SPEECH

Forming the Next Generation of Bankers: The Future of Business Education and Ethics

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Thank you Professor Viswanathan. It is a pleasure to celebrate the Zarb School of Business 50th anniversary. I also want to thank Dean Herman Berliner for his invitation. Dean Berliner once referred to himself as “an unlikely administrator.” I know the feeling. But he is no doubt quite an accomplished one who has contributed greatly and sustainably to advancing the Zarb School and Hofstra’s development.

It’s an honor to have this opportunity to speak about business education and financial services—their nexus and their future. On a personal level, I’m delighted to speak at a university. I began my career as a professor. I then became a university administrator. The future of higher education—and its capacity to create social good—is a point of great interest and importance to me and to our society.

Working now at the Federal Reserve Bank of New York, part of my job is to focus on the stability of the nation’s financial system. That requires a forward-looking perspective, which I hope will inform today’s discussions.

One caveat before I continue: My remarks are based on my personal experience in academia and at the Fed. My views, however, are my own. They may differ from the official views of the Federal Reserve Bank of New York or the Federal Reserve System.[1]

I plan to talk about four topics today:

- *First*, I want to speak briefly about the future of the financial services industry.
- *Second*, I want to explain why reform of both culture and behavior in financial services is a necessary part of that future.
- *Third*, I want to address the special connection between business education and finance.
- *Finally*, I want to suggest how business schools and the official sector can work together to improve conduct and behavior in financial services.

The dynamic forces shaping the future of financial services in many ways are not unique to that industry. Speed, technology, globalism, complexity, connectedness, uncertainty, risk, proximity, customization—these themes arise in many sectors of the economy. I suspect they will be resonant in other discussions today.

I will focus my remarks today on how these themes apply within the financial services sector. In particular, I will focus on three categories—structure, reciprocity and trust—as a model for organizing future changes in financial services.

Let’s take structure first. Trading platforms, information delivery systems, and communication tools will continue to evolve at an astounding pace. Indeed, new technologies are already affecting the way markets behave and market participants engage with each other—as, for example, the “flash crash” of 2010 and the rise of high frequency trading have shown.

More people than ever will have access to financial services. Transactions will occur with unimaginable speed across global distances. We will be ever more interconnected and more rapidly connected. We may also grow increasingly less dependent on financial intermediaries, or the structure and nature of those financial intermediaries may be quite different.

With these changes come new opportunities, but also significant new vulnerabilities. We’re just beginning to appreciate cyber-risks. Increased access and connectivity may become accelerants in a financial crisis. With these changes to the structure of finance, will we be prepared to mitigate attendant risks?

Next, let’s consider reciprocity. When I taught undergraduates, I marveled at the differences between my generation and the generation seated before me. I imagine you feel those differences even more keenly now. The students in our universities today are arguably more self-assured and less reliant on established institutions than their predecessors. What social contract do they envision? What degree of personal responsibility in banking will they demand? Is there room for a financial safety net?

And then there's trust—keeping one's word. Financial services will, in my view, become increasingly commoditized. That is, finance will increasingly deal more in products, less in relationships. How will our expectations of trustworthiness differ in a growing, off-the-shelf market? And who will want to go into that business? How will perceptions of trustworthiness affect the talent that financial services attracts?

Consider the recent rise of "fintech." Why is it that start-up companies are as trusted—perhaps more trusted—than established banks? Is this just a generational anomaly? Or is there a more fundamental change at work?

I identified these three categories—structure, reciprocity and trust—because these are the factors that, in my view, distinguish financial services from other industries.

Unlike many businesses, "[f]inancial firms exist, in part, to benefit the public, not simply their shareholders, employees and corporate clients."[2]

This role demands a degree of social responsibility not imposed on all industries equally.

There are reasons for this. *First*, financial institutions are indispensable intermediaries in the economy. This is the element of structure. Because of this role, problems in banks do not tend to stay in banks. They can impact firms and households across the country and abroad.

Second, banks in particular receive public operating benefits—deposit insurance and access to the Discount Window, among others.[3] In exchange for these benefits, they owe a heightened degree of "other-regarding" decisions and behaviors. This is the element of reciprocity. Other industries do not have this type of safety net, and we do not expect as much from them.

Finally—and most important—is trust. Finance is complex and opaque. It requires trust in the professionals who provide these services. That's why financial firms market themselves as dealers in trust. We should expect these dealers in trust to keep their word—to meet legitimate expectations of trustworthiness. Finance, after all, is the business of credit. And the word "credit" derives from the Latin *credo*—"I trust."

Other enterprises may market themselves under the slogan, "trust us." But in financial services that promise is too important to break. People entrust the financial system with their hard-earned wages, their nest eggs, and their children's and grandchildren's college tuition.

In short, the future of the financial industry, its shape and evolution, perhaps more than other industries, and especially in the current environment, depends critically on restoring trust, reaffirming the reciprocal relationship of finance and society, and ensuring our structures are resilient in the face of crisis.

So, we need to explore more deeply basic questions about what we want from financial service providers, not just in terms of commodities or services, but more deeply in terms of values and quality.

These questions drive the debate over the "culture" of finance. That word—culture—is for some, the end of the discussion. Some view it as too inchoate for rigorous academic discussion. Others see it as too "squishy" for serious business consideration. For now, let's set aside the term and focus on the meaning behind it.

I agree with Bill Dudley, the New York Fed's president —and not just because he's my boss. He sees "deep-seated" and interrelated causes behind the recent scandals at many large financial institutions.[4] The pattern of misconduct is too prevalent to be mere coincidence, and too pervasive to be diagnosed as just a few "bad apples." I'll spare you the full litany.

Suffice it to say, too often financial services firms ceased to function as a service—that is, work for others. The industry largely lacked "other-regarding" norms and behavior. In the financial crisis, and in its wake, many failed to consider "the private and social costs of their decisions."[5] In contrast to the volumes written about the financial crisis, there is comparatively little academic review of post-crisis scandals. We need to better understand—beyond intuition and anecdote—the causes of this rather extraordinary pattern of behavior.

When we do, we'll likely discover how much in common they had with earlier financial scandals. We may find more than common causes. We may also find common responses. For the last one-hundred years, the official sector's response to financial crisis has been a vow: "Never again." But then, another crisis occurs. We would do well to ask whether the recent reforms of the Dodd-Frank Act can live up to that same promise.

Let me be absolutely clear: I believe Dodd-Frank's reforms show great progress on many fronts. But, I am a student of history. And I am a political realist. Regulation is not a panacea. We cannot expect too much from it. My colleagues and I believe that external controls are essential. But we also know they are not sufficient. In light of our history, they do not offer adequate assurance of good decision-making. The fact is, over-reliance on external controls may even discourage personal responsibility. We must avoid the implication that it's someone else's responsibility to spot mistakes.

Let me place a marker here with this question: How might business education contribute to offsetting a tendency to see ethical questions as the responsibility of a control function? Of a regulator? Of an ethicist?

The financial crisis made clear that there are social costs inherent in business decisions. Financial decision-makers must be much more aware of these costs. This goal is ambitious, to say the least. But it's necessary. Well-run financial services support our economic well-being. Poorly-run financial services have been shown, time and again, to be economically ruinous.

Let me say it again: I am a realist. I also worry about placing too great a reliance on self-restraint. After all, Princeton's Alan Blinder has called self-regulation in finance an oxymoron.[6] More recently, two Nobel laureates have argued that "pressures for less than scrupulous behavior" are unavoidable in competitive markets.[7]

Finance is not alone, of course. Tensions between competition and self-restraint arise in other industries too. Financial services do not have a monopoly on scandal. In any industry, decision-makers may become consumed with near-term profit instead of long-term value. Any industry can suffer from a competitive myopia that blinds many to storm signals. What makes finance different are the three elements I mentioned—structure, reciprocity and trust.

Finance is hard-wired—both literally and metaphorically—into the nation's economy. Other industries depend on it. And crises in finance have a tendency to spread to other sectors. An ebb in financial stability or productivity signals low tide for the rest of the economy.

Finance also receives operating benefits available to no other industry. These benefits are given most directly to banks. But other firms, which interact with and depend on banks, are third-party beneficiaries.

And then there is trust. Absent that trust, credit will be withheld in cases where otherwise it would be extended. As a result, economic activity will diminish. Left unabated, another crisis will emerge. Extending credit—that is, extending trust—is what financial services is all about. Other industries make cars or computers or ice cream cones. We trust them to make good products. But in finance, trust is inarguably more central or should be the essence of the product.

So, what might we do together to contribute constructively to the future of the financial services sector?

Business schools like Zarb hold stereoscopic influence over financial services. By this I mean, they inform both the demand for—and the supply of—financial professionals.

Here is what I mean by demand—and this may not be economic orthodoxy. Business schools educate and advise the leading consumers of financial services. They can also shape the views of shareholders in financial firms. In both respects, business schools can affect the demand for certain qualities in financial service.

Now, supply. The financial services industry employs professionals with MBA degrees. Locally, the financial services industry is one of the region's largest employers. It's also the highest paying.[8] Nationwide, financial services firms employ roughly a third of graduates of leading MBA programs.[9] The CEOs of half of the large, systemically important banks hold MBA degrees. Business schools, of course, do more than confer degrees. They create networks of professionals and germinate the norms that bind them. They supply a culture.

Business education, therefore, serves as a fulcrum for finance. It supports and balances the future of financial services. But that does *not* mean its role is purely passive or reactive. Business education can—and should—help guide the qualitative changes that will occur in the financial services industry in the future. Thoughtful, independent discussion of the future of finance is at home in business schools. Such a discussion may include any number of questions. Here are a few examples.

- What values drive individuals— business school students and others— to migrate toward careers in the financial services sector?
- What norms should bind financial professionals to one another?
- What role do we want finance to play in society?

The same questions occupy my colleagues in the official sector. And, they are increasingly on the agenda of many financial firms. We see evidence that some of the largest financial services firms are expressing a commitment to change their culture. They may not have fully endorsed Christine Lagarde's call for capital and culture to share equal billing.[10] But, they are espousing greater alignment of principle and practice.

As that continues, reform agendas at financial firms should soon reach back to recruiting. What are the qualities and skills that are needed in newly minted MBAs? What additional training do experienced employees need? How can business schools better supply what the changing industry demands?

I do not mean to suggest that business schools should teach students right from wrong. Your students are not blank slates. Still, the purpose of business school is to prepare students for the business world. How will your programs change to keep pace with

changes in business?

Permit me to suggest a few learned skills that have particular relevance for financial services. Issue-spotting is one. It's a critical skill that is too often missing in finance. Scandals often arise when people overlook—or, do not want to see—the signs of trouble. Sometimes those signs are missed as a result of personal bias—whether apparent or latent. Those with training in identifying bias and risk will add greater value to firms looking to minimize cost and make realistic assessments of risk.

Of course, issue-spotting is valuable only if identified issues are appropriately escalated. So speaking up is another beneficial skill. Candor—both its gift and its receipt—is a skill that needs to be practiced. Inculcating a culture of candor relies, in turn, on skills like mentoring and coaching. These skills can be developed through experiential or situational learning.

Students need to practice these skills. A greater and earlier emphasis on experiential or situational learning is indicated. In law and medicine, clinical education is no longer delayed until core courses are completed. Why should business be any different? Perhaps first-year business students need their own laboratories to experiment in resolving difficult situations:

- conflicts in values,
- transitions in leadership, or
- interactions with regulators.

Of course, clinics are not the only answer. Classroom training remains a central part of business education. But that training is also dynamic. It changes in response to the needs of industry. As I have said, financial services firms appear to be moving toward greater personal responsibility for outcomes. It's the responsibility of every financial services professional to serve on the front line of good decision-making. Accordingly, discussions of ethics should not be delivered in a single ethics class. After all, most case studies—most business decisions—contain ethical dimensions.

In clinics and in the classroom, we need to train people entering finance to develop "ethics memory" so that they can instinctively make good judgments in difficult situations. Financial regulators share the same goal as business educators: helping others develop a habit of making good choices.[11]

I don't want to be an impolite lunch guest. I cannot ask you to consider changing the way you prepare students for finance without proposing how the official sector can help.

I believe there are three ways: *First,* by convening discussions. *Second*, by brokering opportunities for continuing education. *Third*, by promoting research.

A few minutes ago, I sketched some thoughts on the trajectory of the financial services industry. Would it help to make that discussion more regular? More structured? More inclusive of other views? The official sector could create a forum for the ongoing discussion of the future of financial innovation. I see a need for bankers, regulators and educators to participate in the discussion—in the same room at the same time. How do we expect the industry to change? And, how can we best prepare students for those changes? After all, it's in everyone's interest to have the best prepared MBAs available to staff our nation's financial infrastructure.

Next, the official sector could identify areas where there is a need for executive education. I'm speaking here of retraining experienced professionals. I mentioned earlier the need for greater expertise in cyber-security. Regulatory changes may also create a need for new learning—especially in the areas of compliance, capital and liquidity management, and risk culture. If financial supervisors identify a need for new training, can business schools supply continuing education programs? That would be a valuable and well-compensated service. Business schools can develop programs responsive to an evolving need for training. Those programs would be tailored to new circumstances and evolving social responsibilities.

Finally, business schools are ideally situated to conduct excellent research—in tandem with the official sector—in the areas of behavior and decision-making in finance. Some issues in need of greater attention include:

- The measurement and pricing of culture;
- The effectiveness of financial penalties against corporations as a deterrent against individual misconduct; and
- Beyond deterrence, what effect do penalties have on balancing profit motive and "other-regarding" obligations—within finance and more generally across industries?

Business schools may also take advantage of a natural strength that comes from their setting in a university. They may consider partnering with departments that study culture, or other cultures, for input on different considerations of ethics. For example:

- What's to be learned from the requirements in Islamic finance?

- How are expectations of conduct in developing economies different from standards in mature markets?

Let's work together to identify the most fruitful areas of research.

In closing, I want to again thank the Zarb School of Business and Dean Berliner. Your leadership in convening these discussions is laudable. My colleagues and I look forward to collaborating with you, and to contributing jointly to the future of finance and business education.

Thank you for your kind attention.

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[1] Nick Balamaci, Stephanie Chaly, Ed Cheney, James Hennessy, Jacqueline McCormack, Anand Marri, Thomas Noone, Kevin Stiroh and Joseph Tracy assisted in preparing these remarks.

[2] William C. Dudley, Enhancing Financial Stability by Improving Culture in the Financial Services Industry, Remarks at the Workshop on Reforming Culture and Behavior in the Financial Services Industry, October 20, 2014.

[3] See E. Gerald Corrigan, "Are Banks Special?," *Federal Reserve Bank of Minneapolis Annual Report*, January 1983.

[4] William C. Dudley, Ending Too Big to Fail, Remarks at the Global Economic Policy Forum, November 7, 2013.

[5] Dan Awrey, William Blair, and David Kershaw, "Between Law and Markets: Is There a Role for Culture and Ethics in Financial Regulation?" 38 *Del. J. Corp. L.* 217 (2013).

[6] Alan S. Blinder, *After the Music Stopped* 434 (2013).

[7] George A. Akerlof and Robert J. Shiller, *Phishing for Phools: The Economics of Manipulation and Deception* xi (2015).

[8] New York State Bureau of Labor Market Information, Division of Research and Statistics, *Significant Industries: A Report to the Workforce Development System*, September 2015, 2-3.

[9] "Banks? No, thanks!" *The Economist*, Oct. 11, 2014.

[10] Christine Lagarde, "Economic Inclusion and Financial Integrity," Address to the Conference on Inclusive Capitalism, May 27, 2014 ("[F]inancial leaders [must] tak[e] values as seriously as valuation, culture as seriously as capital.").

[11] Aristotle, *Nicomachean Ethics*, Book II, Chapter 1 (describing moral virtue as a habit (*ethos*)).