, loyal, and people want to bank with an institution that has that.

So at the end of the day, this is something that pays off to the so-called bottom line. The whole idea of having a proper culture and conduct, embedding it, monitoring it, and very, very importantly, what do you do if someone crosses the line?

I think first of all, you have to look at compensation for the individual. Take a hit compensation-wise, and if that doesn't do it, then you look at termination. I think these are all basic points that we've seen, and pretty much agreed to in our surveys of the Group of Thirty.

As I said, we are finalizing that now. There are a lot of other things we came forth with. But this is basically what I think happened along the way. And if institutions, banks are smart, they will never allow themselves to go back to that.

Forget about what the regulators and supervisors say. The institution itself is the first line of defense. And it's always easy when the problems come up, to say, well, the rating agencies gave us triple-A on this particular instrument, and the supervisors, regulators didn't pick it up. And oh, by the way, the politicians were pushing us to make those mortgage loans. No matter what it took.

Rob Cox:

When I think about what you just said, it sounds to me like the cult of shareholder value may have been more influential in forcing companies to think, or banks—companies generally, but let's keep it to banks—in thinking about short-term reward, or short-term incentives.

Bill Rhodes:

Well, that was all part of the short-term profitability. And that was, as you know, for a period of time the most important metric, and the press built it up. You know, what's the shareholder value and—

Rob Cox:

But I'm wondering how do you balance this need to serve shareholders who can turf out a CEO or the boards of directors? At any time, you always have that barometer of the stock price. Bill, you want to answer this? I also want to ask Ellen: how do you manage this? You've got on the one hand your investors, and on the other, you've got this need to build a long-term, stable, culturally good institution.

Bill Rhodes:

Yes, but if your customer does not trust you and the public does not trust you, it's going to fall to the bottom line. So, good business practices like the ones I've mentioned actually help the bottom line. And when you don't have that, you can see the consequences.

Rob Cox:

Yes, yes. Bill Dudley?

President Dudley:

You asked the question, why does this happen? I think there are a lot of reasons, but there are two things that I guess I would talk about. Number one is business became more transactional rather than client-focused, and that's partly the growth of the capital markets.

The second thing is scale. The scale of the institutions got a lot larger. And so I think it became much harder for people at the top to actually—for their views to penetrate deep into the organization.

I really do have a question about whether it's actually possible to manage organizations of several hundred thousand people effectively. Time will tell. One reason to work on culture, though, is to actually get the views of the CEO, and the executive suite, to penetrate down into the organization. It's really difficult the bigger you get and the more complex you get.

Rob Cox:

So how do you manage this balance? Milton Friedman on the one hand and Bill Rhodes on the other, in making sure you're delivering for shareholders but at the same time delivering for the long term and not creating problems down the road?

Ellen Alemany:

Sure, before I answer that question, though, I think if there's any one takeaway from today, it is the point that Bill made, is that having a good culture is good business. And it's the tone from the top and believing that if your colleagues are engaged, if your customers are satisfied, if the communities you do business with prosper, then business is going to prosper, which in turn turns into shareholder value.

And it's always that balance between the short and the long term. And we manage that through lots of different ways. Compensation is only one piece. But in compensation we make sure that we have a balanced business scorecard for the senior managers.

So, a percentage is based on the financial results, and it's not just one financial measure, it's several financial measures. And then the other piece is qualitative. We break it up into three buckets—strategic/operational, risk, and then people/culture. Does this employee demonstrate the CIT values?

We also have clawback, and by having this qualitative, too, if something does go bad or someone doesn't do something that we think is appropriate, you have enough flexibility there to manage the compensation.

Rob Cox:

I want to delve further into incentives because I think it's really critical to this conversation. But just sort of stepping back a little bit to my first question to you, Bill Dudley, which was about the progress we've made. A corollary to that is the President has talked quite a bit about his deregulatory efforts. We've certainly seen some measures from the House Financial Services Committee that probably will never see the light of day in the Senate. But we also have seen the Senate with its bill to soften, shall we say, parts of the Dodd-Frank Act. Is there a danger that this whole cultural discussion gets thrown out with this deregulatory swing back of the pendulum?

President Dudley:

Well, first of all, I guess I don't think that the deregulatory swing is going to be that great, thankfully. I've been talking about this for many months about how it's really important, while we can make regulations simpler and more efficient, that makes a lot of sense, we don't want to go back to where we were in 2007, 2008. So higher capital requirements, higher liquidity requirements, better resolution regime, the ability to centrally clear over-the-counter derivatives, regulate the entities that we clear these through, all of those things need to be kept. Orderly liquidation authority. And so far I'm actually pretty optimistic that the regulatory reforms are going to be around the edges as opposed to wholesale.

The second thing I would just say, though, is that regulation and culture—these are complements, not substitutes. If you think that regulation can somehow substitute for culture, I think you're really mistaken. In fact, in some ways, the more intense the regulatory regime, it can actually undermine culture, because people can actually say, well, the regulators are saying what I can and cannot do, and so as long as I stick within the confines of those regulations, it's all fine.

But that's actually not true. Just because a regulation sets this frame or field of scope, there may be things within that that you actually don't want to do. There are number of examples, as we saw, during the financial crisis. One of the most famous ones was Repo 105, which Lehman Brothers did to dress up their balance sheet to misrepresent their balance sheet to the public. That was legal under the accounting rules, but very deceptive. So that was an example where if you just go by what's regulatory-appropriate, you can actually have very bad outcomes.

So I think that it's not one or the other. You need a good regulatory regime supplemented by various good conduct and culture in the organizations.

Rob Cox:

But I was recently in London speaking to the CEO of a big U.K. bank, and he was saying, "I'm really worried that they're going to relax the Volcker Rule," for instance, and "If those guys are trading using their balance sheet, how are we going to compete?" And so there's definitely a fear about this.

President Dudley:

Oh, you're right, there's always a little bit of pressure that regulation gets rolled back in one regime and everyone says, oh, now these people are more competitive than our people. And so the "race to the bottom" problem is obviously all something we have to be aware of.

That's one reason why I think that the U.S. involvement in Basel with the Bank for International Settlements is important because that helps establish minimum standards that are implemented across the world, to essentially lean against that pressure to race to the bottom in terms of regulation.

Rob Cox:

But some things—for instance, relaxing the threshold at which you're a G-SIFI, things like that—that would help CIT, I would imagine. In other words, you can hold less capital as a result of some of these rule changes.

Ellen Alemany:

We're in an interesting situation because we're actually the first bank in the U.S. that actually raised our hand and said we want to become SIFI. And then we decided to sell the aircraft—we would have been about $80 billion in assets, and we decided to sell our aircraft leasing business, and now we are right at the cusp. We're around $50 billion in assets.

And I had gotten so many questions from investors, our board, et cetera. "Do you de-SIFI?" "Will you save a lot of money if you de-SIFI because you don't have to spend money doing these things?"

And we sat there as a management team and we said, you know what? We needed to improve our capital planning process at the company, and that a lot of what is required for a SIFI bank, and if we want to build a strong foundation to grow the company going forward, we needed to invest in.

So, if the threshold changes, it's really not going to impact what we do day-to-day, because the Federal Reserve Bank still requires us to have a capital planning process that meets the new standards. The standards have been raised for the industry. And we want to build a strong foundation for the company.

Rob Cox:

So, does that mean if you don't have to, even if you don't have to hold an extra one basis point of capital, you would?

Ellen Alemany:

No, it's more of—the whole capital plan—what's involved with the capital planning process. And we also want to maintain capital that's appropriate for the risk profile of the company. And just because the regulators demand a certain level, it's our assessment of what capital is appropriate for the risks that we're taking as a company. It's a guideline.

Rob Cox:

What is your sense of the regulatory environment? How has it changed with the examiners or whoever it is that are sort of crawling around the bank? Are they now smiling, offering lollipops? [CROSSTALK] Pretend Bill is not here. Is there a mood music change of some sort?

Ellen Alemany:

I think that the tone at the top is different in terms of what people are saying—how it actually flows down and impacts us on a day-to-day basis. It really hasn't changed yet in the regulations. For us, there's been more of a tone change at the OCC rather than the Federal Reserve Bank.

President Dudley:

People act like this is sort of this big giant fight between firms and the supervisors. In a lot of ways, the interests are actually very well aligned. We want to have good risk management. We want to have good governance. We want to have adequate capital, adequate liquidity. The firms presumably want all of the same things. So this idea that we're all going head-to-head, I just don't think that is really actually how good supervision and good private sector engagement with that supervision actually works.

Rob Cox:

So you don't have grumpy examiners on your staff?

President Dudley:

I'm sure we have some grumpy examiners on our staff.

Rob Cox:

I mean this actually goes back to the question—you mentioned it before, Ellen—which is good culture being good business. Bill, you wrote a column for us over the summer in which you pointed out that misdeeds and bad behavior and settlements have cost the industry something like $330 billion since the crisis. I mean, that's coming right out of shareholder value.

Bill Rhodes:

Now it's somewhere north of, I think, $350 billion. Those are Boston Consulting figures.

Rob Cox:

Yes, but of course, you know, everything is doing well, everybody is making tons of money now. Is there a risk that these settlements and fines that we've seen meted out are basically just seen by bankers as a cost of doing business over the cycle?

Bill Rhodes:

I certainly don't think so, because in addition to what fines you're paying, you're getting very bad publicity. And it doesn't make the shareholders, your staff, or your customers very happy when they see something like this. Forget about the impact on the bottom line.

And I think Ellen commented on the tone at the top, which is key. But it must go right down to middle management, or right down to the teller level. Everyone has to be a believer in this, and they have to practice it. It has to be embedded and monitored throughout.

And as I said, and then when you have bad players—bad apples, as Bill said—compensation is a first hit. But eventually you're going to have to go to termination. And I think this has to be understood all the way from the top down to the bottom.

The other point is that if, in fact, we see let's say less regulation and supervision across the system, that gives even more importance to the culture and conduct area. Because the last thing an institution wants to do is to repeat some of the failures that we've seen over the last decade or more.

And I think these things built up over the last 20 years or so—it didn't happen overnight. And the price to pay, with loss of trust—forget about the financial settlements—I think has been significant. Because what do you find today? The area of trust has still not I think fully been given by any of the constituents, as I mentioned, to the institutions. Plus the politicians around the world—particularly in the United States, Canada, Western Europe—are still very I'd say antsy about the banking system, as you can see. So I think we still have a lot of work to go in this area. We've made progress but it's like a stop on a train. You've got more distance to go.

Rob Cox:

How do you feel?

President Dudley:

Two things that I think are important. Number one, the fines have gotten a lot bigger. At times there's been actually a risk to firms that's existential. The risk of actually losing your charter. So, I think that's causing the senior management to take this a lot more seriously. So I think that's an important change from what we had before.

I think the second thing is the industry is held in not such high regard now. And that has actually consequences for their ability to attract talent. So we've been having a number of business school deans come in and talk to us at New York Fed over the last few years, and what they say is that there are people who will actually not go into the financial services industry because of this bad conduct. That's not a good cycle. If the most ethical people coming out of the business schools decide that they are not going to go into this industry, that means there's quite a bit more work to do.

Rob Cox:

They're all going into journalism.

Ellen Alemany:

Bill D. actually makes a really good point. By the year 2020, 50% of our workforce is going to be millennials, and the millennials prioritize different things than we did coming up in our careers. They want corporate social responsibility. They want culture, they want values. And so if you have a good culture, it's really a competitive advantage in terms of attracting the millennials to your workforce.

Rob Cox:

So, Bill, you said in one of your speeches on this topic that incentives shape behavior, and behavior drives culture. If you want a culture that will support your long-term business strategy, you need to align incentives with the behaviors that will sustain your business over the long haul.

This is for all of you, but I'll start with you, Bill D. What specifically has been done around the issue of compensation? What are you seeing when you look at comp plans, and not just for the CEOs and CFOs, but throughout the organizations?

President Dudley:

The reason why I stress that, because people always say, culture is sort of a soft subject, so what can we actually do about it as leaders in banking organizations. Well, you can look at how you compensate people, how you promote people. Those are things that you can actually set. And by having an appropriate set of incentives, you're probably going to get the behaviors that are more consistent with what you desire. And if you get that, over time, that will actually establish the culture of the organization. That will sort of set the social norms that define the organization.

So, the reason why I stress incentives is this is something that senior management actually has control over. There are things that they can actually do in terms of how people are compensated, how they are evaluated, how they are promoted. And that's why I really—

Rob Cox:

Well, what are those things? If you were to trace back to 2006—

President Dudley:

Look, I think we've made some progress on the compensation front, in the sense that there's more deferral of compensation, and there's more scope for clawbacks. But I personally think that there's scope for doing even more on this front.

If you go back to the old partnership model where people actually had their capital tied up in the firm, and couldn't get their capital back until years after they retired, they had strong incentives to make sure that the firm didn't—

Rob Cox:

You were at Goldman when it was a partnership, right?

President Dudley:

Well, I wasn't a partner when it was a partnership. But, yeah, I think that culture was helpful in terms of risk management. The willingness to take risk. So, one thing you could look at for example is do we really want to have all these deferrals in the form of stock grants? Maybe we should have these deferrals in the form of total loss-absorbing debt.

Rob Cox:

Like a hybrid coco or whatever those things are?

President Dudley:

Well, or just something that basically if the firm does badly in the future, and fails, the compensation that has been deferred in the form of debt gets converted to equity, and the management actually has to suffer some of the consequences.

Another thing that I think would be really worth looking at a little bit would be who pays the fines when firms have bad conduct and behavior. Why does it always come out of the shareholder's pocket? The shareholders may not have even been shareholders at the time of the bad behavior. Maybe there should be a device that could actually reach down and grab some money out of the pockets of the managers who actually were responsible for the bad behavior and the bad conduct.

Rob Cox:

What have you done Ellen? Do you have specific formulas? Is there something you can tell us about the contours of your incentive schemes that are designed to do exactly what Bill is talking about?

Ellen Alemany:

Sure, I just touched on some of it before, but at least for the senior team, we put a balanced business scorecard in place that's—a percentage of it is financial performance, with financial targets. And then there's a qualitative piece. We also have deferral through performance stock units and restricted and stock units. And then we also have clawback.

Rob Cox:

Have you had to ever claw anything back?

Ellen Alemany:

Not at my current firm, but in a prior firm that I worked at, yes, we have used the clawback for employees. And I actually think that the European banks use it a little more aggressively than the American institutions, and they were really—the European banks were the first to implement clawback.

Rob Cox:

Is that right? When you were at Citi in the '80s and '90s, you probably didn't have all of these kinds of highfalutin bells and whistles on compensation then.

Bill Rhodes:

Well, the compensation was a lot lower to start off with.

Rob Cox:

Oh, that's true.

Bill Rhodes:

I want to just pick up some of the things that Ellen and Bill have said. I think it's very important that your staff—we talk about those at the top, the middle management down to the teller—have pride in the institution that they are working for. And this then spills over to the client and the customer. And I think that's when we're going to get the trust level back. And then when you talk about pros and cons of rating people, for compensation, one of the things that has become somewhat controversial is the role of the whistleblower.

A lot of institutions don't even call it whistleblowing, they call it—I think in CIT, Ellen told me it's a hotline. And the responsibility that if you're sitting next to somebody, or you see something that is not correct, that you will speak up in some form or fashion. And I can run through some institutions where this did not happen, or where the employee tried to speak up and was suppressed or even fired.

And so I think it's key to maintain the pride of the employees and the trust of your customers, that you have some sort of mechanism where if an employee sees something that's being done incorrectly, he or she will speak up. And it makes a lot of sense that this be done really right up to the board level, because what do you want to do? Read about it in the newspaper? Or have your friendly supervisor call you and say, "We just got a call from someone in your organization saying they've seen this or that."

And I think that has been another problem. This was suppressed during this period of time. The whole idea of people in the institutions speaking up, and that also has to go back to pride in the institution, that they will do so because they think it's wrong and they don't want to be with an institution that does bad things.

President Dudley:

And then senior management has to be receptive to that employee.

Bill Rhodes:

Exactly, exactly. Right up to the board level. Because too often—in our first report, as Stuart knows, we worked on, and Bill—was the role of the Board. Because too often boards either didn't want to know, or frankly didn't push senior management to let them know what was going on.

And in the most recent cases that I've seen—it's out there. A number of board members of Wells Fargo said we were never told, we didn't know. And it's not just Wells. All of the institutions involved in this in the United States and Europe went through the same bit. So I think this is key.

Rob Cox:

Let's talk about Wells. Wells is a living and breathing case study, really, in some of this stuff. I mean Bill Dudley—the Fed last week issued an order forbidding Wells from growing its balance sheet further until they say "sufficient improvements" in governance and risk management are made.

As Bill Rhodes points out, four directors, concomitant with this announcement, were leaving the board. I mean if culture is improved broadly across the industry, how are we to interpret what's happened with Wells, which, prior to this last two years, was considered the sort of paragon of good banking culture?

President Dudley:

Well, that goes back to the discussion we were having before on incentives. They had really bad incentives in terms of how they evaluated and compensated their employees. So you were compensated on the basis of how many accounts you opened. And that was sort of problem number one. So the incentives were wrong. And then two, when people complained about it—employees complained about it—and went up the chain of command, that was essentially not heard or ignored.

To Bill's point, you want to have a culture where people are willing and comfortable raising their hands. But that willingness and comfort at raising your hand depends on how that's received in the organization. So at Wells Fargo, apparently, people did raise their hands, or tried to raise their hands, and the message just wasn't received by senior management, and I think it never really got to the board of directors.

Rob Cox:

Has enough been done on Wells Fargo? I will just say, we've called for a full change of management, CEO level, pretty much since this thing came. We didn't think it was—given the level of cultural rot, that you could have someone who had come from that culture running the place. You think they should fire Tim Sloan?

President Dudley:

I don't have a view on that. That's way beyond my pay station. I think Wells Fargo understands that they have to change their culture. I mean, I think they completely understand that. Betsy Duke is the lead director at Wells Fargo, and I've worked with her when she was at the Board of Governors.

Rob Cox:

She's chair now.

President Dudley:

Yes, she's chair now. And I think they get that they have to do some pretty substantive things to change the culture there. So, the proof of the pudding will be in meeting those, so they actually have to do it. And, you know, it's hard to change culture in very large, complex organizations. It's not something that one can do overnight. The problem that people always talk about is that the people at the top of the house may have the greatest intentions. But how can they actually reach down into the middle layers of management and sort of change how people perceive the organization?

You can have a lot of cynicism at the mid-level and lower levels. Like, "Yeah, the senior management is doing this, but they're just doing this because they are under regulatory pressure. They don't really mean it." So it is hard to actually change in these large, complex organizations.

Rob Cox:

There are successful precedents. One could say JPMorgan and Jamie Dimon, there is a sort of inculcated culture at all levels. Of course, we'll see what happens. Headlines may pop at any time and ruin our view of that. But Ellen, you wanted to say something?

Ellen Alemany:

I just want to pick up on that point that cultural change just doesn't happen overnight. And a lot of the studies say it's at least a three-year process, and it's also just not about the regulatory and the compensation. There's what do you do on a day-to-day basis to make sure that the values and behaviors really flow through the entire organization, and that it's living and breathing within the organization.

And some of the things that we do—in every town hall and through all our communication and messaging to our employees, we talk about culture and we talk about our values.

I do town halls where I give out a chairwoman's award for employees who demonstrate that they're living our core values and behaviors. And it doesn't sound like a lot, but it really is very meaningful inside the organization. Through some of our corporate programs, like even wellness, to show that we care about our employees. Or we look at our customer complaints. We have a new product approval process where we sit and we talk about, well, gee, what does this product do for the customer?

We look at business practices, or do you have any financial results that are outsized? I remember taking over a leasing business, and I couldn't figure out—it was a business that when I was at Citi, that Citi had acquired, and I couldn't figure out why they made so much more money in their business versus our business. And so we tried to look at the whole process, front end to back end, and realized that this company we bought had really egregious end-of-lease practices, and we immediately terminated those. Because those things aren't sustainable in the long term.

We have a hotline. I can't tell you how important the hotline is, and it's important that employees feel like they have a safe environment. And we have my head of human resources, my general counsel, and my head of audit chair the ethics committee, and they look at all of the hotline reports that come through and say is there anything here we think we need to investigate further?

So, as I said, there's just so many things you need to do in the company. Having a diverse board, so that there are board members that are more sensitive to some of these types of issues and ask the questions at the board meeting. There's just a long list of things that need to be done.

Rob Cox:

I want to pick up on the Board question, I mean—

Bill Rhodes:

I would say that that is key—tone at the top, but all the way down, as I said, to middle management and the teller, because often this gets shipwrecked at the middle-management level. But one of the things that we recommended in our last report, which came out in July 2015, was an incident—

Rob Cox:

This is the G30?

President Dudley:

The G30 report, yes. One of the things we recommended is that boards take a look at forming separate committees to look at culture and conduct, because the norm usually was to put audit and risk together. First of all, audit and risk never should have been put together, because the tendency was to spend all the time on the audit side and nothing on the risk side.

But in addition to having an audit committee and a separate risk committee, a number of institutions have picked up—or some institutions—have picked up on our recommendation to form a separate committee on culture and conduct.

And the reason why this is so important is so you don't get this point that you were making where the board says "we didn't know what was going on" type thing. Because they are then responsible for seeing that the culture—whatever it is in the institution—is embedded, is monitored, and then action be taken when an employee does the wrong thing.

So, I think there have been improvements along the way of getting the board more involved. And Ellen was talking about the hotline, which was very important, in the sense of getting the staff involved right down to the teller level. That everyone feels it's his job, because the whole idea here is when you enter an institution, no matter what level, you want to have some pride in your job. I mean that's the whole idea, to have pride in what you're doing.

And the reasons that we're getting a lot of college graduate, MBAs, whatever, not wanting to go into the industry is they don't feel this is an area where they could have pride. And that's the whole area of trust that we've got to bring back on the table. And it's not an easy job. As I said, we're like on a train and we made a couple of the right stops, but the journey isn't over.

And as I mentioned before, it will be even more important if the politicians decide that they want to reduce regulation, supervision, the authority of supervisors and regulators—then it's even more important to make sure you have a strong culture and conduct in a positive fashion.

Rob Cox:

I've got a couple more questions before I open it up to the audience. One is this question about are you guys anxious at all about some of the financial innovations we've seen. One of the stories yesterday was about the sort of anti-VIX product that Credit Suisse was selling, and actually, it is redounding negatively on the reputation of Credit Suisse, arguably. Or you see the way banks or some of the exchanges have gotten into bitcoin futures. Bill Dudley, are these appropriate products for banks to be selling? Are they culturally appropriate?

President Dudley:

I think it's really a question of the suitability of the clients that the products are being sold to, and their understanding of the risks associated with the products. I don't have a problem with a product being sold to someone as long as that person is a suitable investor for that product and understands the risks of the product. Because you have to be careful here—you don't want to discourage innovation, and you don't want to discourage offering products that allow a lot of people to hedge risk in various ways, adjust their portfolio for risk.

But you have to make sure that they are appropriate and well designed. I think the thing that we worry about when we look at the financial system and we worry about financial stability risks—where are there cases where there are feedback loops?

So right now with the stock market having a little bumpy ride over the last few days, there's a question: As volatility goes up, is that going to cause people to sell stocks because they have a strategy of investing that's tied to the level of volatility in the stock market? If that were the case, then that could cause the stock market to be bumpy in the future.

So, it's those feedback loops that we focus on very intensely, when we analyze financial markets for financial stability risk. And I think that firms when they design products, they need to be cognizant of that.

I mean the classic example is the stock market crash in 1987, when people had this product called portfolio insurance, which meant that when the stock market went down, you had to sell stocks. So as the stock market went down, portfolio insurance kicked in, you had to sell, and that caused the stock market to go down even further.

That probably was not a very well designed product, and people I don't think had thought through what the implications were, how that product would actually work in practice.

Some of these VIX products, I think people are going to now look at this with the benefit of hindsight and say, "Were these really well designed?"

This wasn't that big a bump in the equity market, and these products actually blew up. So you have to sort of ask yourself the question, "Were these products well-designed?"

Rob Cox:

Are there are other elements out there, things that worry you, whether it's risk parity trades or some ETFs? I mean when you look at what's happened in the last couple of days with the stock market, what keeps you up at night?

President Dudley:

Look, I think the stock market had a remarkable rise over a very long time, with extremely low volatility. I, and many others, had observed that the valuation of the equity market is elevated. And so having a bump like this has virtually no consequence, in my view, of the economic outlook.

My outlook hasn't changed just because the stock market is a little bit lower than it was a few days ago. I mean it's still up sharply from where it was a year ago. That said, if the stock market were to go down precipitously, and stay down, then that would actually feed into the economic outlook, and then that would affect my view in terms of the implications for monetary policy.

But so far, this is a big story in the press. It's a big story for financial market participants. But I don't think it's a big story at all at this point for central bankers.

Rob Cox:

Go ahead Ellen.

Ellen Alemany:

What concerns me is really what's being done in the unregulated bank space. So for example, the fintech space. We bought a fintech company, Direct Capital, a couple of years ago. And it took a lot of work to have it work within a bank environment, including significantly reducing the amount of pricing that we earn on the product, the transparency of the terms we give to customers, but they can get a 30-minute credit approval from us.

But there are other companies out there that, if customers don't understand the fine print, they're being charged 35, 40% on some of these products. It's the business of BDOs out there that are lending to middle-market companies at terms that we haven't seen since before the financial crisis. And my concern is that this is the whole shadow banking system that hurt us during the last crisis, and if interest rates rise substantially, these companies are going to get into trouble, and guess who finances them? Banks. Banks are giving lines of credit to these companies. So I am worried about this whole shadow banking system, and I think that our regulators should look more at some of these, into these.

Rob Cox:

Can I ask just sort of one corollary, something you raised a minute ago, which was diversity of boards. But let me ask, where does the whole "Me Too" movement fit into this discussion about banking culture? I'll start with you, Ellen. Or, how should it?

Ellen Alemany:

No, it does, and I've gotten a lot of questions of, well, gee, why hasn't—we haven't seen financial services companies, fortunately, in the press a lot. And as an industry, we faced this 20 to 30 years ago. The old boom-boom room at Salomon Brothers. I think that the industry, to give it credit, was terrific in terms of sensitivity training, making sure you have a proper code of conduct, actually having public firings, if somebody demonstrated inappropriate behavior, et cetera.

And I think that it's really positive that people are feeling they can come out and talk about things right now, but I think as an industry, in financial services, we took a lot of steps to avoid that.

Rob Cox:

Do you agree with that, Bill Dudley? That's sort of been the premise that we've written—the sort of "they went through this." The financial industry went through this and created a lot of safeguards.

President Dudley:

You know, I hope so. I hope that's right.

Rob Cox:

Yes.

President Dudley:

You never know what's unknowable, but I hope that's right. It should be right.

Rob Cox:

All right, I'm going to open this up to questions from the audience. Please, no filibustering. Ask your question, state your case. We'll start here with the gentleman. I think we have mics.

Audience Member:

Just to follow up on the shadow banking question. If you could elaborate more with respect to the potential risks as far as shadow banking globally. Of course we have it here, but China has a rather large shadow banking situation, and although we can contain it here in the United States, what happens with the risks overseas that might impact the U.S. economy?

Rob Cox:

You want to take that Bill?

Bill Rhodes:

Well, I would just say I think it's a very good question, and I'm very concerned, and Ellen brought it up right now, shadow banking. And you mentioned China, where it's a particular problem.

It's not clear to me that they've gotten their hands around it either, because every time they close something up, they come up with something else. Trust companies—I could run through all of the instruments, because the Chinese business community is very adept at innovation. And we have to remember that China is the world's second largest economy. In fact, if it hadn't been for China in 2008, when they put a stimulus package in, anywhere from $850 billion to $1 trillion, we would have had a Great Depression, not a Great Recession.

And so I'm very concerned about that. And China is probably where it's most serious. But as Ellen brought up there are problems here, there are problems in Europe also. When you talk to bankers in Europe, and there was an article in the Financial Times and Reuters the other day about this whole question of regulation of shadow banking in Europe.

I think it's a major challenge, this whole question of shadow banking, because here we spend the time on supervising, the regulatory side, and what the banking community is doing. And the tendency is you don't see that same effort in the shadow banking area. So I think it's most important.

Audience Member:

I have a question really for Bill, just because on a really good day my currency and fixed-income portfolio managers complain about the lack of liquidity in the market, let alone on Friday and Monday. So I'm just wondering how much you view liquidity as an issue and how concerned you are about a liquidity crunch.

President Dudley:

Well, people have been looking at the issue of what have the changes in regulation done to liquidity in various fixed-income markets. I think there's probably been some consequence, for example, in the repo market, and a few other markets.

But I think generally, I would say market functioning actually seems to be pretty good. I mean there was a period on Friday where there was a very sharp movement downward around three o'clock in the equity market. So there's something that we have to look at and evaluate what really caused that.

But I think generally, liquidity actually is pretty good. If you look at things like bid-offer, bid-ask spreads, more people can execute. I think it's not as good as it was back in 2006, 2007. But there's a lot of reasons not to want to return to 2006, 2007.

Rob Cox:

When you say "not as good," you mean bid-ask spreads—

President Dudley:

Well, I think there's probably not as much depth in the market. In other words, if you want to do a large transaction, you're probably going to have a little bit more of a price concession now than back then.

People talk about the corporate bond market as one area where dealers have reduced the amount of corporate bonds that they hold on their balance sheets because of capital charges against those corporate bonds have gone up.

So, I think there has been some consequence, but in general, I think markets are functioning quite well. I think the ability of savers to meet borrowers efficiently in the financial system is very much intact. And actually what we care about is, is the financial system able to supply credit to small businesses, to households, in an efficient manner to support economic growth? And I think if you look around the world, the answer is yes. I mean we have a global synchronized recovery now, which I think is quite positive.

So, it's something that we're going to continue to look at. There is no question we want to continue to focus on what's the appropriate level of regulation, what are some of the consequences of regulation for things like liquidity? But so far, I would say, we have a much safer financial system, and that's able to perform its function throughout the business cycle.

Now the other thing is, if you have looser requirements for things like capital and liquidity, it might lead you to have a little bit more free flow of credit at the top of a boom. But what happens if the system then breaks in the economic downturn? So you really want a system that's actually sustainable throughout the business cycle. And I think we have a much better system now to ensure that.

Audience Member:

To what extent might banking culture improvement include a reduction in the pay gap between the C-suite and the average worker?

Rob Cox:

Ellen?

Ellen Alemany:

I don't think they have to worry about my pay ratio. No, just kidding. But, you know I think I'm going to pass that to one of the Bills. I'd have to think about that.

President Dudley:

Look, I think the issue of income inequality and the issue of income mobility in this country is really important. I think that some of the things that you see happening in the political space is a consequence of U.S. poor performance in both those regards.

I've been surprised at how high the pay is at the very top of the house. It seems like people would be willing to do the jobs for probably considerably less money. But how we got this result, that's something that people very much debate. People talk about the winner-take-all society.

I think that as a country we need to do a lot better on working on both the income distribution issue, but even more importantly, in my mind, is income mobility. You know there's a lot of work that Raj Chetty and a number of his associates have done about income mobility, and what they find is where you're born has a huge consequence in your ability to have income mobility through your lifetime.

So it's not about you, it's actually literally where you were born physically. That says that in the United States we have a lot of work to do, to create a much more even set of opportunities for people so that it doesn't matter where you're born. It depends on your work ethic. So I think there's a lot more we can do in the United States in this realm.

Audience Member:

I was just wondering if changing the culture seems like a very noble attempt at changing the industry. But how will you avoid poaching your talent if there are firms that are not on the same objective as you are? You know it happens all the time. It happens with traders, it happens with—they're just going to want to go to a Goldman rather than a Citi if Citi is not paying them.

Rob Cox:

Ellen, you brought this up a little bit, the issue of shadow banking is part of that I suppose.

Ellen Alemany:

Yes, I mean so maybe I'm being a little idealistic here, but I don't think it's all about the money. I mean there are some individuals that it's about the money, but I think for the most part, our employees, it's about working for a firm that they can be proud of, that has a good culture, that is interested in long-term shareholder value, et cetera. And I think if you have a good employee proposition, it will prevent some of your employees from being poached. And in institutions where they are having troubles right now, it's actually an opportunity for us because they want to come work for a company where they feel that the employee proposition is very positive.

President Dudley:

And if it is all about the culture for those individuals, maybe they don't actually fit in with your culture.

Ellen Alemany:

Yes, exactly.

Rob Cox:

You know we're talking about banking culture. But there are a lot of other industries that have—we've given them a social license with our data, for instance. Big tech is a great example. I don't see conversations like this being promulgated by whatever it is—the regulators, should there be any—of the Googles and the Facebooks. It's great that we're all focused on this, but as a society, are we focusing on the wrong industry right now?

President Dudley:

Well, let's take care of the financial industry first, before we start moving out.

Rob Cox:

I'm trying to figure out what you're going to do next, Bill.

Bill Rhodes:

Well, you know, the answer to that, I think this goes back to the shadow banking and comments that were made here. I think some of these real large, enormous high-tech firms are eyeing, as you read in the newspaper all the time, are eyeing the entrance into the financial sector. And we brought up China before, and this is a big issue now on China, with Alibaba, and the others. How much are the supervisors, regulators going to be allowing them to get into what amounts to virtual banking?

So it all really goes back to that. And I think it's going to be one of the major issues in the financial system going forward. And the question is, has this really been thought out by the politicians, the supervisors, regulators? Not clear. And very importantly, by the banking industry itself so that it can remain competitive? And so I think it is a major issue going forward, without a doubt.

Rob Cox:

I think that is all we've got time for. I want to thank you all for coming out in this—and hopefully you can get out of here, it looks like it's coming down like cats and dogs now. Please thank my panelists, and thank you for coming.